EXPANDING ALTERNATIVES: FROM STRUCTURED NOTES TO STRUCTURED FUNDS

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"It's not about what it is, it's about what it can become."
Dr. Seuss, The Lorax

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INTRODUCTION

As the financial crisis fades in the rear view mirror,[1] the asset management business continues to adjust to significant shifts in investor tastes.[2] Observable trends include an increasing sensitivity to fees, a growing appetite for alternative streams of return, and a pronounced desire for regulated investment vehicles.[3] Recently, asset managers have also witnessed a meaningful shift in investment philosophy – from active management to more passive strategies.[4] At the same time, the asset management industry is showing the signs typical of a maturing business, as it strains to maintain its operating leverage.[5] As one commentator has

1. For a favorite summary of the financial crisis and its underlying causes, *see generally* Michael C. Macchiarola, *Beware of Risk Everywhere: An Important Lesson from the Current Credit Crisis*, 5 HASTINGS BUS. L. J. 267 (2009) (outlining both the causes of the financial crisis as well as lessons to be learned from the crisis).

2. *See, e.g.*, Citi, *The Rise of Liquid Alternatives & the Changing Dynamics of Alternative Product Manufacturing and Distribution*, CITI PRIME FINANCE 4 (May 2013), http://cooconnect.com/sites/default/files/The%20rise%20of%20liquid%20alternatives%20and%20the%20changing%20dynamics%20of%20product%20manufacturing%20and%20distribution%20-%20May%202013.pdf [HTTPS://PERMA.CC/G3QV-5TA6] (noting that "shifting dynamics in the wealth adviser market are creating a growing need for alternative strategies.").

3. Michael C. Macchiarola, *Abstinence in the Face of the Mutual Fund Debt Elixir: In Response to Professor John Morley*, 31 YALE J. ON REG. ONLINE 60 (2014) [hereinafter Macchiarola, *Abstinence in the Face of Mutual Fund Debt*]. *See also* Jeff Benjamin, *The Perfect Storm: Why Alts Make Sense*, INVESTMENT NEWS (Mar. 30, 2014), http://www.investmentnews.com/article/20140330/REG/303309999/the-perfect-storm-why-alts-make-sense [HTTPS://PERMA.CC/TB23-GL7V] (asserting that "diversifying into products and strategies designed to hedge risk can mean that clients can sleep soundly at night."); SEI, *The Retail Alternatives Phenomenon: What enterprising private fund managers need to know*, SEIC 2 (2013) http://www.seic.com/docs/IMS/SEI-IMS-RetailAlternatives-US-2013.pdf [HTTPS://PERMA.CC/53KJ-RV7D] [hereinafter SEI, The Retail Alternatives Phenomenon] (noting that "the blend of alternative strategies with the transparency, liquidity and regulatory oversight of regulated retail investment vehicles has growing appeal to financial advisors and their clients.").

4. Eric Balchunas, *Passive Revolution*, BLOOMBERG BUSINESSWEEK (Dec. 14, 2015) (noting that U.S. investors allocated $365 billion to index mutual funds and ETFs and withdrew $147 billion from actively managed funds in 2015).

5. Casey Quirk, *The Roar of the Crowd: How Individual Investors Transform Competition in Asset Management*, CASEY QUIRK BY DELOITTE 2 (Nov. 2015), http://www.caseyquirk.com/content/whitepapers/The%20Roar%20of%20the%20Crowd.pdf [HTTPS://PERMA.CC/7XDA-K3CL] [hereinafter Casey Quirk, *The Roar*]. *See also* Marlon Weems, *Disintermediation: The Real Race to Zero*, TABB FORUM (Sep. 25, 2013), http://tabbforum.com/opinions/disintermediation-the-real-race-to-zero [HTTPS://PERMA.CC/7A74-4K2X] (arguing that institutional accounts are struggling "to cut costs and recover from the turmoil of the past five years" and that "many have awakened to

observed, "[i]ncreasingly the same competitive dynamics that shape other financial services industries will affect asset managers: intensifying rivalry among too many players with similar value propositions, resulting in consolidation and disruption."[6] This realignment has brought volatility to the time-honored business model of the traditional asset manager. At the same time, it is likely to uncover opportunities for new market entrants and innovative product structures. This Article imagines one such structure.

Recently, a lesser known corner of the investment products universe has been garnering significant attention from investors and asset managers alike. While unit investment trusts (each, a "UIT", and together, "UITs") have evolved already "far beyond their humble origins as fixed packages of municipal bonds [and] have grown significantly in recent years,"[7] the market remains far from exhausting its full potential.[8] Advances in product structuring, an aversion to high fee product, and shifting investor tastes are latticing to expand the UIT's possible applications. The UIT is poised to emerge as a reliable, economic, and efficient conduit for investors seeking defined outcome,[9] smart beta,[10] and alternative streams of return.[11]

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the logic of 'insourcing.'").

6. Casey Quirk, *The Roar*, *supra* note 5, at 2.

7. Daisy Maxey, *Advisers Warm Up to Unit Investment Trusts*, WALL ST. J., Nov. 29, 2012, http://www.wsj.com/articles/SB10001424127887324469304578145432957312820 [HTTPS://PERMA.CC/YX6S-SF2Y]. *See also* Jay B. Gould and Gerald T. Lins, *Unit Investment Trusts: Structure and Regulation Under the Federal Securities Laws*, 43 BUS. LAW. 1177 (Aug. 1988) (observing that "the number and variety of investment products offered to the general public has dramatically increased."); Thomas S. Harman, *Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Investment Vehicles*, 1987 DUKE L.J. 1045 (1987) (commenting that the UIT "has experienced many changes since its inception some sixty years ago as a 'fixed trust.'").

8. In 2015, new UIT deposits were more than four times greater than those just a dozen years ago. In fact, 2015 represented the largest year for new deposits into the product, eclipsing the prior record established in 1999. *See* INV. CO. INST., *Section 2: Closed-End Funds, Exchange-Traded Funds, and Unit Investment Trusts*, in 2016 INVESTMENT COMPANY FACT BOOK (2016), https://www.ici.org/pdf/2016_factbook.pdf [HTTPS://PERMA.CC/X7CR-J3DU] [hereinafter, 2016 ICI Fact Book] (showing $12.7 million and $65.9 million as the new UIT deposits for 2003 and 2015, respectively).

9. For purposes of this Article, "defined outcome" investments will include products which allow for a specific level of protection and/or enhanced return to be put in place at the time of investment and last for a fixed time. Such a process is typically achieved through the use of derivatives and allows investors to know the controlled range of the investment outcomes in advance and plan accordingly.

10. The term "smart beta" is the subject of much attention and many compete to formalize its definition. *See, e.g.*, Rob Arnott and Engin Kose, *What "Smart Beta" Means to Us*, RES. AFFILIATES FUNDAMENTALS 1 (Aug. 2014), https://www.researchaffiliates.com/documents/What%20Smart%20Beta%20Means%20To%20Us%20v2_pdf.pdf [HTTPS://PERMA.CC/9MT8-RKDM] (noting that smart beta is "in the process of seeking an established meaning"). Our favorite definition is offered by Towers

Offerings of bespoke trusts might not be far in the future, unlocking the possibility of solutions tailored for retail and institutional investors seeking access to certain non-traditional streams of return, or anxious to improve the transparency, credit risk, liquidity, and economic bulwark of existing alternative investment and smart beta allocations.

This Article proceeds in five parts. Part I briefly describes the evolving landscape for public funds in the United States. As much has been written on this subject, this section does not endeavor to break new ground.[12] Instead, it describes simply the process by which today's investors are transitioning from traditional mutual funds[13] in favor of alternative mutual funds[14] and smart beta strategies.[15] This section of the

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Watson: "Smart beta is simply about trying to identify good investment ideas with better structure . . . smart beta strategies should be simple, low cost, transparent and systematic." *See* Towers Watson, *Understanding Smart Beta*, 1, Aug. 2013 (explaining the purpose of smart beta).

11. The relative size of the markets for open end funds, closed end funds, exchange traded funds and unit investment trusts is instructive. Total assets for each category are by no means stagnant and have fluctuated over time. *See generally* ICI Fact Book, *supra* note 8 (documenting fluctuations in investments in open end funds, closed end funds, exchange traded funds, and unit investment trusts).

12. *See generally* Casey Quirk, *The Complete Firm 2013: Competing for the 21st Century Investor*, CASEY QUIRK BY DELOITTE (Feb. 2013), http://www.caseyquirk.com/content/whitepapers/The%20Complete%20Firm.pdf [HTTPS://PERMA.CC/973K-HHGK] [hereinafter, Casey Quirk, *The Complete Firm*](detailing the current trends and opportunities in public funds); Citi, *The Rise of Liquid Alternatives & the Changing Dynamics of Alternative Product Manufacturing and Distribution*, CITI PRIME FINANCE (May 2013), http://cooconnect.com/sites/default/files/The%20rise%20of%20liquid%20alternatives%20and%20the%20changing%20dynamics%20of%20product%20manufacturing%20and%20distribution%20-%20May%202013.pdf [HTTPS://PERMA.CC/E59P-CADU] (using survey findings to describe the various ways in which the industry is evolving); Goldman Sachs, *Retail Liquid Alternatives: The Next Frontier*, (Dec. 6, 2013) [hereinafter, Goldman Sachs, *Retail*] (highlighting the growth of retail liquid alternatives and how asset managers are beginning to take advantage of those opportunities); SEI, *Regulated Alternative Funds: The New Conventional*, SEIC (Nov. 2011), http://www.seic.com/IMS/SEI_IMS_NewConventional.pdf [HTTPS://PERMA.CC/HL6X-BU8P] [hereinafter SEI, Regulated Alternative Funds] (noting how various segments of investors are looking towards alternative strategies in response to a convergence of various factors and trends).

13. For purposes of this Article, traditional mutual funds include those registered under the Investment Company Act and invested predominantly in the traditional fixed income and equity asset classes. For purposes of this Article, such registration also distinguishes "public" funds from "private" funds.

14. For purposes of this Article, alternative mutual funds include Investment Company Act-registered funds packaging returns of illiquid assets such as real estate, venture capital, commodities, and collectibles, as well as other more liquid "hedge fund" strategies such as event-driven, global macro, and managed future. *See generally* Equinox Funds, *Allocating to "Liquid Alternatives": The Importance of Correlation*, 3 (Apr. 11, 2016) (exploring

Article also establishes the background and proper context for the product-specific ideas that follow. Part II introduces the unit investment trust, outlining the general structure and limitations of the vehicle and exploring its legal and economic framework. This Part also builds on the efforts of several authors to examine briefly the dynamic history of the UIT and summarizes the size and shape of today's UIT market.[16] Part III offers a general discussion of two related markets: structured notes and the nascent, fast-growing category of "liquid alternative mutual funds."[17] Particular emphasis is placed on defined outcome and smart beta strategies, as those lend themselves neatly to a unit investment trust product. Part IV presents the Article's main premise – *many of the return streams offered in today's structured notes or alternative mutual funds might be offered more reliably as unit investment trusts*. This Part outlines a viable framework for so-called "structured unit investment trusts" or "structured funds"[18] – designed to deliver defined outcome, smart beta, and alternative streams of return in a reliable, economic, and efficient fashion. This Part highlights several advantages of such a product before describing briefly the ongoing efforts of market participants and handicapping the likelihood that such a product will be embraced by regulators and investors alike. Finally, Part V offers a very brief conclusion.

PART I

In recent years, the memory of the punishing losses wrought by the

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alternative investment strategies).

15. Regarding a proper definition of "smart beta", *see Towers* Watson, *supra* note 10.

16. For an excellent, though slightly dated, history of the UIT vehicle, *see* Harman, *supra* note 7, at 1046. *See also* Gould and Lins, *supra* note 7, at 1177 (describing key features of UITs as well as the process of creating registering UITs).

17. *See, e.g.*, Janet Levaux, *Alt Mutual Funds Hit $300B*, RESEARCH (July 28, 2014), http://www.thinkadvisor.com/2014/07/28/alt-mutual-funds-hit-300b?slreturn=1480213404 [HTTPS://PERMA.CC/PU6M-YV3L] (noting that "2013 marked the strongest asset flows into alternative funds and the largest number of fund launches on record.").

18. This Article will use the terms "structured unit investment trust" and "structured fund" interchangeably. While the product structure described herein conforms to the requirements of a unit investment trust articulated in Section 4(2) of the Investment Company Act, it also fits the common understanding of a "fund", a term which remains undefined in the Investment Company Act. Historically, several UITs have described themselves as "funds," the plain meaning of which presumably includes trusts. *See generally What is an "Investment Fund"*, Investopedia.com, http://www.investopedia.com/terms/i/investment-fund.asp [HTTPS://PERMA.CC/3W32-WW3X] (defining an "investment fund" as "a supply of capital belonging to numerous investors used to collectively purchase securities while each investor retains ownership and control of his own shares.").

financial crisis, increased correlation among asset classes, unanticipated illiquidity, and celebrated scandals have combined to leave the traditional investment management industry bewildered.[19] Most recently, investor demand for mutual funds declined in 2015, with net redemptions of $102 billion.[20] Mutual fund industry assets rarely decrease, with 2015 marking only the sixth time since 1975 that the total mutual fund assets measured at year-end failed to exceed those at the start of the year.[21] During that same period, a developing industry that counted only 426 funds with $45 billion in assets, has ballooned to a mature business with greater than 8,000 funds and $15.6 trillion under management.[22]

Despite the exponential growth and massive size of the mutual fund market, fundamental questions have mounted in recent years. Chief among the concerns is the issue of whether the menu of products – as currently constructed and sold – adequately meets the needs of a more discerning investing public increasingly conscious of fee levels, skeptical of the value of active management, and in search of a more tailored and tactical set of solutions. As a recent industry report offered:

> Some of the outflows from long-term mutual funds in 2015 reflect a broader shift, driven by both investors and retirement plan sponsors, toward other pooled investment vehicles. This trend is reflected in the outflows from actively managed funds and the growth of index mutual funds, ETFs, and collective investment trusts (CITs) since 2007.[23]

Investors and their financial advisors continue to assert broadening control over their investment portfolios – favoring product solutions which offer both absolute return and non-correlation.[24] At the same time,

19. *See* Macchiarola, *Abstinence in the Face of Mutual Fund Debt*, *supra* note 3 (noting the Great Recessions disruptive impact on the investment management industry). *See generally* Christopher J. Bricker, Christine M. Johnson & Sandra Testani, *Liquid Alternatives: The Next Dimension in Asset Allocation*, ALLIANCEBERNSTEIN 1 (July 2014), http://supplements.pionline.com/uploads/supplements/AB_Final_ALT-7125-0714.pdf [HTTPS://PERMA.CC/G2UM-W44J] ("The 2008 global financial crisis marked a turning point for investors, bringing new focus to the search for diversifying and transparent investment options.").

20. 2016 ICI Fact Book, *supra* note 8, at 26.

21. *Id.*

22. 2016 ICI Fact Book, *supra* note 8, at 170.

23. *Id.* at 44.

24. *See, e.g.*, Jennifer Banzaca, *Alternative Mutual Funds: How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital? (Part One of Two)*, 6.5 HEDGE FUND LAW REP., Feb. 1, 2013 (noting that the "demand for retail alternative products is growing because of retail investors' desires for innovative investment strategies, diversification and uncorrelated returns."). *See also* Goldman Sachs, *Retail*,

investors expect neatly tailored offerings that emphasize transparency and optimize liquidity.[25] Demand is accelerating for investment products that "combine access to non-correlated strategies and asset classes with the liquidity and transparency of registered investment products."[26]

Investors "increasingly regard 'alternative' investments – including unlisted securities, hedging strategies, derivatives and innovative structuring – as mainstream."[27] Those asset managers catering successfully to the growing demand for such products are likely to gain an increasing share of incremental industry dollars.[28] So-called "alternative" strategies were once an exclusive corner of the investment world accessible only to institutional investors.[29] Today, however, there is a demonstrable movement to "democratize" these strategies,[30] with financial advisors increasingly turning to alternative investments to assist clients in achieving low correlation to traditional stocks and bonds, reduced portfolio volatility, and appropriate returns.[31] The mass affluent and high-net-worth investors have accounted for the majority of the growth in alternative investment assets.[32]

As a matter of portfolio theory, the introduction of a non-traditional

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supra note 12 (describing a more discerning investing public).

25. *See, e.g.*, Banzaca, *supra* note 24 (highlighting that evolving investor preferences are one primary reason asset managers should look to alternative mutual funds.).

26. SEI, *Exotic to Mainstream: Growth of Alternative Mutual Funds in the U.S. and Europe* 2 (2010). *See also* Goldman Sachs, *Retail*, *supra* note 12 ("Investors are re-risking, but with an eye for yield, uncorrelated asset classes and risk-adjusted returns."); Josh Charney, *Alternative Investments, All Grown Up, in* 5 ALT. INVS. OBSERVER, no. 2, 2013, at 4 http://advisor.morningstar.com/uploaded/pdf/AIO_QuarterlyQ22013_nonACC.PDF [HTTPS://PERMA.CC/2XXY-H2NZ] ("The recent drift into alternative investments can be traced to the challenges created by the post-2008 investment climate."); Diane M. Sulzbach and Philip T. Masterson, *Offering Alternative Investment Strategies in a Mutual Fund Structure: Practical Considerations*, 15 THE INV. LAW., NO. 10, Oct. 2008, at 1 ("[A]lternative investment products appeal to investors seeking to invest in hedge funds, who may not qualify to invest in them directly.").

27. Casey Quirk, *The Complete Firm*, *supra* note 12, at 7; *see also* Banzaca, *supra* note 24, at 3 (noting that alternatives are quickly moving into the mainstream retail market).

28. Casey Quirk, *The Complete Firm*, *supra* note 12, at 7.

29. *See* SEI, *Regulated Alternative Funds, supra* note 12, at 1.

30. *See, e.g.*, *id.* ("In what is beginning to seem like the distant past, a clear line had once separated traditional and alternative investment products.").

31. Jeff Schlegel, *Making Sense of Alternative Investments in the '40 Act Space*, FINANCIAL ADVISOR 1 (Jul. 22, 2013). *See also* Bricker, Johnson & Testani, *supra* note 19, at 2 ("Adding a liquid alternative allocation to a traditional portfolio has the potential to enhance long-term portfolio returns and reduce risk – and it may lower sensitivity to market and interest-rate fluctuations.").

32. Casey Quirk, *The Complete Firm*, *supra* note 12, at 7. *See also* Citi Prime Finance, *supra* note 12, at 47 (suggesting that "[g]rowth in liquid alternatives is expected to come from a broadening set of retail investors.").

stream of return into the traditional 60/40 portfolio can have a profound effect on the efficient frontier – offering more expected return per unit of risk expended. This concept lays at the heart of modern finance, which demarks an "efficient" portfolio as one seeking to reduce its overall risk without sacrificing return.[33] In finance, efficiency is achieved by combining assets with returns that are less than perfectly correlated; that is achieved by adding to an existing portfolio an asset whose returns do not move in lock-step, thereby reducing the risk of the original portfolio.[34] The application of Modern Portfolio Theory alone validates the impressive growth of the liquid alternatives category to date, as the traditional blend of fixed income and equities in a generic portfolio leaves an investor more exposed than is optimal as correlations converge during periods of market turbulence.[35] The observable diversification benefit has been complemented by the fact that, in recent years, alternative assets have performed well on an absolute basis.[36]

In addition to the dual benefits of portfolio diversification and absolute return, the desire of investors to realize investment returns through more regulated conduits represents a natural response to the various high-profile scandals that have beset the investment industry over the past several years.[37] Some observers have suggested that many of the last spate of financial scandals might have been averted by the increased

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33. For a thoughtful reflection on the developments of Modern Portfolio Theory, *see generally* Frank J. Fabozzi, Francis Gupta and Harry M. Markowitz, *The Legacy of Modern Portfolio Theory*, J. INVESTING 7 (Fall 2002) *et seq*.

34. *Id*. at 8.

35. *See, e.g*., Jon Danielsson, The Emperor has no Clothes: Limits to Risk Modelling, (June 2000), at 5 (describing how, for example, "the presence of VaR based risk limits led to the execution of similar trading strategies, escalating the crisis."). *See also* Sarah Max, *Alternative Investments: Surfing the Market*, BARRON'S (Oct. 24, 2015) http://www.barrons.com/articles/alternative-investments-surfing-the-market-1445664165 [HTTPS://PERMA.CC/5QRQ-SSHQ] (identifying Modern Portfolio Theory as the philosophy underpinning liquid alternative mutual funds).

36. According to a study by the traditional asset manager AllianceBernstein, "Over the last 20 years, alternatives have provided better returns than stocks, bonds or cash, with less than half the volatility of stocks." *See* Bricker, Johnson & Testani, *supra* note 19, at 2.

37. The number and breadth of recent scandals is impressive indeed. While each scandal is proceeding through the legal and regulatory systems at its own pace (and no judgment is made on these pages with respect to any individual's guilt or innocence), the spate of scandals have included alleged "rogue traders" (i.e. Jerome Kerviel at Société Générale, Bruno Iksil at JP Morgan and Kweku Adoboli at UBS), "rigged exchanges" (i.e. high frequency trading, LIBOR fixing, gold fixing), fraudulent funds (i.e. Madoff), greedy executives (i.e. Angelo Mozillo at Countrywide, Joseph Nacchio at Qwest), insider trading (i.e. Rajat Gupta, Raj Rajaratnam), corrupted counselors (i.e. Marc Dreier) and bad banks (i.e. Goldman Sachs "Abacus" deal, BNP Paribas illicit dollar trades).

transparency and regulation that today's investors more regularly demand.[38] For example, today's more discerning and skeptical investing public requires routinely that investment exposures be bundled in highly regulated investment vehicles, with detailed specifications around risk measurement and management, liquidity, diversification, and leverage.[39] Even when more sophisticated investors transact in less regulated product, deliberate attention is paid and care taken to ensure that assets and collateral are custodied and valued properly.[40] One expression of the emphasis on regulated structures is the willingness of institutional accounts to invest in mutual fund holdings.[41] This trend signals a rational response for any cohort for whom a quantifiable improvement in product design and regulation justifies the higher fee structure generally attributable to mutual fund shares, as the Investment Company Act of 1940 (the "Investment Company Act") provides the comfort of a regulated vehicle which has enjoyed three quarters of a century virtually scandal free.[42]

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38. *See, e.g.*, Anita K. Krug, *The Regulatory Response to Madoff*, BERKELEY CTR. FOR LAW, BUS. & ECON. (Mar. 2009):

> If the goal arising from the Madoff fraud is to better protect investors in hedge funds and other private funds, and if hedge funds' operations evince information dispersion problems similar to those leading to the enactment of the Investment Company Act, then looking to the model of regulation established by the Investment Company Act may be an appropriate first step.

But cf. Matt Taibbi, *Why Didn't the SEC Catch Madoff? It Might Have Been Policy Not To*, ROLLING STONE, May 31, 2013, http://www.rollingstone.com/politics/news/why-didnt-the-sec-catch-madoff-it-might-have-been-policy-not-to-20130531 [HTTPS://PERMA.CC/US4P-PG2W] (observing that, during the period from January 1, 2002 through January 20, 2009, the SEC failed to file a single case under the Investment Advisers Act or the Investment Company Act).

39. *See, e.g.*, SEI, *Regulated Alternative Funds, supra* note 12, at 1 (describing generally various new alternative investment vehicles, both on the domestic frontier and abroad).

40. *See generally* Comm. Payments & Mkt. Infrastructures, *Developments in Collateral Management Services*, BANK FOR INTERNATIONAL SETTLEMENTS 1, Sep. 2014 (describing an emphasis on the best practices of collateral management and observing that "market participants that provide large-scale lending have shown an increased preference for secured lending transactions over unsecured lending transactions.").

41. *See, e.g.*, Corrie Driebusch, *The New ABCs of Mutual Funds*, WALL ST. J., Jun. 3, 2013, http://www.wsj.com/articles/SB10001424127887324063304578523154145807688 [HTTPS://PERMA.CC/RF67-DSS9] (commenting that the institutional share class of mutual funds had grown its assets from $766 billion in 2003 to $3.4 trillion in 2013, marking the "biggest growth of any type of share class Morningstar tracks.").

42. *See, e.g.,* Paul Roye, Division Director of Div. of Inv. Mgmt., U.S., Sec. & Exch. Comm'n, Keynote Address at the EEESI General Membership Meeting 2000: Regulation of Mutual Funds in the United States: A Successful Regulatory Regime (Sept. 22, 2000) (noting that the Investment Company Act "has proved to be remarkably resilient")*; see also* John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343, 344 (2013)

Spurred by the dual demands of an alternative asset return profile and a more regulated product wrapper, the past few years have seen the emergence of a new supply of funds broadly characterized as "liquid alternatives."[43] Generally, this term describes investments offering access to alternative investment strategies via more traditional structures such as mutual funds, closed-end funds, UCITS, or exchange traded funds.[44] Private fund managers and their trading programs often provide the content of these liquid alternative funds, as historically such firms have dominated the management of the investor pools in alternative asset categories which include long/short equity, global macro, managed futures, private equity, real estate, merger arbitrage, and commodities.[45] Recent changes to the capital markets precipitated by the financial crisis coupled with a low interest-rate environment and the enormous growth of private funds, has encouraged the demand for these alternatives by retail investors.[46] In embracing liquid alternatives, private managers must adjust to the reality, however, that fees charged for products regulated under the Investment Company Act are lower than those for the typical hedge fund.[47] Moreover, registered investment companies are prohibited from charging a performance fee common to most private funds and infrastructure and distribution costs add additional pressure to the economics for new advisors

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(observing the "almost complete absence of bankruptcies among mutual funds in the last 70 years.").

43. For a list of the liquid alternative mutual funds launched in 2014 alone, *see List of New Liquid Alternative Funds Launched in 2014*, DAILYALTS, 2016, http://dailyalts.com/new-liquid-alternative-fund-launches-2014/ [HTTPS://PERMA.CC/4HMK-Y3BJ].

44. *See generally* William Marr and Alexander Rubin, *The Emergence of Liquid Alternatives and the Case for Managed Futures Mutual Funds*, 2, (2012) https://www.umbfs.com/groups/public/documents/web_content/039761.pdf [HTTPS://PERMA.CC/A2XR-VLED] (describing the growth of liquid alternatives and managed futures mutual funds as investment funds).

45. Unless otherwise stated, the terms "private fund" and "hedge fund" will be used interchangeably throughout this Article. In each case, the term describes a fund exempt from the Investment Company Act of 1940 by the terms of Section 3(c)(1) or 3(c)(7).

46. *See* Wulf A. Kaal, *Confluence of Private and Mutual Funds* (U of St. Thomas (Minnesota) Legal Studies Research Paper No. 16-06) at 4, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715083 [HTTPS://PERMA.CC/HY59-JWP5] (noting that the net assets into liquid alternative funds "increased almost 200% from 2009 to 2014.").

47. *See generally* Barclays Prime Services, *Going Mainstream: Developments and Opportunities for Hedge Fund Managers in the '40 Act Space*, BARCLAYS at 13-14 (Apr. 2014) http://www.barclayscommunications.com/CapSol_Publications/492282/Going_Mainstream_A4.pdf [HTTPS://PERMA.CC/6JCL-HLD2] [hereinafter, Barclays, *Going Mainstream*] (describing the reaction of hedge fund managers to the reality of a far different fee and expenses model in the '40 Act space).

and sub-advisors.[48]

Alternative streams of return are also accessible through various passive strategies, which have proliferated in recent years, as investors have grown concerned about the efficacy of active management. Despite the commercial success of active managers, it has long been accepted in academic circles that these managers rarely outperform a benchmark over any meaningful interval of time.[49] This relative underperformance and the higher transaction costs of actively managed funds have energized a search for more efficient means of accessing market returns.[50]

In recent years, that search has resulted in a burgeoning group of so-called "smart beta" strategies.[51] These strategies attempt to improve or alter the return profile of an investment relative to more-traditional market benchmarks.[52] Smart beta architects seek to (i) distill investment returns into their individual component parts and (ii) build transparent, rules-based strategies reliably providing exposure to those market segments, factors, or

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48. *See generally* Barclays, *Going Mainstream*, *supra* note 47, at 13-14 (describing the reaction of hedge fund managers to the reality of a far different fee and expenses model in the '40 Act space). In addition, the popularity of expense caps and 12b-1 fees coupled with the investor preference for institutional share classes make the margins for registered products very thin when compared to hedge funds. *See* SEI, *The Retail Alternatives Phenomenon, supra* note 3, at 21 (observing that "many private funds have chosen to be sub-advisors, allowing them to focus on investment management while the sponsoring firm handles distribution, administration and back-office functions.")

49. *See, e.g.*, Burton Malkiel, *Reflections on the Efficient Market Hypothesis: 30 Years Later*, 40 FIN. REVIEW 1, 1-3 (2005) (suggesting that "a blindfolded chimpanzee throwing darts at the stock pages could select a portfolio that would do as well as the experts," and observing that large cap equity funds are outperformed by the S&P 500 Index® for a 1, 3, 5 and 10-year period between 63 and 90% of the time).

50. *See, e.g.*, Some Thoughts on the Evolution of the Design of Financial Products, Olden Lane Whitepaper No. 2 (June 2016) at 3 [hereinafter Olden Lane No. 2] ("Economy, efficiency and exposure in the form of betas, both traditional and alternative, are the watchwords of the time.").

51. *See Smart Beta: 2015 global survey findings from asset owners*, FTSE RUSSELL 1 (2016), http://www.ftserussell.com/sites/default/files/research/smart_beta_2015_global_survey_findings_from_asset_owners_final.pdf [HTTPS://PERMA.CC/LZ8A-P842] ("Strategy-based exposures have gained a lot in popularity over the past few years."). *See also* Ben Johnson, *A Sensible Approach to 'Smart Beta'*, MORNINGSTAR (May 14, 2014) http://news.morningstar.com/articlenet/article.aspx?id=647771 [HTTPS://PERMA.CC/98A4-SNKC] (observing 59% growth year-over-year and describing "smart beta" as at the "leading edge of the most recent wave of product proliferation within the global exchange–traded products landscape."); Paul Sullivan, *'Smart Beta' Investing Lets the Yardstick Pick the Stocks*, N.Y. TIMES, Jun. 28, 2014, at B5 (describing the exponential growth of smart beta investing).

52. Johnson, *supra* note 51. *Cf.* Towers Watson, *supra* note 10 (describing the appeal of smart beta strategies as a realization that certain hedge fund strategies "can be reproduced with simple, easily accessible strategies at a lower cost.").

concepts.[53] While some commentators have proclaimed the smart beta movement to be in its infancy,[54] others have declared it a fad, questioning whether it is anything more than "another example of marketing hype by product providers."[55] To date, smart beta strategies have been accessed primarily through over-the-counter derivatives or structured notes, and, in either case, typically with a bank as counterparty.

In smart beta, the nation's leading banks have developed a considerable inventory of systematic investment content to capitalize on growing investor demand for passive and systematic investment. Yet, together all the bank proprietary strategies, which number in the hundreds if not thousands, account for only $100 billion in assets under management.[56] The strategies developed by the global banks suffer from a low value structure of delivery, with distribution confined to those investors with the financial and personnel resources to conclude and manage ISDA agreements or a shrinking number of other investors willing to buy a bank issued structured note. In smart beta, content and structure today remain very much at odds.

Non-traditional strategies continue to creep into the fund space.[57] They represent a challenge to the traditional top-down asset management firm structure where managers are grown organically and allocations are decided subjectively by internal staff. Instead, alternative funds tend toward a "sourcing and structuring" model in which investment decisions are derived more systematically. In such a construct, the fund sponsor adds value by identifying desirable streams of return or trading programs and optimizing the delivery of those returns to investors. As a result, traditional asset managers looking to run an alternative sleeve of their business in a

53. *See generally Smart Beta: Implications for Active Management*, RUSSELL INVESTMENTS 4 (Sep. 2013), *http://www.cfasociety.org/orlando/Lists/EventsCalendar/Attachments/1/Russell%20Smart%20Beta%20Indexes_IAM_Agather_Final.pdf* [HTTPS://PERMA.CC/8SFM-KEE].

54. *See, e.g.*, Towers Watson, *supra* note 10, at 2 ("We believe we are still at the 'pioneer' stage in the evolution of smart beta").

55. Chris Flood, *Market divided over smart-beta success*, FIN. TIMES (May 4, 2014), https://www.ft.com/content/fc6feaa8-c497-11e3-b2fb-00144feabdc0 [HTTPS://PERMA.CC/25Q7-28UX].

56. This number was offered privately to the authors in a presentation not for onward distribution. The authors have retained the presentation.

57. *See, e.g.*, *Morningstar and Barron's 2014-2015 Alternative Investment Survey of U.S. Institutions and Financial Advisors*, MORNINGSTAR 5 (July 2015), http://leeds-faculty.colorado.edu/grossd/MBAX%206220%20Fall%202016/Readings/Morningstar%20 Alternative%20Investment%20Survey%202014-2015.pdf [HTTPS://PERMA.CC/R4PJ-4Z69] [hereinafter Morningstar and Barron's] (suggesting that "[e]ven as flows have moderated, fund companies continue to launch funds at a record clip").

manner similar to their existing business are likely to find confusion and disappointment.[58] The transition to liquid alternative funds will more likely reward those nimble and enterprising firms best able to (1) source reliably coveted alternative streams of return or smart beta indices, (2) deliver adroitly and consistently those streams in the most desirable and economic wrapper for investors, and (3) educate the marketplace and distribute effectively and consistently the resulting product into the appropriate sales channel. As the remainder of this Article hopes to highlight, the UIT offers tremendous flexibility and promise in this regard.

PART II

A unit investment trust is an investment vehicle which qualifies as an "investment company" pursuant to the requirements of the Investment Company Act.[59] Typically organized under a trust indenture, UITs issue "only redeemable securities, each of which represents an undivided interest in a unit of specified securities."[60] The trust indenture sets forth the important provisions of the UIT, including its term, the conditions by which it may be terminated early, and the responsibilities of its sponsor, evaluator, and trustee.[61] The Investment Company Act distinguishes UITs from management investment companies by requiring that UITs have a

58. In large measure, we think far too many of today's asset managers are content to sit on an annuity earned for their organization by those who blazed a trail many years ago. Moreover, if alternatives are more fully embraced by investors, many asset managers are going to be targeted for disintermediation. *See* SEI, The Retail Alternatives Phenomenon, *supra* note 3, at 3 (cautioning private fund managers that "[t]he distribution of retail alternatives is complex, involving a maze of sales channels, specialized consultants and intermediary platforms.").

59. *See* Investment Company Act § 4(2)(a)-(c), 15 U.S.C. § 80a-4 (defining a unit investment trust as "an investment company which (A) is organized under a trust indenture, contract of 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; but does not include a voting trust."). *See also* Gould and Lins, *supra* note 7, at 1178 ("Because a unit investment trust both issues securities and uses the proceeds to purchase securities, it comes within the definition of an investment company").

60. *See* Investment Company Act § 4(2)(a)-(c), 15 U.S.C. § 80a-4 (describing the characteristics of a unit investment trust). *See also Unit Investment Trusts*, U.S. SEC, www.sec.gov/answers/uit.htm [HTTPS://PERMA.CC/KSA5-73Y9] (setting out the traditional traits of a UIT).

61. *See* Gould and Lins, *supra* note 7, at 1180 (noting the essential parts of a trust indenture). *See also* US Securities and Exchange Commission, Div. of Inv. Mgmt., Memorandum on the Reg. and Operation of Unit Inv. Trs., (Sept. 1988), 5 [hereinafter Regulation and Operation Memo] (recognizing that a unit investment trust is managed by a trust indenture, rather than a board of directors).

fixed portfolio, essentially no management, and maintain a simple capital structure.[62] Because UITs lack a board of directors, corporate officers, or an investment advisor, active management is prohibited within the vehicle.[63] As a result, UITs are more constrained than other available fund structures (i.e. actively managed open-end funds) and are comprised of portfolios sometimes described as static or "fixed."[64] Concurrent with the creation of the unit investment trust structure, the Chief Counsel of the Investment Trust Study described the vehicle to Congress as "[a] device, whereby they sell an individual an interest in a package of securities, a list of which is made known," adding that "they cannot change the package, except under certain circumstances."[65]

The absence of management in UITs has traditionally referred to a prohibition against the substitution of investments that are not specified in the UIT's prospectus and governing documents on its inception date.[66] This feature provides an important protection against any self-dealing or conflict of interest of an investment manager. In the unit investment trust, management is ordinarily reduced to a minimum, as "the controlling document, the trust agreement, usually specifies not only the securities in which the funds may be invested but also the specific number of each

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62. *See generally* LETTER FROM THE CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, TRANSMITTING PURSUANT TO LAW, A REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 567 at 15 (1940) [hereinafter LETTER FROM THE CHAIRMAN OF THE SEC] ("The investor was assured, therefore, that both changes in his investment and manipulation were impossible."). *See also* Regulation and Operation Memo, *supra* note 61, at 2 ("Unlike the more prevalent type of investment company such as the mutual fund, a UIT does not have an investment adviser that manages its portfolio.").

63. *See generally* Investment Company Act § 4(2)(a)-(c), 15 U.S.C. § 80a-4(2)(a)-(c) (defining a "unit investment trust"). *See also* Harman, *supra* note 7, at 1047 ("Because UITs, unlike mutual funds, have no investment adviser or board of directors, certain provisions of the 1940 Act clearly are irrelevant to them.").

64. *But cf.* Laurin Blumenthal Kleiman, *Unit Investment Trusts*, *in* FINANCIAL PRODUCT FUNDAMENTALS, 8-29 (Clifford E. Kirsch, ed. 2016) (noting that "the fixed trust concept has evolved significantly over time.").

65. *See A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisors, and for Other Purposes: Hearings Before a Subcommittee of the Committee on Banking and Currency* 76th Cong. 3 at 184 (1940) (testimony of David Schenker, Chief Counsel of the Investment Trust Study of the SEC) (describing a "fixed trust" in connection with the development of the UIT concept).

66. *See, e.g.*, PaineWebber Equity Trs., SEC Division of Investment Management No-Action Letter, No. 811-3722 (Jul. 19, 1993) https://www.sec.gov/divisions/investment/noaction/1993/painewebber071993.pdf [HTTPS://PERMA.CC/6BE7-TAUH] (granting no-action relief where equity holdings of a UIT will be sold in the event that their ratings fall below a predetermined level and the "proceeds from disposition will not be reinvested in substitute securities.").

security which may be purchased."[67]

Concerned about abuses that had taken place in "fixed trust" predecessors of the UIT vehicle, Congress included a special section of the Investment Company Act setting minimum requirements for a UIT's trust indenture and addressing certain abuses.[68] For example, Section 26 of the Investment Company Act imposes a minimum capital requirement for banks chosen as UIT trustees,[69] enforces limitations on the fees chargeable to unitholders, and sets certain requirements with respect to UIT assets.[70] These requirements prohibit a trustee from resigning before a successor is appointed or trust assets are liquidated,[71] and requires the UIT sponsor to maintain unitholder records and to inform unitholders in the event that a security is replaced within the UIT's portfolio.[72]

In a thorough analysis of the structure, the SEC's former chief counsel concluded that UITs offer "attractive investments because they offer liquidity and diversity at an affordable price."[73] The affordability in

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67. LETTER FROM THE CHAIRMAN OF THE SEC, *supra* note 62 (noting that the trust agreement plays a managerial role in unit investment trusts). *See also* Regulation and Operation Memo, *supra* note 61, at 21 ("substitution of portfolio securities should only occur under unusual circumstances, for example, when the creditworthiness or economic viability of the issuer of the portfolio security is seriously in doubt."); *see also A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisors, and for Other Purposes: Hearings Before a Subcommittee of the Committee on Banking and Currency* 76th Cong. 3 at 300 (1940)(testimony of John H. Hollands, SEC staff attorney) (adding that "[t]he investor really exercises his own judgment, because he is ordinarily shown the list of securities in which his funds will be invested, and it is only under very special circumstances that the portfolio can be changed and those securities eliminated and others substituted.").

68. Gould and Lins, *supra* note 7, at 1180.

69. *See* Investment Company Act § 26(a)(1), 15 U.S.C. § 80a-26(a)(1) Section (setting the minimum capital requirement at $500,000).

70. *See* Investment Company Act § 26(a)(2), 15 U.S.C. § 80a-26(a)(2) (noting the conditions where a unit investment trust can be sold). *See also* Regulation and Operation Memo, *supra* note 61, at 19 *et seq*. (describing the workings of Section 26(a)(2)).

71. *See* Investment Company Act § 26(a)(3), 15 U.S.C. § 80a-26(a)(3) of Investment Company Act of 1940 ("[T]he trustee or custodian shall not resign until either (A) the trust has been completely liquidated and the proceeds of the liquidation distributed to the security holders of the trust, or (B) a successor trustee or custodian, having the qualifications prescribed in paragraph (1), has been designated").

72. *See* Investment Company Act § 26(a)(4), 15 U.S.C. § 80a-26(a)(4) ("[A] record will be kept by the depositor or an agent of the depositor of the name and address of, and the shares issued by the trust and held by, every holder of any security issued pursuant to such instrument"). *See also* Regulation and Operation Memo, *supra* note 61, at 21 ("The trust indenture must provide that whenever a portfolio security is substituted the depositor must mail a notice of the substitution to unitholders within five days after the substitution.").

73. Harman, *supra* note 7, at 1046. *See also* Kleiman, *supra* note 64, at 8-2 (noting that UITs "provide a unique opportunity for the investor who seeks the diversification and

comparison to the typical mutual fund has two main drivers. First, the UIT lacks an investment adviser "to whom it must pay an annual management fee."[74] Instead, a trust's assets will theoretically remain in the trust for its entire term, allowing the investor "to make the investment decisions rather than an investment advisor or manager" and, at the same time, allay any "fears of portfolio manipulation or mismanagement."[75] Aside from protecting against style drift that often besets managed funds, the fixed nature of the UIT portfolio also ensures that brokerage commissions will be smaller than those of the typical mutual fund, which pays to turn over its portfolio on a more frequent basis.[76] An illustration comparing the main attributes of the mutual fund and the UIT structures is provided in Figure 1 below.

liquidity of a mutual fund without the costs associated with portfolio management."); *see also* Gould and Lins, *supra* note 7, at 1177 (observing that "a UIT permits the average investor to diversify at an affordable cost" and listing "diversification, professional investment management and economies of scale in transaction costs" as attributes of the UIT); Regulation and Operation Memo, *supra* note 61, at 2 ("Because a UIT is unmanaged, it also permits an investor – unlike a mutual fund – to obtain diversification without paying an annual management fee.").

74. Harman, *supra* note 7, at 1046.

75. Gould and Lins, *supra* note 7, at 1181.

76. Harman, *supra* note 7, at 1046. *See generally* Brian Reid and Kimberlee Millar, *Mutual Funds and Portfolio Turnover*, INV. CO. INST. RES. COMMENT. (Nov. 17, 2004), https://www.ici.org/pdf/rc_v1n2.pdf [HTTPS://PERMA.CC/3XNZ-DYH2] (describing the importance of understanding the trading activities of fund managers and the transaction costs they incur).

	MUTUAL FUND	UIT
PORTFOLIO MANAGEMENT	Active	Static portfolio
STRUCTURE	Corporation or Business Trust	Trust
GOVERNANCE	Actively overseen by board of directors or trustees	Minimally supervised by a trustee No board of directors
REDEEMABILITY	Redeemable daily at NAV	Secondary market liquidity Redeemable daily at NAV
TERM	Indefinite	Fixed life 1 to 99 years
TAX	Sub-chapter M	Sub-chapter M Grantor Trust
DISTRIBUTION	Continuously on a "best effort" basis through distributor	Single firm commitment of a fixed size through a syndicate
FEES & CHARGES	Management fee, custody fees, transfer agency fees, shareholder servicing cost, sales charges and ongoing distribution fees	Sales charge and minimal ongoing trustee and sponsor fees

FIGURE 1.[77]

As an investment company, the UIT is required to adhere to the strict registration and disclosure regime of the federal securities laws. A UIT sponsor must navigate both the Securities Act of 1933 (the "Securities Act") and the Investment Company Act, as UITs register their units under the Securities Act after registering the trust entity itself under the

77. Adapted from a chart appearing at Kleiman, *supra* note 64, at App. 8A-1.

Investment Company Act.[78] A UIT is typically comprised of multiple series, with each series referring to a distinct portfolio of assets. An individual unitholder, therefore, looks only to the performance of a particular series' portfolio of underlying assets for her investment return.[79] And because each series is considered a distinct offering under the Securities Act, filing a separate registration statement to gain effectiveness under Section 8(a) and with its assets and liabilities ring-fenced from those of any other series of the same trust.[80] By contrast, the trust itself – and not each series – registers under the Investment Company Act.

INVESTMENT COMPANY ACT AND SECURITIES ACT REGISTRATION

Because a UIT "both issues securities *and* uses the proceeds to purchase securities," it fits within the statutory definition of an investment company described in Section 3(a)(1) of the Investment Company Act.[81] The regulation of a UIT under the Investment Company Act is highly tailored, however, to account for the vehicle's unique characteristics versus other investment company types. Form N-8B-2 describes the trust and the units that it will offer to the public. The form requires disclosures regarding the sponsor, various workings of the trust, its fees, expenses and sales loads and provisions for the purchase, sale, creation and redemption of securities.[82]

In 1982, the SEC adopted Rule 487 of the Securities Act, granting UITs registration relief not previously granted to any other type of issuer.[83]

78. *See generally* Harman, *supra* note 7, at 1061:

Each series is considered a separate offering under the 1933 Act and must file a separate registration statement that becomes effective under section 8(a) of that act. Only the trust itself, however – and not each series – need register under the 1940 Act.

See also Regulation and Operation Memo, *supra* note 61, at 12-13 (noting the registration requirements for unit investment trusts).

79. Harman, *supra* note 7, at 1061. *See also* Regulation and Operation Memo, *supra* note 61, at 3 ("Each series is, essentially, a separate investment company, and an investor looks solely to the series in which he has invested for his investment return.").

80. Kleiman, *supra* note 64, at 8-16.

81. Gould and Lins, *supra* note 7, at 1178. *See also* Investment Company Act § 3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (defining investment company as a securities issuer that invests and reinvests securities).

82. Gould and Lins, *supra* note 7, at 1194-95. *See also* Regulation and Operation Memo, *supra* note 61, at 13 (describing the Form N-8B-2 disclosures).

83. *See* Automatic Effectiveness of Registration Statements Filed By Certain Unit Investment Trusts, Securities Act Release No. 6401 (May 7, 1982) [hereinafter Securities Act Release No. 6401] (describing the registration requirements for UITs); *see also* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed.

After a trust's registration pursuant to Form N-8B-2 and following the effectiveness of a trust's first series, Rule 487 permits subsequent registration statements filed by the same trust to "become effective automatically on a date and at a time designated by the registrant, if certain conditions are met."[84] Rule 487 represented a concession by the SEC that there are often substantial similarities in the series issued by UITs and an acknowledgement that the *de novo* review of registration statements could become both "routine" and "burdensome" for Commission staff.[85] Following the Rule's adoption, the SEC grants UITs automatic effectiveness if the sponsor can represent that the disclosures made in respect of a new trust

> [D]o not differ in any material respect from those contained in the registration statements of one or more specifically identified previous series of the trust, except to the extent such differences are necessary to identify the specific portfolio securities of, and to provide essential information for, the series being registered.[86]

Aside from streamlining the review process for the regulator, Rule 487 brings a significant advantage for UIT issuers, as it enables UIT issuers to bring product to market whenever they choose, unconstrained by Commission review.[87] As a commercial matter, the Rule shortens the UIT selling cycle – from conception to actual sale – distinguishing it from any other product regulated under the Investment Company Act and more closely aligning it with the typical selling cycle for structured notes.[88]

Reg. 44,722, 44,722 (Aug. 3, 2005) (codified in scattered sections of 17 C.F.R.) (adopting subsequent rule related to a similar concept embedded in the shelf registration rules ushered in by Securities Offering Reform).

84. Securities Act Release No. 6401, *supra* note 83, at 1.

85. *See, e.g.*, Statement of John S.R. Shad to the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (Mar. 25, 1983) at 86 (commenting that UITs that differ "only with respect to the specific composition of the portfolio . . . do not present disclosure issues that require staff review and comment prior to effectiveness of the registration statement."). *See also* Regulation and Operation Memo, *supra* note 61, at 15-16 (offering that "subsequent series of a UIT rarely present new substantive issues.").

86. Securities Act Release No. 6401, *supra* note 83, at 2.

87. *See* Harman, *supra* note 7, at 1063 (expounding on the impact of rule 487).

88. *See* Harman, *supra* note 7, at 1063 (observing that adoption of the Rule made UIT sponsors "the first issuers to gain the sort of control over the registration process that some corporate issuers would later gain when rule 415 – the 'shelf-registration' rule – was adopted.").

A. *Creation and Liquidity of a Unit Investment Trust*

While the structure of a particular series of a unit investment trust will differ depending on the nature of its underlying portfolio, the essential mechanics of each offering will remain quite similar. In all cases, the process of creation is initiated by the sponsor's acquisition of a portfolio of securities satisfying the series' investment objectives. The sponsor deposits the securities with the trustee in exchange for the receipt of units representing fractional undivided interests ("units") of the trust. Once created (and, in all cases, following the effectiveness of a registration statement), units are offered to the public through the sponsor and other broker dealers at a public offering price.[89] During the initial offering period, the public offering price will be based upon the aggregate market value of the portfolio's underlying securities plus a front-end sales charge.[90] Today, the sales charge for the typical UIT offering ranges from 1.95% to 5.5% of the public offering price, depending upon the offering's term and the type of securities comprising the underlying portfolio.[91]

A UIT's portfolio is selected by its sponsor to reflect a specific investment theme. UIT products have been traditionally categorized into three main styles: (i) tax-exempt debt, (ii) taxable debt, and (iii) equity UITs.[92] Tax-exempt UITs invest in portfolios of municipal bonds and pass through tax-exempt interest income to unitholders. New assets deposited into tax-exempt UITs totaled just $875 million in 2015, down from $915 million in 2014.[93] Taxable debt UITs include portfolios comprised of some combination of U.S. and/or international corporate bonds, government

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89. *See, e.g.*, Prospectus, Capital Strength Portfolio, Series 24, FT 4727, (Apr. 11, 2014), http://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=1c5c93aa-48ed-4125-a862-38a0132a2741 [HTTPS://PERMA.CC/S3N7-U7QF] (making units available at a $10.00 public offering price).

90. Most offerings also include a deferred sales charge. However, specific exemptive relief must be granted by the SEC before a deferred sales charge can be collected. *See, e.g.*, Prospectus, Capital Strength Portfolio, Series 35, Ft. 6241 (Sep. 16, 2016), https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=8d88cbf2-db18-4715-901c-75836595882a [HTTPS://PERMA.CC/G9TS-7HBP] (making units available at a $10.00 public offering price).

91. Presumably, the market could support a premium for a UIT requiring complex structuring. The maximum charge is typically subject to reduction under certain circumstances, including volume discounts, which typically depend on the type and term of the series, which can vary.

92. 2016 ICI Fact Book, *supra* note 8, at 185. This categorization, however, can be misleading. The equity category, for example, serves as a catch-all and includes trusts with underlyings varying from closed end funds to business development companies.

93. 2016 ICI Fact Book, *supra* note 8, at 185.

bonds, or government agency certificates.[94] New assets deposited into taxable debt UITs totaled $492 million in 2015, down from $624 million in 2014.[95] Equity-related UITs comprise the significant majority of the market's assets today. These trusts often construct portfolios around a particular investment theme or market sector.[96] New assets deposited into equity-related UITs totaled $64.5 billion in 2015, slightly exceeding the $63.9 billion of issuance from a year earlier.[97] Overall, 1,619 new trusts were created in 2015, with the average new trust taking deposits of just more than $40 million.[98]

Unit holders are provided liquidity through the secondary market and via redemption.[99] While under no obligation to do so, sponsors regularly maintain a secondary market for units of each outstanding series.[100] Other broker-dealers may also maintain a secondary market for units. In such a secondary market, investor purchases are executed at the current public offering price plus a front-end sales charge.[101] The sales charge imposed by a series on a secondary market transaction varies because of, among other things, the type of portfolio securities held and the term of the series. The maximum sales charge imposed in a secondary market may also be subject

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94. 2016 ICI Fact Book, *supra* note 8, at 20.

95. 2016 ICI Fact Book, *supra* note 8, at 185.

96. *See, e.g.*, Prospectus, Capital Strength Portfolio, Series 25, FT 4874, (Jun. 25, 2014) (comprised of companies with the following qualities: well-capitalized with strong balance sheets; skilled management; high liquidity; ability to generate earnings growth; and a record of financial strength and profit growth); Prospectus, Incapital Unit Trust, Series 44, Incapital Morningstar Wide Moat Portfolio, (Form 2Q) (Apr. 10, 2014) (describing a UIT comprised of portfolio of equity securities of companies recommended by Morningstar Investment Services, Inc. that the Sponsor believes has the best chance of capital appreciation over its life).

97. 2016 ICI Fact Book, *supra* note 8, at 185.

98. Based on monthly data compiled by the Investment Company Institute and maintained by the authors.

99. Presumably, both the UIT sponsor and its unitholders benefit from a secondary market. The sponsor typically receives a sales charge on units resold in the secondary market. Unitholders benefit from the fact that the trust does not have to sell its assets - possibly under disadvantageous circumstances - to meet redemptions, meaning that the fixed costs of the trust are absorbed by a larger pool of investors.

100. *See, e.g.*, Prospectus, Nuveen Unit Investment Trust, Series 166, Nuveen Argus Modern Innovators Portfolio, 4Q 2016, (Oct. 20, 2016) at B-8 https://www.incapnet.com/Pages/Public/PublicWebsiteDocumentFetch.aspx?FileId=45499c1b-6adb-41e8-a9ed-888a17881b0e [HTTPS://PERMA.CC/WN4T-ARQT] (providing that "Nuveen intends to, but is not obligated to, maintain a secondary market for units" and cautioning that "[i]f the Sponsor decides to maintain a secondary market, it may suspend or discontinue purchases of units of the Trust if the supply of units exceeds demand, or for other business reasons.").

101. *See Id*. (stating that secondary market transactions for units will be "at the current price which is based on the net asset value.").

to volume discounts based on the amount of units purchased.[102] In the event that a secondary market is not maintained, unitholders may take advantage of the UIT's liquidity requirement by redeeming units through the trustee at prices generally based upon the evaluation of the underlying securities.[103]

B. *Participants in a UIT Offering*

There are several important participants in a successful UIT offering. The function of the sponsor, trustee, supervisor and evaluator are described below.

A UIT's sponsor, often referred to as the depositor, organizes the trust and launches each series with the deposit of the initial portfolio of assets with the trustee.[104] As a general matter, the sponsor bears all of the trust's organizational costs.[105] In 1995, however, the Commission allowed for certain organizational expenses to be charged to the trust itself.[106] These charges included the costs of preparing and printing the registration statement and organizational trust documents, the registration of units and the trust's initial audit.[107] For its services, the depositor typically earns a one-time creation and development fee at a series' inception.[108] Also, for

102. *See, e.g.*, Prospectus, First Trust Dow® Target 5 4Q '16 - Term 1/9/18, First Trust 6350, at 70 (Oct. 7, 2016) (describing generally the volume discounts and limiting the program to units not eligible for a separate rollover, redemption or termination proceeds discount). *Cf.* Prospectus, Business Development Company Opportunities Portfolio, Series 2016-3 REIT Portfolio, Series 2016-3 - A Hartford Investment Management Company ("HIMCO") Portfolio, Advisors Disciplined Trust 1718 (Jul. 29, 2016) at 38 ("Secondary market sales of all unit trusts are excluded for purposes of these volume concessions").

103. *See* Investment Company Act, § 22(e), 15 U.S.C. § 80a-22 ("No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption"). *See also* Regulation and Operation Memo, *supra* note 61, at 25 ("When investors liquidate or redeem their units, they must receive the current net asset value for them.").

104. *See generally* Regulation and Operation Memo, *supra* note 61, at 7 (describing the duties of the sponsor when organizing the trust).

105. *See* Kleiman, *supra* note 64, at 8-10.

106. *See* Letter to Pierre de St. Phalle, Esq., SEC Interpretive Letter (May 9, 1995) [hereinafter Letter to Pierre de St. Phalle] (concluding that the Investment Company Act does not prohibit a UTI from bearing its own organizational expenses).

107. *See id.* ("open-end and closed-end management investment companies currently bear their own organizational expenses, and we see no reason to impose a different standard on UITs.")

108. *See An Investor's Guide to Unit Investment Trusts*, GUGGENHEIM INVESTMENTS 6 (Feb. 2013), http://uit.guggenheiminvestments.com/Libraries/Literature_en/

providing bookkeeping and administrative services to a trust, the sponsor may receive an additional annual fee, not to exceed its actual costs.[109]

The UIT's supervisor oversees the portfolio. A supervisor is typically empowered to remove a security from a trust, but only in the event that it is determined to be (i) detrimental to the trust and the interest of the unitholders or (ii) it has suffered a material decline in value or diminishment of creditworthiness.[110] The supervisor also identifies specific securities to be sold by the trust in the event that a non-pro rata sale is required to raise proceeds in support of a redemption.[111] For providing these supervisory services, the supervisor customarily receives a fee, provided it is set forth in the relevant prospectus.[112]

Although the sponsor or trustee may perform evaluation services for the UIT, trusts typically employ an investment firm to act as evaluator.[113] The evaluator values the portfolio as provided in the trust indenture and

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An_Investor_s_Guide_to_UITs.pdf [HTTPS://PERMA.CC/V5FG-G642] (detailing the two elements comprising the sale charge for a typical UIT). As there is no ongoing management of a UIT, the creation and development fee is paid at the UIT's inception (and is not ongoing). In addition, the depositor may realize a profit or a loss resulting from (i) the difference between the purchase prices of the securities to the depositor and the costs of such securities to a series, which may be based on the offering side evaluation of the securities and (ii) any market making activities with respect to the units. Finally, the depositor may realize additional profits or losses during the initial offering period on unsold units as a result of changes in the daily evaluation of the assets included in the UIT's portfolio. *See generally Unit Investment Trusts – Features, Costs and Compensation*, MORGAN STANLEY (Oct. 2016), https://www.morganstanley.com/assets/pdfs/wealth-management-disclosures/uit_features.pdf [HTTPS://PERMA.CC/D69C-7S89] (describing the fees available to a UIT's sponsor and its distribution partners).

109. *See* Investment Company Act, § 26(a)(2)(C), 15 U.S.C. § 80a-26 (providing guidelines for the administration of UITs).

110. One UIT sponsor describes this role as follows:

> Securities in a UIT portfolio are generally monitored or supervised by analysts who are watchful for unanticipated developments that could make their retention in the portfolio detrimental to investors. A security may only be sold under limited circumstances in the case of a significant adverse occurrence, such as fraud, bankruptcy or a severe change in credit rating.

See An Investor's Guide to Unit Investment Trusts, *supra* note 108, at 5.

111. *See,* Harman, *supra* note 7, at 1050 (providing that "for the purpose of meeting redemptions, the evaluator may designate the portfolio securities to be sold after consideration of a variety of factors such as interest rates, marketability, and market value.").

112. *See* Investment Company Act, § 26(a)(2)(C), 15 U.S.C. § 80a-26 (providing that the administration of the UIT should be carried out pursuant to the specifications in the creating documents).

113. *See* Gould and Lins, *supra* note 7, at 1190 (noting that while sponsors and trustees can perform evaluation services, a UIT typically has a separate evaluator).

according to a written asset valuation policy.[114] The evaluator may also collaborate with the sponsor and the trustee to select independent evaluation providers and pricing vendors.[115] The evaluator normally earns a fee for these services, provided it is set forth in the relevant prospectus.[116]

The trustee (i) maintains trust assets, (ii) distributes interest and/or dividends paid by the trust's portfolio, (iii) performs recordkeeping and reporting requirements, (iv) provides an annual report to unitholders and (v) ensures that all trust expenses are properly paid.[117] In exchange for its services, the trustee is typically paid an assets-based fee which typically ranges from 10-12 basis points.[118] To ensure solvency and protect against abandonment of the trust, the Investment Company Act (i) requires the trustee to maintain aggregate capital of $500,000 and (ii) prohibits the trustee from resigning until liquidation or the appointment of a successor.[119]

UIT units are sold by an underwriter or a syndicate of underwriters.[120] In the most typical offering, the underwriter will purchase a specific number of trust units on a certain date certain in return for a concession, which generally represents a percentage of the public offering price of the units.[121]

C. *Fees and Charges*

While each individual offering must be judged on its own merits, it is quite possible for the fee structure to offer a commercial advantage for the UIT versus other investment vehicles. Because UITs are not actively managed, ongoing expenses will generally be low, consisting principally of

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114. *See* Regulation and Operation Memo, *supra* note 61, at 7-8 (outlining the structure of a UIT and specifying the role of the evaluator).

115. *See* Investment Company Act Release, 50 Fed. Reg. 21282, 21283, n.13 (proposed May 14, 1985) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274) ("Instead the structure of a unit investment trust is set forth in the trust indenture which designates a sponsor, trustee and evaluator to conduct the operations of the trust.")

116. *See* Investment Company Act Release, 50 Fed. Reg. 21282, 21283, n.13 (proposed May 14, 1985) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274) (noting that evaluators are typically paid a fee, including a continuing fee usually paid on a monthly basis). *See also* Investment Company Act § 26(a)(2)(C), 15 U.S.C. § 80a-26 (highlighting that individuals who perform administrative services may be paid a fee).

117. *See* Regulation and Operation Memo, *supra* note 61, at 5-6 (laying out the responsibilities of a trustee in the UIT structure).

118. *Id.* at 6.

119. *See* Investment Company Act,§ 26(a)(1) and § 26(a)(3).

120. *See* Regulation and Operation Memo, *supra* note 61, at 8-9 (noting that underwriters usually become owners of units before reselling them to the general public while sponsors may purchase units from investors and reoffer them to other investors).

121. *Id.* at 8.

regular annual charges by the Trustee and the evaluator's fee for ongoing evaluations, administration, bookkeeping and continuing portfolio supervisory services. A brief summary of the typical fee structure of a UIT follows.

A UIT sponsor typically collects a transactional sales fee in varying amounts which are levied on both primary and secondary market sales.[122] The transactional sales fee is established in consultation with the selling group and, in most instances, is not retained by the sponsor. In addition to the transactional sales fee, a depositor typically earns a creation and development fee for designing and structuring each series.[123] This fee is a fixed amount per unit and is paid to the depositor at the close of the initial offering period or accrued on a daily basis.

Certain organizational expenses incurred by the sponsor in establishing a UIT may be paid by the trust itself in the form of a reimbursement.[124] Such fees include, but are not limited to, the cost of the initial preparation and typesetting of the registration statement, prospectuses and other trust documents, the cost of the negotiation and preparation of various trust agreements, the fees of securities regulators, commodities regulators and state registration fees, the initial valuation and audit of the particular series, the costs of any portfolio consultant, any licensing fees, the initial fees and expenses of the trustee, the custodian, the transfer agent and the administrator, and legal and other out-of-pocket expenses related thereto.[125]

Individual series may incur additional charges in the form of:

> (a) expenses and disbursements for services provided, including license fees, legal, tax accounting and reporting and auditing

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122. *Id.* at 7 (explaining the makeup of the sales charge received by the sponsor which cover, among other things, distribution expenses, sales commissions and the expense of creating and developing a particular series.)

123. *See, e.g.*, *A Guide to Investing in Unit Investment Trusts*, RAYMOND JAMES (2016), https://raymondjames.com/wealth-management/advice-products-and-services/investment-solutions/unit-investment-trusts [HTTPS://PERMA.CC/672B-U2YF] (observing that creation and development fees are paid to the sponsor "from the trust for creating and developing the trust and organizing and offering the portfolio."); UBS, *Understanding unit investment trusts* (2011) *https://onlineservices.ubs.com/staticfiles/pws/adobe/uit_disclosure.pdf* [HTTPS://PERMA.CC/RAA6-F6YJ] ("Most UITs charge a creation and development (C&D) fee to compensate the sponsor for the costs of building the trust.").

124. *See* Letter to Pierre de St. Phalle, *supra* note 106 (agreeing with the requestor that the Investment Company Act does not prohibit a UIT from bearing its own organization expenses).

125. *Id.* at n.6 (noting such expenses do not include the printing of preliminary prospectuses and prospectuses, expenses incurred in the preparation and printing of brochures and other advertising materials and any other selling expenses).

> expenses and expenses of attorneys, accountants and other advisors, expenses incurred in connection with any communications disseminated in connection with custody or sub-custody of assets; (b) various governmental charges; (c) foreign custodial and transaction fees; (d) fees in connection with the execution of the purchase and sale or securities, and foreign exchange transactions; and (e) expenses related to the updating of the registration statement for a series of a UIT, to the extent of legal fees, typesetting fees, electronic filing expenses and regulatory filing fees.[126]

The absence of a board of directors and the lack of portfolio turnover mean that the annual operating expenses of a UIT tend to be quite reasonable when compared to other investment company products. Moreover, some of these expenses will enjoy economies of scale as the size of the underlying portfolio grows and certain fixed costs can be spread over a larger asset base.

To further illustrate the fees of a typical UIT offering, an annotated hypothetical expense table is provided as Figure 2 below.[127]

	Percentage of Offering Price	
	Commission Account	Fee-Based Account
Sales Fees		
Transactional Sales Charge*	[2.50] %	[0.50] %
Creation and Development Fee**	[0.60] %	[0.60] %
Total Sales Fees	[3.10] %	[0.60] %
Organization Costs		
Legal, Blue Sky, Audit & Misc. Costs	[0.50] %	[0.50] %
Total Estimated Organization Costs***	[0.50] %	[0.50] %
Total Upfront Costs (Sales Fees & Organization Costs)	**[3.60]%**	**[1.10]%**
Annual Fund Operating Expenses****		
Trustee's Fee	[0.12] %	[0.12] %
Supervisory, Evaluation and Admin. fee	[0.07] %	[0.07] %
Other Trust operating expenses	[0.16] %	[0.16] %
Total	[0.35] %	[0.35] %

* The **transactional sales charge** is set in consultation with the distribution channel. A dealer concession is customary but will not apply to fee-based accounts. The Sponsor often retains a small portion of this fee to offset certain distribution costs.

** The **creation and development fee** is paid to the Sponsor for creating and developing the series. "C&D" includes determining the series' objective, policies, composition and size, selecting service providers and information services and the performance of certain administrative and ministerial functions.

*** **Estimated organization costs** will vary depending on the size and makeup of an individual series. Legal costs, auditor costs, and the cost of blue sky registrations are included here.

**** **Annual operating expenses** change little by series. Some out-of-pocket expenses (i.e. printing and distribution, legal, tax preparation, final audit and any required customization) will tend to shrink as the size of a series grows or the complexity of its structure and underlying portfolio wanes.

FIGURE 2.[128]

126. *See, e.g.*, Prospectus, Advisors Corporate Trust, Investment Grade 3-7 Year, Series 4 – A Hartford Investment Management Company ("HIMCO") Portfolio, Advisors Disciplined Trust 1727 at 29, (July 29, 2016) https://www.aamlive.com/FISDocuments/FISDocuments/SecurityMaster/52481878/ADT%201727%20Prospectus%20(002).pdf [HTTPS://PERMA.CC/WA9A-KBE5] (summarizing the various expenses applicable to a typical UIT series).

127. This table is offered for illustrative purposes only and does not reflect the actual fees and expenses of any particular product offering.

128. Author created.

A UIT's sponsor and principal underwriter are also subject to the standards of Section 36 of the Investment Company Act, which establishes a fiduciary duty with respect to the compensation for services and for material payments.[129]

D. *The Commercial History of the Unit Investment Trust*

The first true U.S. investment companies of any size or consequence appeared in the 1920s, with new funds being created "at the rate of almost one a day."[130] Following the market's crash in the wake of Black Tuesday, investors focused attention on products with features of safety.[131] The open-end fund's redeem-ability daily at its net asset value, and the fixed trust's elimination of management, held particular appeal for a skeptical investor class.[132]

Fixed trusts flourished in the early 1930s, largely as a "reaction against the excesses of managed investment companies."[133] Catalyzed by pervasive newspaper, magazine, mail and radio advertisements, over $600 million in trust certificates were issued in the first two years of that decade alone.[134] These early predecessors of the unit investment trust "essentially served as vehicles through which one could invest in common stocks, particularly securities listed on the New York Stock Exchange."[135] The trust vehicle enabled investors to pool monies and buy portfolios in smaller slices. Yet, these trusts quickly met controversy, with excessive fees and inappropriate advertising threatening the viability of the fixed trust structure.[136] Abuses continued to plague unitized trusts of the early 1930s,

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129. *See* Regulation and Operation Memo, *supra* note 61, at 24-25 (summarizing the fiduciary standard and the process by which a plaintiff may be granted relief).

130. THOMAS P. LEMKE, GERALD T. LINS & THOMAS A. SMITH III, REGULATION OF INVESTMENT COMPANIES 1 (rev. ed. 1997).

131. *See* Harman, *supra* note 7, at 1051 (noting that "[f]ixed trusts capitalized on the public's distrust of management by emphasizing the trusts' "fixed" nature: investors got what they saw and could rest assured that no management would later or tinker with their investments.").

132. *Id*. at 1-2.

133. *See* Regulation and Operation Memo, *supra* note 61, at 3.

134. *See* JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM COLUMBUS TO THE ROBBER BARONS 238 (2002) [hereinafter MARKHAM, A FINANCIAL HISTORY] (discussing confederate finance and confederate debt from the mid-to-late 1800s). *See also* H.R. DOC. NO. 76-567 (1940) (discussing the rapid growth and development of fixed trusts in the United States and the contributory factors).

135. Harman, *supra* note 7, at 1047.

136. MARKHAM, A FINANCIAL HISTORY, *supra* note 134.

and their popularity diminished until a new regulatory regime was ushered in with the Investment Company Act.[137]

With the adoption of the Investment Company Act, "unit investment trusts" were classified as one of three forms of an investment company. These trusts gained in popularity over the next two decades, but "their raison d'être had completely changed."[138] The UIT had become a funding vehicle utilized to purchase interests in either the stock of a single industrial corporation or a particular mutual fund.[139] These trusts issued "periodic payment plan certificates" as "a mechanism for buying something else on an installment basis."[140]

The 1960s brought the next incarnation for the UIT vehicle, with the trusts employed to provide investors the only tax-exempt means of obtaining a diversified portfolio of municipal bonds.[141] With the marginal tax rate on the wealthiest Americans topping 90% for most of the decade, the UIT business relished a prosperous momentum as the preferred vehicle of tax efficiency.[142] In addition to the tax benefits, municipal bond UIT investors enjoyed the protections afforded by the Investment Company Act – as the municipal bond market remained virtually unregulated prior to the creation of the Municipal Securities Rulemaking Board (MSRB) in 1975.[143]

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137. *See* JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS: FROM ENRON TO REFORM 422 (2006) (describing one commentator referring to the Investment Company Act of 1940 as "the most intrusive financial legislation known to man or beast.").

138. Harman, *supra* note 7, at 1052.

139. *See The Unit Investment Trust: Maintaining Integrity Through Time*, Olden Lane Whitepaper No. 1, 5 (Jan. 2016) [hereinafter Olden Lane No. 1] (noting the UIT had become a funding vehicle for purchasing interests in stock or single companies or mutual funds).

140. Harman, *supra* note 7, at 1052 (noting that by 1964, over seventy-five percent of the $2.9 million active UIT assets were invested in investment companies other than UITs, most of which were mutual funds).

141. Olden Lane No. 1, *supra* note 139, at 5 (noting that municipal bond related UITs enjoyed a preferred status in the marketplace until the Tax Reform Act of 1976 finally clarified that mutual funds could pass through income from municipal bonds on the same tax-free basis as investment companies organized as trusts).

142. *See generally U.S. Individual Income Tax: Personal Exemptions and Lowest and Highest Tax Bracket Tax Rates and Tax Base for Regular Tax, Tax Years 1913-2015*, TAX POLICY CENTER, http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543 [HTTPS://PERMA.CC/LQR2-RJ3E] (featuring a chart laying out the tax statistics for the relevant time period).

143. *See generally* Municipal Securities Rulemaking Board, *Creation of the MSRB*, http://www.msrb.org/About-MSRB/About-the-MSRB/Creation-of-the-MSRB.aspx [HTTPS://PERMA.CC/3C8Q-GTDK] (outlining the history of the MSRB). *See also* Philip Grommet, *A Call for Action: An Analysis of the Impending Regulatory Crisis in the Municipal Securities Market*, 38 J. LEGIS. 237, 248 *et seq.* (2012) (describing the regulatory

The pooling effect of UITs, stuffed with portfolios of municipal bonds, offered investors protection from the idiosyncratic risk of single bond positions and again provided access to a market that would have otherwise remained beyond their reach.[144]

A combination of historically high interest rates, changing perceptions in sources of retirement funding and an uninspiring equity market in the 1970s motivated individual investors to seek high levels of current income.[145] In an effort to meet this market need, the first corporate bond and preferred stock UIT came to market in 1972.[146] The first UIT with government securities followed in 1978.[147]

UIT sponsors pivoted again in the 1980s, embracing equities and equity-related strategies in response to evolving investor tastes. One of the most successful and creative trusts followed AT&T's 1982 agreement to relinquish control of the Bell operating companies which provided local telephone service throughout the United States. In exchange for their AT&T shares, investors in these "Humpty Dumpty" trusts received when issued shares in the seven regional phone companies being spun out of Ma Bell. The Merrill Lynch Equity Income Fund First Exchange Series AT&T Shares offered these existing AT&T investors the opportunity to retain their economic exposure by exchanging AT&T shares for a unit investment trust constructed to hold a portfolio comprised of (i) shares of the "new" AT&T and (ii) shares of each of the newly created regional operating companies.[148] The product raised more than $1 billion.[149]

The first "Dogs of the Dow" UIT provided unitholders exposure to a basket of the poorest performing stocks in the Dow Jones Industrial Average over the prior year. This strategy also found great success, and

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history and ongoing challenges involving the regulation of the municipal securities market).

144. *See* Bureau of Labor Statistics, *CPI Inflation Calculator*, http://www.bls.gov/data/inflation_calculator.htm [HTTPS://PERMA.CC/RW6Y-HYEU] (providing data that municipal bonds typically trade in $100,000 round lots, making them virtually inaccessible to most individual investors and $100,000 in 1961 has the equivalent buying power of $808,458.19 today).

145. Olden Lane No. 1, *supra* note 139.

146. Olden Lane No. 1, *supra* note 139.

147. *See* Harman, *supra* note 7, at 1053 (noting that by 1986, over ninety percent of the 7,900 UIT series were invested predominantly in municipal securities). *See also* 2016 ICI Fact Book, *supra* note 8, at 20.

148. *See, e.g.*, Bill Barnhart, *'Phone Funds' Created to Cope with AT&T Stock and Spinoffs*, CHI. TRIB., Aug. 2, 1983, §3, at 3 (discussing the dissolution of AT&T and the division of shares); *Uncertain Times Ahead for AT&T*, ST. PETERSBURG TIMES, Aug. 15, 1983 (noting that the Merrill Lynch fund has been nicknamed the "Humpty Dumpty Fund" and commenting that "[g]oing this route offers simplicity and convenience").

149. Olden Lane No. 1, *supra* note 139.

marked a significant pivot by UIT sponsors to trusts based on well-defined strategies with back-tested results. Strategies applying screens to re-weight established indices based on specific attributes or factors soon flourished within the UIT wrapper. In a sense, these techniques amounted to a crude predecessor to today's "Smart-Beta" strategies.[150] Buy-write structures represented the next UIT innovation; offering unitholders a package comprised of a basket of long stock positions plus premium income generated from the sale of long term out-of-the-money call options (i.e. LEAPs) on the same stock. These strategies remain popular today for baskets of underlying stocks with maturities ranging from one and a half to two years.[151]

For the UIT business, the 1990s was highlighted by the birth of the exchange traded fund ("ETF"). Notably, the first ETFs were structured as UITs.[152] Over time, however, the ETF market evolved away from the UIT structure, finding its requirement that the investment manager attempt to replicate fully the underlying index by owning every constituent security overly inflexible. Product structures also balked at the structure's prohibition against reinvesting dividend proceeds in additional securities.

One of the most high-profile and creative attempts to incorporate the unit investment trust structure to meet an identifiable investor demand occurred in 1996. One determined financial professional set out to utilize the UIT to "allow small investors to own just a sliver of a single share" of Warren Buffett's much celebrated Berkshire Hathaway.[153] With the much-celebrated stock trading for more than $30,000 per share, Saul Katz was drawn to the pooling benefits of the UIT structure. He planned to buy shares of Berkshire Hathaway in a UIT and sell slices of the UIT to retail investors. Buffett resisted the plan, suggesting that the trust was against the long-term interest of existing Berkshire shareholders.[154] Later that year,

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150. *Id.*

151. In 2015 alone, First Trust registered six trusts under its "Capital Strength Buy-Write Portfolio" banner and raised almost $900 million in deposits. *See, e.g.*, Fact Sheet Capital Strength Buy-Write, FIRST TRUST 20 http://www.ftportfolios.com/retail/dp/dpsummary.aspx?fundid=10695 [HTTPS://PERMA.CC/H449-CSX2].

152. An example of a UIT is the SPDR S&P 500® ETF (SPY), the oldest, largest, and most traded ETF in the world. Other examples include SPDR MidCap 400® and SPDR Dow Jones Industrial Average.

153. Erik Holm and Anupreeta Das, *The Pitch for the Berkshire Trust: 'Mutual Funds, Schmutual Funds'*, WALL ST. J., Apr. 28, 2016, http://blogs.wsj.com/moneybeat/2016/04/28/the-pitch-for-the-berkshire-trust-mutual-funds-schmutual-funds/ [HTTPS://PERMA.CC/78PJ-6TFY].

154. *See* Berkshire Hathaway Inc., Chairman's Letter (Feb. 28, 1997) http://www.berkshirehathaway.com/letters/1996.html [HTTPS://PERMA.CC/R9W3-RPB9] (asserting that the UIT would likely cause a speculative bubble in Berkshire shares and

Berkshire frustrated the UIT scheme by announcing plans for a new class of B shares, which were initially the equivalent of 1/30th of the existing Class A shares of Berkshire.[155]

Equity portfolios first surpassed fixed income assets (including taxable and tax-free unit investment trusts) in 1998. By 2014, equity portfolios accounted for 85% of the assets in unit investment trusts, the highest share ever recorded.[156] UITs comprised of equity portfolios have now accounted for the majority of trusts over the past several decades.[157] The large majority of today's UIT products are focused on quantitative strategies,[158] asset allocation,[159] thematic sectors,[160] and income generation.[161] Unfortunately, existing product continues to be categorized rather crudely as "equity trusts" or "fixed income trusts," with equity trusts focused on domestic or international equities and, fixed income trusts further categorized as taxable or tax-free.[162] A chart of the UIT flows (by new deposits) from 1995 through year-end 2015 is provided in Figure 3 below:

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offering that "they would have used our past, and definitely non-repeatable, record to entice naïve small investors").

155. *See* Anupreeta Das, *Berkshire Hathaway Shareholders: Have You Thanked Samuel Katz?*, WALL ST. J., Apr. 28, 2016, http://www.wsj.com/articles/berkshire-hathaway-shareholders-have-you-thanked-samuel-katz-1461835801 [HTTPS://PERMA.CC/XEG7-T29J] (describing the decision to create a new class of B shares in 1996).

156. 2016 ICI Fact Book, *supra* note 8, at 185.

157. *See* 2016 Fact Book, *supra* note 8, at 20.

158. *See, e.g.*, Fact Sheet The Dow Target 10 Portfolio, October 2015 Series, FIRST TRUST, *available at* https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=4c30f941-b1c1-48d6-815e-08e02b473a34 [HTTPS://PERMA.CC/BG9V-DWPB] (revealing portfolio strategies and quantitative analyses).

159. *See, e.g.*, Fact Sheet, 60/40 Strategic Allocation Portfolio, 4th Quarter 2015 Series, FIRST TRUST, *available at* https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=cbf39986-c7a5-4511-9dd0-ad4b3913e96e [HTTPS://PERMA.CC/7R3H-SX2U] (showing an example of and UIT seeking to invest 60% of assets into common stocks and 40% into exchange-traded funds).

160. *See, e.g.*, Product Detail, *Global Technology Leaders Portfolio – Morgan Stanley,* INVESCO, *available at* https://www.invesco.com/static/us/investors/contentdetail?contentId=870f7f14b6dcf410VgnVCM100000c2f1bf0aRCRD&dnsName=us [HTTPS://PERMA.CC/5VQT-2ACZ] (showing a capital appreciation portfolio).

161. *See, e.g.*, Fact Sheet, *Nuveen Large Cap Dividend Portfolio*, INCAPITAL, 4Q 2015, *available at* https://www.incapnet.com/Pages/Public/PublicWebsiteDocumentFetch.aspx?FileId=da7a23eb-5b33-4651-97d1-7813e059a601 [HTTPS://PERMA.CC/6TV3-JNRK] (discussing the dividend portfolio for Nuveen).

162. Regrettably, precision has suffered as the equity category typically includes trusts with portfolios comprised of exchange traded funds, closed-end funds and business development companies.

	New deposits			
	Millions of dollars, annual			
Year	**Total trusts**	**Equity**	**Taxable debt**	**Tax-free debt**
1995	11,264	6,743	1,154	3,367
1996	21,662	18,316	800	2,546
1997	38,546	35,855	771	1,919
1998	47,675	45,947	562	1,166
1999	52,046	50,629	343	1,074
2000	43,649	42,570	196	883
2001	19,049	16,927	572	1,550
2002	11,600	9,131	862	1,607
2003	12,731	10,071	931	1,729
2004	17,125	14,559	981	1,585
2005	22,598	21,526	289	782
2006	29,057	28,185	294	578
2007	35,836	35,101	298	438
2008	23,590	22,335	557	698
2009	22,293	16,159	2,201	3,933
2010	30,936	25,003	928	5,006
2011	36,026	31,900	765	3,361
2012	43,404	40,012	1,236	2,157
2013	55,628	53,719	916	993
2014	65,529	63,991	624	915
2015	65,949	64,582	492	875

FIGURE 3.[163]

PART III

This Part offers a general discussion of two related markets; the structured notes market and the burgeoning markets for "alternative mutual funds". As a general matter, each of these product structures provides certain tradeoffs for an investor. Most recently, the structured notes market has struggled to attract flows,[164] and its growth potential might remain constrained by inherent limitations. By contrast, great excitement has accompanied the explosive growth of alternative mutual funds.[165] A brief

163. *Id.*

164. *See* discussion at 165, *infra*. *See, e.g.*, Daisy Maxey, *Advisers Gain Access to Complex Structured Products*, WALL ST. J., Mar. 13, 2013, http://www.wsj.com/articles/SB10001424127887323393304578358413092621452 [HTTPS://PERMA.CC/QHP8-ANJT] (describing a market that is still recovering from the losses investors bore following the Bear Stearns and Lehman Brothers collapses).

165. *See, e.g.*, Sam Diedrich, *'Alternative' or 'Hedged' Mutual Funds: What are They,*

examination of each follows.

A. *The Market for Structured Notes*

There exists no standardized definition of structured notes in the business or regulatory context, or in the federal securities laws.[166] Yet, structured notes are today found in the portfolios of a significant share of U.S. investors.[167] A "structured product" is generally understood to be an investment package comprised of a fixed income security and an exposure to an underlying asset usually achieved through a derivative.[168] The product's fixed income portion may provide for interest payments at specified rates and intervals, while the derivative provides for the payment, if any, due to the investor at the product's maturity. The underlying assets in a structured investment are "securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency."[169] A "structured note" simply describes a structured product issued in note form, where the requirement to pay the return is the obligation of the note's issuer.[170] Today, the structured note

How Do They Work, and Should You Invest, FORBES, Feb 28, 2014, http://www.forbes.com/sites/samdiedrich/2014/02/28/alternative-or-hedged-mutual-funds-what-are-they-how-do-they-work-and-should-you-invest/#1c4edadd6200t [HTTPS://PERMA.CC/N6F2-6Y2P] (crediting these funds with "unleashing a new gold rush of sorts for alternative asset managers.").

166. *See* Jennifer Bethel and Allen Ferrel, *Policy issues Raised By Structured Products* 1, (Harv. Law Sch., Discussion Paper No. 560, 2007) ("A structured product has no precise definition, either in a business or a regulatory context."). Certainly, the typical structure qualifies as a security for purposes of the act, as "notes" are one of the particularly prescribed classes of assets named within the "security" definition in Section 2(a)(1) of the Securities Act.

167. *See, e.g.*, Craig McCann and Dengpan Luo, *Are Structured Products Suitable for Retail Investors?*, SECURITIES CONSULTING AND LITIGATION GROUP (2006) http://www.slcg.com/pdf/workingpapers/StructuredProducts.pdf [HTTPS://PERMA.CC/9CCW-J4HU] ("Sales of structured products have soared in recent years as brokerage firms have found a retail market for products once sold only to sophisticated investors.").

168. *See* Kevin Dugan, *Investors seek rules-based indexes to beat stock gains, diversify*, BLOOMBERG, Dec. 12, 2013, http://www.bloomberg.com/news/articles/2013-12-12/investors-seek-rule-based-indexes-to-beat-stock-gains-diversify [HTTPS://PERMA.CC/B93Z-6KSU] (noting that "[b]anks create structured notes by packaging debt with derivatives to offer customized bets to retail investors while earning fees and raising money.").

169. NASD Notice to Members 05-59, *Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products*, FIN. INDUS. REG. AUTH., Sept. 2005, at 8 n.1. *See also* Bethel and Ferrel, *supra* note 166, at 1 (defining a structured product as "a security derived from or based on another security (including a bond), basket of securities, index, commodity or foreign currency.").

170. *See* FINRA, *Investor Alert, Structured Notes with Principal Protection: Note the*

market in the United States is a significant (yet stagnant) source of capital for many bank issuers, with approximately $43.5 billion in face amount of structured notes issued in the United States in 2015.[171]

Structured notes are regularly included within a broader investment portfolio and are employed as a means to achieve specific asset allocation objectives. For example, investors who are confident in a particular market view, but only for a limited time horizon, might prefer an exposure that will appreciate significantly if the market view is realized, but will terminate or can be liquidated within a reasonable time if the expected result does not come to pass.[172] A structured note might be employed effectively to provide an investor: (i) a payout tailored to protect against a decline in the price of the underlying asset, (ii) enhanced exposure (i.e. a leveraged return) to the underlying asset, (iii) yield enhancement in the form of a coupon, or (iv) a bespoke payout different from the standard return available from buying or selling a position in the underlying asset.[173] In fact, structured notes allow investors the flexibility to tailor investment exposures to a market view, or to employ a tactical strategy in response to challenging market environments.[174] Particular offerings can be designed to provide full or partial principal protection, leveraged exposure, or to hedge a market risk held elsewhere in an investor's portfolio. Structured

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Terms of Your Investment, (2011), http://www.finra.org/investors/alerts/structured-notes-principal-protection-note-terms-your-investment#sthash.mc8FyeEQ.dpuf [HTTPS://PERMA.CC/8W2N-PQDS] ("Structured products in general do not represent ownership of any portfolio of assets but rather are promises to pay made by the product issuers."); *see* also Michael C. Macchiarola, *Rethinking Sports Wagering*, 85 IND. L. J. SUPP. 1, 10 (2010) ("In the typical case, a structured note allows an investor to make an initial investment in exchange for an issuer's obligation to pay an amount at maturity. The amount due at maturity will usually depend upon certain contingent events and their magnitudes."); *see also* Sidley Austin, *Accessing the U.S. Capital Markets–Securities Products: An Introduction to United States Securities Laws* (2009) at 76 [hereinafter, Sidley Austin, *Accessing*]; *see* also Frank Armstrong III, *Structured Notes Buyers Beware*, FORBES (Nov. 30, 2012, 5:14 PM), http://www.forbes.com/sites/greatspeculations/2012/11/30/structured-notes-buyers-be-warned/#4504a81d210c [HTTPS://PERMA.CC/93FT-KPGE] ("A structured note is an IOU from an investment bank using derivatives to create the desired exposure to one or more investments.").

171. This represents a significant decline from a market that regularly enjoyed more than $100 million of annual issuance prior to the financial crisis of 2008. *See* Bloomberg Brief, *Structured Notes*, BLOOMBERG 7 (Jan. 14, 2016) ("[B]anks sold $43.5 billion of SEC-registered notes last year.").

172. *See* SCOTT Y. PENG & RAVI E. DATTATREYA, THE STRUCTURED NOTE MARKET: THE DEFINITIVE GUIDE FOR INVESTORS, TRADERS AND ISSUERS 302 (1995).

173. Michael C. Macchiarola, *Securities Linked to the Performance of Tiger Woods? Not Such a Long Shot*, 42 CREIGHTON L. REV. 29, 52-53 (2009) [hereinafter, Macchiarola, *Securities*].

174. *Id*. at 53.

notes are also employed as access products to "provide investors with an opportunity to access asset classes, such as commodities and foreign currencies, which have been primarily available solely to institutional investors in the past."[175]

A structured note requires an initial investment in exchange for the obligation of an issuer to pay an amount at maturity. Generally, the amount due at a note's maturity is "dependent upon certain contingent events and their magnitudes."[176] In addition to meeting the demand for tactical point-to-point investing, these products have had great allure for an issuer, for whom an investor's initial investment represents a cash inflow at the time of the note's issuance.[177] In recent years, however, this flow's desirability has been less certain as large balances can lead to undesirable capital treatment for bank issuers.[178]

The market for structured notes has not been without controversy. In recent years, criticism has focused on several attributes which might make the structured note wrapper less desirable than it first appeared. Critics have charged that structured notes have shortcomings in the areas of credit risk, liquidity and price transparency.[179] Others have pointed to "perceived

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175. *Id.* *See also* Sidley Austin, *Accessing*, *supra* note 170, at 76-77 (naming tax simplification and overall portfolio diversification as additional potential benefits to the structured notes purchaser).

176. Macchiarola, *Securities*, *supra* note 173, at 53.

177. *Id.*

178. *See, e.g.*, John Glover, *Biggest Banks to Gain Flexibility in FSB Too-Big-to-Fail-Fix*, BLOOMBERG (Sept. 8, 2015, 8:07 AM), http://www.bloomberg.com/news/articles/2015-09-08/biggest-banks-to-gain-flexibility-in-fsb-s-too-big-to-fail-fix [HTTPS://PERMA.CC/V4HY-9G4J] (*quoting* Head of Structured Bond Trading at Citigroup Inc., London, Bhaavit Agrawal) ("[I]f structured bonds are not going to be TLAC eligible, banks that rely on structured notes for a sizable part of their funding and need to raise TLAC will have to change their funding mix."). *See also* Michael Watt, *Structured Products Market Wary of TLAC Threat*, THE BANKER (July 1, 2015, 10:36 AM), http://www.thebanker.com/Markets/Capital-Mkts/Structured-products-market-wary-of-TLAC-threat?ct=true [HTTPS://PERMA.CC/7QEX-MY4C]. *See generally* Kevin Buehler et al., *Between Deluge and Drought: The Future of US Bank Liquidity and Funding* 5 (McKinsey Working Papers on Risk, No. 48, 2013) (noting a dramatic decline in bank reliance on short-term funding following the financial crisis in response to regulatory and market pressures). On October 30, 2015, the Federal Reserve Board issued its notice of proposed rulemaking relating to certain United States bank holding companies. Among other things, United States' "systemically important banks" will be required to maintain a minimum amount of unsecured long-term debt and a minimum about of total loss-absorbing capital ("TLAC"). If structured notes remain ineligible for inclusion in the TLAC calculation when the final rule is adopted, either the notes will have to be reshaped to qualify as something more TLAC-friendly or a different unsecured debt will have to be issued in their place.

179. *See generally* SEC, INVESTOR BULLETIN: STRUCTURED NOTES (2015) [hereinafter SEC, *Investor Bulletin*].

and structural inefficiencies" that are "holding back latent demand for structured investments."[180] Each criticism is described briefly, in turn, below.

Structured note investors assume the credit risk of the issuing bank. Since structured notes place the holder in the position of general unsecured creditor of the issuer, investors bear the risk should an issuer fail to repay the debt when due. This means that a structured note's "underlying derivatives could have a positive return but the notes could still be worthless which is exactly what happened to investors in Lehman Brother's notes sold by UBS prior to its collapse."[181] Accordingly, investors should consider that a structured note adds a layer of credit risk on top of the market risk embedded in the underlying derivatives.

A structured notes issuer often commits to provide secondary market liquidity during the note's term. While a secondary market provides investors some assurance of liquidity, such a provision is far from ensuring the ability to sell notes prior to maturity at a particular price. As a practical matter, noteholders are more frequently provided something less than an express promise of a secondary market and, therefore, should be prepared to hold a structured note to its maturity date. Even when a secondary market is provided, noteholders risk selling at a steep discount to a note's value at the time of sale. In practice, since structured notes rarely trade after issuance, their liquidity is far from reliable. And, while most investors expect to hold structured notes to maturity, unforeseen circumstances do arise and "personal emergencies do happen."[182] In such circumstances, a selling noteholder is subject to the non-transparent pricing of an unreliable secondary market established by the note's issuer,

180. *See* Joseph Halpern & Lawrence Solomon, *Deconstructed Notes*, EXCEED INVESTMENTS (Jun. 19, 2014), http://exceedinvestments.com/exceed-investments-survey-finds-additional-advisor-demand-for-structured-investments-provided-inefficiencies-are-addressed/#forward. [HTTPS://PERMA.CC/S88B-JPDG] (finding additional advisor demand for structured investments provided inefficiencies are addressed).

181. Armstrong III, *supra* note 170. *See also* Jonathan Stempel, *UBS to Pay $120 Million in Settlement Over Lehman Notes*, REUTERS (Aug. 9, 2013, 11:18 AM), http://www.reuters.com/article/us-ubs-lehman-settlement-idUSBRE9780KP20130809 [HTTPS://PERMA.CC/5BQY-AYEJ] (describing an arrangement in which UBS agreed to pay $120 million to settle claims that it misled investors about the financial condition of Lehman Brothers Holdings Inc. in connection with the sale of structured notes); Elaine Moore, *Banks Increase Structured Product Offers*, FIN. TIMES (Feb. 3, 2012), https://www.ft.com/content/bc3c3ab4-4c34-11e1-bd09-00144feabdc0 [HTTPS://PERMA.CC/V3VV-JXLM] (noting that awareness of counterparty risk "has increased since Lehman Brothers collapsed in 2008, and defaulted on its structured products pay-outs.").

182. Armstrong III, *supra* note 170.

"assuming they are willing or interesting in making an offer at all."[183] Finally, adding to the opacity of pricing, notes are often valued by a pricing matrix or proprietary pricing formula which can result in a value quite different than the net asset value calculated pursuant to the more robust valuation requirement of a registered fund.

In addition to the aforementioned structural challenges confronting the notes market, the regulatory environment for structured notes has turned decidedly challenging in recent years, requiring today's bank issuers to satisfy mistrustful regulators. In a recent Investor Bulletin, the SEC's Office of Investor Education and Advocacy highlighted several of the most prominent potential risks of a structured note investment. The Bulletin identified specifically market risk, complexity, valuation, payoff structure, liquidity and credit risk.[184] In May 2015, the Chief of the SEC's Office of Capital Markets Trends delivered a speech to an industry group further addressing a variety of issues involving structured notes.[185] While the SEC principally regulates prospectus disclosures, SEC staff has gone further in recent years, encouraging issuers to consider whether each new product (i) "make[s] sense" for retail investors, (ii) can be readily explained to investors who are not sophisticated, (iii) is appropriate for sale to retail investors at all and (iv) is correctly priced or could be replaced with a lower cost alternative.[186]

In October 2015, the SEC brought its first case against an issuer of retail structured notes. UBS, one of the largest structured notes issuers, agreed to pay $19.5 million to settle charges that it made false or misleading statements and omissions in offering materials provided to investors in structured notes linked to a proprietary foreign exchange trading strategy.[187] In June 2016, the SEC agreed to a settlement whereby Merrill Lynch agreed to pay a $10 million penalty in connection with false and misleading statements in the offering materials provided to retail

183. *Id.*

184. *See* SEC, *Investor Bulletin*, *supra* note 179.

185. Amy M. Starr, *Structured Products – Complexity and Disclosure – Do Retail Investors Really Understand What They are Buying and What the Risks Are?*, SEC (May 14, 2015), https://www.sec.gov/news/speech/speech-amy-starr-structured-products-.html [HTTPS://PERMA.CC/MF8Q-DNAH].

186. In her speech, Ms. Starr also noted the growth in the use of proprietary indices in certain structured notes, and challenged market participants to ensure that (i) disclosure of the key features of the index, including embedded fees and costs, are understandable to retail investors, (ii) the brokers and advisors selling the products understand the nature of product, and its risks and (iii) broker-dealer policies relating to sales and supervision are properly implemented to ensure that proper sales practices. *Id.*

187. *See* Press Release, *UBS to Pay $19.5 Million Settlement Involving Notes Linked to Currency Index*, SEC (Oct. 13, 2015) (on file with author).

investors for the structured notes linked to a proprietary volatility index.[188] Together, the two enforcement actions highlight the fact that the issuing and hedging activities performed by banks in connection with structured notes present many opportunities for manipulation and conflicts of interest. As a result, at least one market observer expects "regulatory attention to continue" around the creation and distribution of structured notes.[189]

B. *The Market for Alternative Mutual Funds*

The recent growth of alternative mutual funds has been impressive by any measure. From a base of less than $40 billion around the time of the 2008 financial crisis, alternative investment mutual funds have now grown to nearly $300 billion, with a compounded annual growth rate of more than 40% during the period.[190] Moreover, the combination of increasing investor awareness and appetite, and the continued variety and improvement in available offerings, is likely to ensure that growth of this category continues into the future.[191]

It is notable that the growth of these funds accelerated in the years following the financial crisis. Much of their appeal can be attributed to the relative performance of several particular alternative strategies versus the

188. *See* Press Release, *Merrill Lynch Paying $10 Million Penalty for Misleading Investors in Structured Notes*, SEC (June 23, 2016) (on file with author).

189. *See The SEC, Structured Products, Disclosure, and Retail Investors*, (Morrison & Foerster, Structured Thoughts News Bulletin, Vol. 6, Issue 4), June 23, 2015, at 5. While beyond the scope of this Article, additional pressure on the structured notes market is likely to come from the recently proposed regulations of the Department of Labor concerning the fiduciary duty owed to employee benefit plans. It is likely that these proposals will result in an unfavorable treatment for structured products purchased with retirement monies. *See generally* Peter E. Haller et al., *The Department of Labor Re-Proposes Fiduciary Rulemaking for Employee Benefit Plans and IRAs*, WILLKIE FARR & GALLAGHER LLP 5 (May 8, 2015), http://www.willkie.com/~/media/Files/Publications/2015/05/The_Department_of_Labor_Re_Proposes_Fiduciary_Rulemaking.pdf [HTTPS://PERMA.CC/E9WC-CWBS].

190. Citi Investor Services: Business Advisory, *The Rise of Liquid Alternatives: Presentation to CAIA in Chicago*, 4 (May 21, 2014), http://dailyalts.com/wp-content/uploads/2014/08/Citi-Rise-of-Liquid-Alternatives.pdf [HTTPS://PERMA.CC/7LPV-5BCC]. *See also Finding a New Balance with Alternatives*, BMO GLOBAL ASSET MANAGEMENT 1 (Apr. 2016), http://bmogamviewpoints.com/wp-content/uploads/2016/04/BMO-Finding-a-New-Balance-Whitepaper-2016_R6.pdf [HTTPS://PERMA.CC/3YVG-TA55] (observing that liquid alternative funds grew from $50 billion in 2006 to $310 billion in AUM in 2015).

191. *See, e.g.*, Barclays, *supra* note 47 (noting strong growth related to these assets). In fact, some speculate that assets in these funds will exceed $1 trillion in 2018. *E.g.*, Citi Investor Services, *supra* note 190, at 26 (anticipating assets in these funds to increase to $1.2 trillion).

outsized losses in the equity markets during the crisis.[192] To a certain extent, the financial crisis catalyzed this newline of business and validated its defensive *bona fides* as part of an overall portfolio".[193] In this regard, the category's acceleration represents the tangible manifestation of the non-correlation that is today becoming a portfolio requisite.[194]

Given the robust and sustained performance of the equity markets since 2008, however, alternative asset classes have confronted some performance disappointments.[195] The strong equity performance has also deemphasized the need for protection within a portfolio in the minds of many investors.[196] The high cost of the delivery vehicle has also frustrated the return expectations for the liquid alternative funds category, as mutual funds provide an expensive "wrapper" for relatively expensive alternative strategies.[197] Despite their impressive growth, many perceptive observers have begun to question whether flows into the space are beginning to

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192. In 2008, for example, the S&P500 Total Return Index lost 37.00% of its value while the Barclays BTOP 50 Index, representing the largest commodity trading advisors, returned 13.58%. *See Managed Futures: The Potential Benefits of a Short and Long Term Perspective*, EQUINOX FUNDS 4-5 (2016), http://equinoxfunds.com/sites/default/files/Insights_MF%20Potential%20Benefits.pdf [HTTPS://PERMA.CC/2TYP-NLWJ] (comparing the performance of various asset classes over the past 15 years).

193. *See* Olden Lane No. 2, *supra* note 50, at 5.

194. *See* Morningstar and Barron's, *supra* note 57, at 37 ("Once again, diversification/low correlation remains the top driver for investing in alternatives.").

195. According to the *Financial Times*, "the average fund [in the category] lost money, regardless of whether the sector is measured over one, three, five or 10 years." *See* Stephen Foley & Mary Childs, *Liquid Alternative Mutual Funds Leave Investors Disappointed*, FIN. TIMES 1 (May 22, 2016), https://www.ft.com/content/a485f82e-1d18-11e6-a7bc-ee846770ec15 [HTTPS://PERMA.CC/FQQ2-GRE2].

196. *See* Morningstar and Barron's, *supra* note 57, at 4 (observing the disappointing performance of the "average" fund).

197. *See* Sulzbach & Masterson, *supra* note 26, at 1 (explaining that "although alternative mutual funds offer investors potential portfolio diversification and return benefits, they generally have high fees and expenses and pose unique risks such as volatility, the use of leverage, and potentially less liquidity that investors and their financial advisers must evaluate.")*; see also* Olden Lane No. 2, *supra* note 50, at 5 (observing that, even allowing for the general prohibition on most forms of incentive fees in mutual funds, the combination of fees in these funds inevitably compromise returns, especially if we are entering a period of lower global growth and correspondingly lower market returns, and further observing that "[e]fficiency in content and structure then become the contemporary investment imperative."); Dan Weil, *Alternative Mutual Funds: Are They Worth It?*, BANKRATE (Oct. 16, 2014), http://www.bankrate.com/finance/investing/are-liquid-alternative-mutual-funds-worth-it.aspx [HTTPS://PERMA.CC/P2CA-7JSZ] (reporting average expense ratio of 1.78 percent for liquid alternative funds versus 1.31 percent for actively managed equity funds).

plateau.[198] Yet, new market entrants continue to be drawn to the category and fund creation progresses in earnest.[199] Liquid alternative mutual funds have also been forced to confront a growing wave in favor of passive over active management. By one report, in calendar year 2015 alone, passive index mutual funds and ETFs brought in $365 billion of new money while actively managed funds suffered net outflows.[200] Finally, the flow trends suggest that certain liquid alternatives investors "aren't always taking a long-term approach to alternatives,"[201] instead preferring a more tactical approach. Such a strategy might be at odds with the perpetual nature of the current set of available offerings, the rhythm of the offering calendar and their underlying fee schedule.

"Fixed income plus derivative" style products, resembling the attributes of a structured note, have already been sold successfully in both open-end and closed end fund wrappers. The giant asset manager, PIMCO, for example, has offered open-end funds under its "StocksPLUS" and "IndexPLUS" banners for more than twenty years.[202] These funds mean to blend active and passage management through the ownership of a package of assets comprised of (i) fixed income plus (ii) derivatives linked to a market benchmark. Generally, the goal of these funds is to offer investors a total return that exceeds the relevant benchmark.

In January 2012, Eaton Vance successfully raised $26 million for the "eUnits™ 2 Year U.S. Market Participation Trust: Upside to Cap / Buffered Downside."[203] Offered in a closed-end fund wrapper, the eUnits™ represented "a new type of exchange-traded structured investment . . . seek[ing] to enable holders to participate in the returns of a specified market benchmark over a defined term, typically up to a cap,

198. Morningstar and Barron's, *supra* note 57, at 16 ("While this sudden deceleration is significant, alts still grew at the fastest clip relative to all other asset classes."); *see also Liquid Alternative Investments Market Analysis & Performance Summary*, GOLDMAN SACHS ASSET MGMT. 1 (2015 Year End) ("After the turbulent markets of 2015, many liquid alternative fund investors, especially those new to the asset class, may be wondering whether these investment vehicles work.").

199. Morningstar and Barron's, *supra* note 57, at 5 ("Even as flows have moderated, fund companies continue to launch funds at a record clip.").

200. Eric Balchunas, *Passive Revolution*, BLOOMBERG BUSINESSWEEK (Dec. 14-20, 2015).

201. Morningstar and Barron's, *supra* note 57, at 4.

202. Today, PIMCO offers several equity-related strategy funds. For a comprehensive listing of the PIMCO family of funds and the related fund documents, *see* PIMCO, https://www.pimco.com/investments/mutual-funds [HTTPS://PERMA.CC/3LWY-PKWK].

203. SEC, 1933 ACT FILE NO. 333-163101, EUNITS™ 2 YEAR U.S. MARKET PARTICIPATION TRUST: UPSIDE TO CAP / BUFFERED DOWNSIDE PROSPECTUS (2012), *available at*, https://www.sec.gov/Archives/edgar/data/1476721/000119312512024829/d288219dn2a.htm [HTTPS://PERMA.CC/664J-VUZS].

while reducing exposure to loss in the event of a decline in the benchmark."[204] Repeating the familiar structured investment of fixed income plus derivative, market exposures were achieved through a combination of third-party dealer contracts and a portfolio of term-matched U.S. Treasuries. Because of their closed-end fund structure, the eUnits™ were able to avoid the concentrated credit exposure that has plagued structured notes in recent years by diversifying the fund's derivatives transactions among multiple counterparties and requiring that each counterparty post collateral to secure mark-to-market obligations to the fund. Unlike more traditional closed-end funds, eUnits™ represented a fixed-term instrument with substantially fixed holdings. Care was taken to mitigate secondary market trading discounts by facilitating arbitrage within the structure versus a disclosed hedge portfolio. Eaton Vance completed a second eUnits™ offering in May, 2012, which raised just over $20 million.[205] Together, the eUnits™ product line attracted a variety of purchasers, including (i) regular structured notes buyers, (ii) individuals who had never bought structured notes, and (iii) individuals who had abandoned the structured notes market because of credit-related issues.[206]

Eaton Vance's eUnits™ offerings did not represent the first closed-end fund product with a structured return linked to the S&P 500® Index. Almost a decade earlier, Merrill Lynch led the highly successful sale of an "S&P 500® GEARED Fund," which offered a three times levered return to the index, subject to a maximum return. That offering raised $135 million.[207]

In November 2013, DoubleLine Capital employed the fixed income plus derivative structure to import the smart-beta strategy incorporated in a bank developed proprietary index in its DoubleLine Shiller Enhanced

204. Eaton Vance Launches First eUnits™, PR NEWSWIRE (Jan. 27, 2012), http://www.prnewswire.com/news-releases/eaton-vance-launches-first-eunits-138196254.html [https://perma.cc/L2T4-YD3K] [hereinafter Eaton Vance Release]. This offering allowed investors to participate in the upside of the S&P500® Index up to a maximum return of 17 to 23 percent. In the event that the index declined over the term of the offering, investors would not experience any loss in respect of any portion of such a decline that did not exceed 15 percent of the index' level at the portfolio's inception. *See also* 1933 Act File No. 333-163101, *supra* note 200 (explaining the eUnits™ trust investment program).

205. Eaton Vance Release *supra* note 204.

206. Discussions that the authors have had with various professionals involved in the distribution of these products confirms this to be the case. All discussions were conducted in confidentiality. Names of professionals are withheld to protect confidentiality.

207. Prospectus, S&P 500® GEARED Fund Inc. (Oct. 27, 2004), https://www.sec.gov/Archives/edgar/data/1299506/000119312504180131/d497.htm [HTTPS://PERMA.CC/F2WG-5PW4].

CAPE Fund.[208] The open end fund's strategy employs an "index overlay" technique to offer "exposure to the 'cheapest sectors' of the large cap equity markets" as determined by a proprietary index developed by Nobel Laureate and Yale Professor Robert Shiller in consultation with Barclays Bank.[209] The remaining assets of the fund are invested in a fixed income portfolio managed by the celebrated manager, Jeffrey Gundlach.[210] According to DoubleLine's website, "[b]oth segments of the portfolio offer a value play in their respective markets," as the Barclays Shiller CAPE® US Sector Index strives to outperform the S&P 500® Index and the managed fixed income portion of the fund strives to outperform cash.[211] In the end, the product hopes to offer "one diversified value product with two unique source of possible value."[212]

As these offerings of structured products in open end and closed end formats have highlighted, in certain circumstances, the fund structure can offer significant improvement over the typical structured note. Most notably, a structured fund offers the possibility for (i) decreased credit risk, (ii) enhanced transparency, (iii) a more investor-friendly investment process, and (iv) tighter secondary market pricing and liquidity versus the typical structured note. Such a structure also embraces an oversight regime, which includes the full participation of the SEC's Division of Investment Management, the professionals charged with the oversight of registered investment company products.[213] In fact, if the style of returns

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208. Summary Prospectus, Doubleline Funds, Doubleline Shiller Enhanced Cape, (Jul. 31, 2015), https://www.sec.gov/Archives/edgar/data/1480207/000119312515272421/d892910d497k.htm [HTTPS://PERMA.CC/KT8V-46QB]. Interestingly, the product was not the first to import a bank-developed proprietary index into an open-end structure. That honor seems to belong to the Equinox Commodity Strategy Fund, which was subsequently re-structured and closed unceremoniously in 2013. *See* Press Release, PR Newswire, Equinox Fund Management Announces Launch of Equinox Commodity Strategy Fund (June 13, 2011), http://www.prnewswire.com/news-releases/equinox-fund-management-announces-launch-of-equinox-commodity-strategy-fund-123748514.html [HTTPS://PERMA.CC/Y648-V47F]. *See also* Chuck Jaffe, *Nine Dumbest Mutual Fund Moves of 2013*, MARKETWATCH (Dec. 16, 2013, 9:22 AM), http://www.marketwatch.com/story/9-dumbest-mutual-fund-moves-of-2013-2013-12-13 [HTTPS://PERMA.CC/55BT-UMF5].

209. *Shiller Enhanced Cape*, DOUBLELINE, http://doubleline.com/shiller-enhanced-cape/ [HTTPS://PERMA.CC/SR9W-UB7H] [hereinafter Shiller].

210. For a biography of Robert Shiller, *see Short Bio,* http://www.econ.yale.edu/~shiller/bio.htm [HTTPS://PERMA.CC/LK3J-X2FQ]. For a colorful profile of Jeffrey Gundlach, see Roben Farzad, *Jeffrey Gundlach, Bond Savant*, BLOOMBERG (May 10, 2012, 8:15 PM), http://www.bloomberg.com/news/articles/2012-05-10/jeffrey-gundlach-bond-savant [HTTPS://PERMA.CC/R4LQ-HFFU].

211. *Shiller*, *supra* note 209.

212. *Id.*

213. *See generally US Securities and Exchange Commission, Investment Management, About the Office*, https://www.sec.gov/investment [HTTPS://PERMA.CC/38XK-VQDN]

offered by structured notes could be reliably packaged in UITs, the resulting products would solve many of the issues that typically befall today's structured notes offerings.

PART IV

This Article's main proposal – that *many of the return streams offered in today's structured notes or alternative mutual funds can be offered more reliably as unit investment trusts* – is not necessarily novel. In the first instance, it is born of an appreciation that the market's burgeoning opportunity is manifestly not more of the same. Instead, today's investors demand a renewed alignment with product sponsors, rooted in the understanding that active management has limited marginal utility in the public markets, especially when offered at a premium price point. Comparable value might be uncovered in an allocation to efficient vehicles to deliver defined outcomes and various sources of beta, ranging from traditional to alternative. Accomplished responsibly, such products might bring lower cost, and an increased transparency and liquidity. High fees over any meaningful interval of time only compromise returns, an effect that is ever pronounced in a prolonged low interest rate environment.[214]

This Article's proposal attempts to synthesize and scale ideas already introduced by others. At its core, this Article argues that the unit investment trust structure might be employed more tactically – beyond the industry's currently self-imposed limits. Done effectively, such an undertaking might steal market share from investment offerings that are today packaged, out of habit or otherwise, as open-end funds or structured notes.

Integrating structured products return types and the registered funds wrapper, in the form of unit investment trusts, addresses a substantial and rapidly developing opportunity in the retail marketplace.

When compared to structured notes, the structured unit investment trust presented in this Article offers potential improvement of an investors' experience through mitigated credit risk, improved transparency, and more reliable liquidity.

[hereinafter *Investment Management, About the Office*].

214. *See* Casey Quirk, *The Roar*, *supra* note 5, at 10 (explaining that "In highly regulated, fee-sensitive client segments . . . many allocators will use index-tracking instruments to replace more expensive, low-tracking-error active managers.").

A. *Constructing a Structured Unit Investment Trust*

Structured UITs will mimic the fixed income plus derivative nature of a structured note and still maintain fidelity to the fixed trust nature of the traditional UIT structure. Each structured UIT will be a fixed package of U.S. Treasuries (or other fixed income securities) and individually negotiated options contracts. The portfolio's composition will be specified in each trust's governing documents and described in detail in the relevant prospectus, which includes a summary of the option contract's material terms.

More specifically, a structured UIT might seek to achieve a particular investment objective by purchasing a combination of (i) U.S. Treasury obligations maturing on or shortly before the Trust's termination date and (ii) individually-negotiated over the counter options contracts linked to the performance of a particular underlying reference index, also expiring shortly before the Trust's termination. A basic diagram of the structured UIT is provided below as Figure 4. Depending on its investment objective, any such trust might seek to offer a specific level of protection and/or enhanced return, put in place at the time of investment and affording investors a controlled range of investment outcomes at the expiration of a limited term. Such alternatives would be imparted in a maximum gain,[215] contingent principal protection[216] and/or participation rate feature[217]

215. Maximum gain features limit the reference asset return available to a unitholder by setting a predefined maximum gain. In the event that the underlying reference asset exceeds the maximum gain for a given period, a unitholder will receive only the maximum gain amount/percentage.

216. Certain structured UITs may incorporate a contingent protection feature, designed to insulate the investor from incurring a principal loss if the value of the reference asset does not decline beyond a specified contingent protection level. In the event that the reference asset posts a negative return that exceeds the contingent protection level during the UIT's term, the unitholder will realize a principal loss (excluding sales charges and other upfront costs) equal to the loss of the reference asset beyond the contingent protection level. In such a case, the amount returned to a unitholder will be less than originally invested. For example, a structured UIT with a 70% contingent protection level implies that a unitholder will receive $1,000 per unit at the product's termination if the loss of the reference asset during the relevant period is not greater than 30% (i.e. 100% - 70%).

217. Certain structured UITs may employ a participation rate feature, allowing unitholders to participate in a proportion of the positive return of the reference asset in excess of 100%, as specified in a relevant prospectus and often quoted as a percentage (i.e., 120%). For a structured UIT with a participation rate greater than 100%, the return to the unitholder is calculated as the product of (1) any positive return of the underlying asset (or index) multiplied by (2) the participation rate. This feature allows unitholders to participate in an enhanced return of the underlying asset (or index), but will often be subject to an overall maximum gain.

embedded within the structured UIT's derivative agreements.

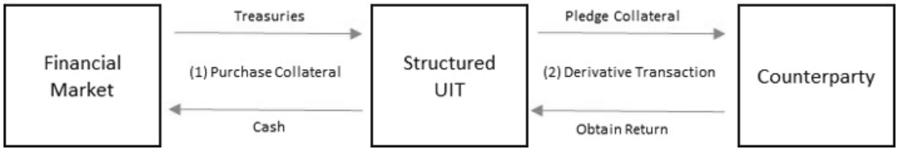

FIGURE 4.

Structured UITs might provide unitholders economic exposure similar to that available in the typical retail structured note, but with structural improvement. The $40 billion a year notes market in the U.S. has stalled over the past several years, with investors cautious about the credit risk of bank issuers, regulators increasingly hostile to sales practices and banks guarded about the balance sheet effects of note issuance.[218] The inclusion of U.S. Treasuries in the proposed structure ensures that unitholders will receive the principal component of the units in excess of any trust liabilities. And, as further depicted in Figure 5 below, each options contract may include a bilateral collateral arrangement whereby each party pledges to the other a security interest in a segregated collateral account held at an independent custodian. A typical arrangement will require each party to fund its respective collateral account to at least the amount of its net mark-to-market liability under the relevant options agreement on a daily basis. Options transactions constructed in this way limit the investor's credit risk exposure to a minimal amount and represent profound credit enhancement relative to a structured note where any return of invested amounts and capital gain takes the form of a general unsecured obligation of the financial company issuer. Counterparty risks may be mitigated further by diversifying the structured UIT's derivative exposure across multiple counterparties.

218. See discussion *supra* note 187. *See, e.g.*, Maxey, *supra* note 164 (describing the hesitation of certain investors to purchase notes following certain bank failures); Amy M. Starr, *supra* note 185 ("My office is concerned that for some complex indices or referenced assets or issuers there may be a lack of transparency about the index, asset or issuer at the time of issuance and on an ongoing basis."); John Glover, *Biggest Banks to Gain Flexibility in FSB Too-Big-to-Fail-Fix*, BLOOMBERG BUSINESS (Sep. 8, 2015), https://www.bloomberg.com/news/articles/2015-09-08/biggest-banks-to-gain-flexibility-in-fsb-s-too-big-to-fail-fix [HTTPS://PERMA.CC/SSQ6-V2FZ] (describing a new regulatory capital treatment for structured notes and its effects on banks).

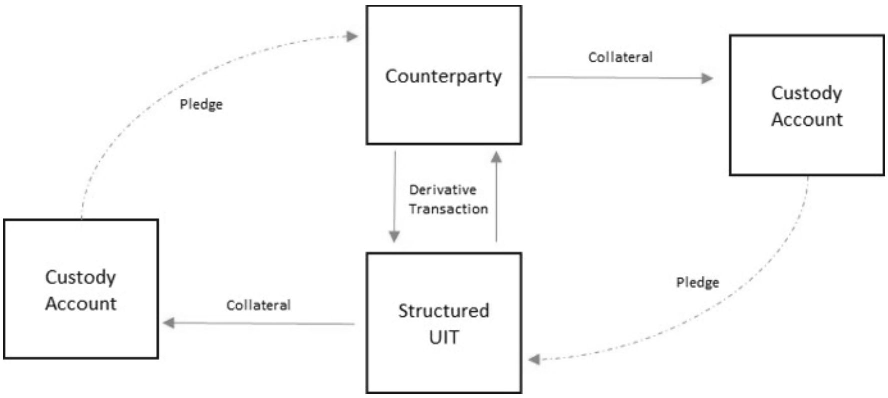

FIGURE 5.

Unlike most retail structured notes, products created as structured UITs offer both daily valuation and redemption rights based on net asset value in order to abide by the requirements of the Investment Company Act.[219] These features represent significant advantages relative to a structured note where limited secondary market liquidity may or may not be available at prices generally determined by the issuer or its affiliated broker-dealer rather than a robust market price.[220] Properly negotiated options agreements will afford a structured UIT elective rights to terminate a portion of its exposure on a daily basis and dispute rights in respect of unreasonable pricing determinations by the options counterparty. The integration of multiple counterparties in a structured UIT portfolio enhances price discovery to inform the UIT evaluator's determination of fair value and any decision by the sponsor to dispute a particular price. Thus, a structured UIT investor may confidently rely upon the right to redeem structured UIT units on a daily basis at the price determined pursuant to a robust valuation process governed by regulatory and accounting standards.

Finally, because any such UIT will be a registered investment company, it will offer unitholders more full transparency in respect of its design and the contents of its portfolio. The composition of a structured

219. Investment Company Act, § 22(e), 15 U.S.C.A. § 80a-22 (1987).

220. *See* JPMorgan Chase Financial Company LLC: Capped Buffered Enhanced Participation Equity Notes due 2018 Prospectus, https://www.sec.gov/Archives/edgar/data/19617/000095010316015535/dp67930_424b2-3p813.htm [HTTPS://PERMA.CC/EK8Q-CM22] (explaining "JPMS intends to offer to purchase the notes in the secondary market but is not required to do so. Even if there is a secondary market, it may not provide enough liquidity to allow you to trade or sell the notes easily. Because other dealers are not likely to make a secondary market for the notes, the price at which you may be able to trade your notes is likely to depend on the price, if any, at which JPMS is willing to buy the notes.").

UIT's portfolio and each holding's contribution to the initial net asset value of the UIT will be set forth in audited financial statements contained in the structured UIT prospectus.[221] The structured UIT prospectus sets forth applicable sales charges and trust expenses in a robust tabular format.[222] In addition, in the UIT market, sales commissions are charged as an amount added to the principal investment as opposed to an embedded fee, which is typical of most structured notes. As a result, such charges may become evident to an investor simply by comparing the issue price to the economic return profile of the product. Moreover, by moving these product types into the UIT universe, product disclosures would benefit from review and comment of the Commission's Division of Investment Management prior to the effectiveness of each new product offering, thus allowing the industry and regulators to work more closely in crafting plain English disclosures discernable to a greater number of investors. Today, structured notes offerings become routinely effective without any period of prior examination by the Commission staff.

Relative to an investment in a structured note, investors in a structured UIT would benefit from the express protections of various provisions of the Investment Company Act that make such harms much less likely, including but not limited to:

> (i) robust registration and disclosure requirements, providing for transparency to unitholders in the form of annual reports and portfolio schedules;[223]
> (ii) requirement that the UIT adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, appoint a Chief Compliance Officer to administer the policies and procedures, and review the policies and procedures;[224]
> (iii) strict limitations on the UIT's ability to enter into affiliated transactions;[225]
> (iv) requirement that the UIT adopt a Code of Ethics, approved by the depositor, and containing provisions reasonably necessary to prevent prohibited conduct;[226]

221. Securities and Exchange Commission, Form S-6, https://www.sec.gov/about/forms/forms-6.pdf [HTTPS://PERMA.CC/BX2A-8SGL].

222. *Id*.

223. Investment Company Act, § 24(f), 15 U.S.C.A. § 80a-24. *See* Regulation and Operation Memo, *supra* note 61, at 16-17 (describing the registration and disclosure requirements pursuant to Section 24 and Rule 24f-2).

224. Investment Company Act, 17 C.F.R. § 270.38a-1 (2003).

225. *See generally* Inv. Co. Act of 1940, § 17 (1987) (explaining the limitations on the UIT's ability to enter into affiliated transactions).

226. Investment Company Act, § 17j-1, 15 U.S.C.A. § 80a-17 (2012).

(v) stringent recordkeeping requirements, including obligation of UIT sponsor to maintain records and notify unitholders of substitutions of portfolio assets;[227] and
(vi) requirement that the UIT adopt and adhere to robust valuation policies and procedures with respect to the net asset value of the UIT portfolio.[228]

B. *Favoring the Unit Investment Trust Over Other Registered Investment Companies*

The unique attributes of the unit investment trust relative to other registered investment companies make it the most suitable vehicle for a structured fund.

The statutory requirement that a UIT maintain a relatively fixed, unmanaged portfolio provides investors with greater certainty and transparency in respect of the expected return in various market conditions than a managed fund can enable.[229] The fixed and transparent nature of the UIT portfolio is an important attribute for attracting structured product investors who expect fidelity to a defined return profile set in place at the time of investment. Such investors consider investment products in light of personal factors such as investment objectives, risk tolerance and time horizon. Similar to a structured note investment, investors may choose to make their investment in a structured UIT understanding that it remains protected from subsequent manipulation or modification.

Further, the absence of management helps to sanitize the structured UIT from conflicts of interest that impact other registered investment companies.[230] Unlike a managed fund, there is no investment manager paid a percentage of the value of the structured UITs assets. Therefore, UIT sponsors and evaluators have no incentive to manipulate fair valuation determinations to inflate values. UIT sponsors have no need to advertise

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227. Investment Company Act, § 26(a)(4), 15 U.S.C.A. § 80a-26 (2012).

228. Investment Company Act, § 2(a)(41), 15 U.S.C.A. § 80a-2 (2012).

229. *See* Harman, *supra* note 7, at 1051 (distinguishing fixed trusts from managed vehicles); *see also A Guide to First Trust Unit Investment Trusts*, FIRST TRUSTS, at 2, https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=2c0acb75-c76a-4dd2-b976-cbd5b975c202 [HTTPS://PERMA.CC/T9FH-BNUC] (suggesting that the fixed nature of the UIT provides the "comfort of knowing what you own and [] eliminate[ing] emotional investing" and allows investors to take greater control of overall exposures, and avoid concentrated positions and portfolio overlap).

230. See, e.g., LETTER FROM THE CHAIRMAN OF THE SEC, *supra* note 62 ("Management is ordinarily reduced to a minimum, because the controlling document, the trust agreement, usually specifies not only the securities in which the funds may be invested but also the specific number of each security which may be purchased.")

their investment management ability to the market. There is no incentive to manipulate valuations or investments to impact a performance track record. Simply, UITs do not afford any party the opportunity to manipulate the UIT portfolio in a self-interested manner.

The costs of investment management and the organization and function of an independent Board of Directors are eliminated from the structured UIT, allowing the product to operate more cost efficiently than managed funds. This structural efficiency is essential to compete with structured notes that may be offered at a minimal expense, and because the UIT does not require the infrastructure of a managed fund, the vehicle can be profitable for its sponsor with a much lower asset raise. Moreover, an issuer's commitment to a UIT product has a fixed term, meaning that the potential profitability of a product launch does not require a speculative assessment of likely investor appetite many years down the road.

Such features allow for the creation of bespoke product tailored to the investment goals and time horizons of a particular investor base and afford structured UIT sponsors the potential to contribute a more customized set of options for investors, more responsive to individual circumstances than any managed fund offering.

Finally, the possibility of the Rule 487 automatic effectiveness[231] allows the structured UIT to wring out much of the cost and uncertainty that regularly accompanies the more elastic creation time cycle of the typical managed fund. And, once the creation process is scaled and streamlined, the structured UIT creation time cycle should allow an issuer to craft timely offerings in response to evolving client tastes in a manner not available to even the most efficient open end fund operation. Such an accelerated schedule might allow a fund salesforce to be armed with timely thematic product at all times.

To date, only a handful of UIT offerings identifiable as "structured investments" have been brought to market. In October 2011, for example, Advisors Asset Management ("AAM") offered the Advisors Disciplined Trust 459, under the "Multi Enhanced Return Investment Trust, High 50" banner.[232] Believed to be the first offering of a UIT portfolio comprised of a fixed income allocation and a purchased derivative, the product invested in U.S. Treasuries and call options on a basket of fifty high dividend paying

231. Securities Act Release No. 6401, *supra* note 83, at 1.

232. *See* Advisors Disciplined Trust 459: Multi Enhanced Return Investment Trust, High 50 October 2011 Series Prospectus, http://pdf.secdatabase.com/193/0001013228-11-002015.pdf [HTTPS://PERMA.CC/DT8L-NWG9] (explaining that the Trust, offered in October 2011, invested in U.S. Treasuries and call options on a basket of 50 high dividend paying stocks and that the collective investment sought an enhanced total return. Barclays Bank PLC was the option counterparty).

stocks.[233] The product was tailored to provide investors what AAM termed "an enhanced total return."[234] Following Advisors Disciplined Trust 459, AAM brought an additional structured UIT offering to market in January 2013.[235] Advisors Disciplined Trust 927 invested in a portfolio comprised of U.S. Treasuries and credit derivatives that offered its investors a high yield contingent upon the occurrence of certain credit events related to a basket of fixed income securities.[236] These early efforts to market structured funds struggled to attract significant interest in the retail investment community due in part to a general wariness towards the complicated and aggressive strategies they employed.

In December 2012, Matrix Capital Group, Inc. ("Matrix") attempted to register a UIT that offered a similar return profile as the eUnits fund by investing in U.S. Treasuries and exchange traded options.[237] Matrix amended the registration statement for Matrix Defined Trust Series 20 four times between February 2013 and July 2014. The registration statement failed to gain effectiveness.[238] Subsequently, between September 2015 and April 2016, three other firms, including AAM, attempted to register offerings of structured UITs investing in portfolios of U.S. Treasuries and exchange traded options to achieve a structured return profile linked to the S&P 500® Index. None of these efforts have gained effectiveness to date.[239]

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233. *Id*.

234. *Id*. at 1.

235. *See* Advisors Disciplined Trust 972: ARBR Portfolio, Series 1 (Advisors Reference Bond Portfolio): http://www.sec.gov/Archives/edgar/data/1556132/000101322813000093/adt972-487.txt [HTTPS://PERMA.CC/A5C5-YEH5] (explaining that the Trust, offered in January 2103, invested in U.S. Treasuries and put options and call options on five specific corporate bonds. Société Générale was the option counterparty).

236. *Id*.

237. *See* Matrix Defined Trust 20: Convexcel SUIT℠ U.S. Treasury Strips and Index Option Trust, Series 1 Prospectus, https://www.sec.gov/Archives/edgar/data/1468678/000101322812002583/matrixprofinalwrap.htm [HTTPS://PERMA.CC/48WF-BFLY] (explaining that Matrix Defined Trust 50 is invested in zero coupon U.S. Treasury obligations and exchange traded options).

238. *See* Matrix Defined Trust 20: SEC File No: 333-185505, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1468678 [HTTPS://PERMA.CC/7DBS-LV7N] (showing the most recently revised prospectus for the investment tool).

239. *See* ALAIA Market Linked Trust 1 Prospectus, https://www.sec.gov/Archives/edgar/data/1652446/000121465915006525/a819150s6.htm [HTTPS://PERMA.CC/4BEP-9N58] (showing a prospectus filed by Beech Hill Securities attempting to register a UIT investing in U.S. Treasuries and exchange traded options); Elkorn Unit Trust, Series 6: Elkhorn IWM Vest 10% Buffered Return Portfolio Prospectus, https://www.sec.gov/Archives/edgar/data/1644051/000152862115003559/s6wraps.txt [HTTPS://PERMA.CC/J7SA-94UH] (presenting a prospectus filed by Elkhorn Securities attempting to register a UIT investing in U.S. Treasuries and exchange traded options);

In March 2015, Olden Lane Securities LLC, attempted to register a structured UIT offering that closely resembled the Eaton Vance eUnits by investing in individually negotiated structured option transactions with multiple counterparties to achieve a structured return profile linked to the S&P 500® Index.[240] The authors of this Article were closely involved in the efforts to register the offering of Olden Lane Trust Series 1. In July 2016, Olden Lane finally withdrew the registration statement after submitting six amendments and engaging in lengthy and exhaustive negotiations with the Commission staff between June 2015 and July 2016.[241]

In recent years, some of the most interesting innovations in the UIT space have been found in the efforts of several sponsors to include structured payouts within the UIT wrapper. When compared to structured notes, a structured fund offers the potential to improve the experience for investors.

However, all recent and current efforts to advance such innovations have confronted apparent resistance from the Commission staff and experienced prolonged delay or failure to gain effectiveness. The fate of these efforts reveals an apparent policy shift assumed by the Commission staff since the AAM and Eaton Vance offerings between 2011 and 2013. Yet, the specific policy changes steering the resistance of the Commission staff to such offerings remain opaque and absent from the Commission's formal rulemaking and public statements. The newfound hostility of the Commission staff to such innovations appears injudicious in light of the significant reduction of credit and liquidity risk that such innovations offer relative to registered structured notes, and the improved transparency and independence of structured UITs relative to commonplace retail structured product. The proclivity of the Commission staff to implement such policies through informal actions and communications designed to disrupt the registration of structured UIT offerings is a troubling development for the investment management industry. First, it signals a hostility to the Division of Investment Management's stated charge to facilitate

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Advisors Disciplined Trust 1682: ACE MLT℠ Portfolio Series 2016-1 Prospectus, https://www.sec.gov/Archives/edgar/data/1662283/000101322816004031/adt1682_fulls6main.htm [HTTPS://PERMA.CC/Y6CU-8LJR] (showing a prospectus filed by Advisors Asset Management attempting to register a UIT investing in U.S. Treasuries and exchange traded options).

240. *See* Olden Lane Trust 1: Cap Trigger Performance Portfolio Prospectus, https://www.sec.gov/Archives/edgar/data/1636919/000091412115000158/ol31884357-s6.htm [HTTPS://PERMA.CC/A2YK-2QCG] (showing registration statement filed by Olden Lane Securities for structured UIT).

241. *See* Olden Lane Trust 1: SEC File No. 333-202887, https://www.sec.gov/cgi-bin/browse-edgar?company=Olden+Lane+Trust&owner=exclude&action=getcompany [HTTPS://PERMA.CC/T6W6-ZH59] (noting Olden Lane Securities withdrawal request).

appropriate innovation in investment products and services through its regulation.[242] Moreover, it reveals an inclination to resist financial innovation in the shadows and avoid a public airing of the merits of such innovations and the formal policies that may be advisable to support or resist them.

PART V

Much work remains to refine and streamline a process by which alternative streams of return and smart beta solutions might be reliably and repeatedly packaged within structured unit investment trusts. Enough evidence exists, however, to intrigue many market observers as to the possibilities. When measured against the typical open-end mutual fund, the unit investment trust might offer a cheaper and more streamlined wrapper. With significantly lower costs for its issuer than an open end fund, the UIT offers a scalable package by which customized risk exposures to underlying assets might be neatly tailored in registered form, on a bespoke basis and with a non-perpetual life. These advantages play particularly well in an investment world clamoring for tailored solutions and fearful of over-building product into a distribution model requiring great expense and reliant on a sizeable headcount for success. And, when compared to structured notes, the UIT might provide its unitholders ease of use, improved liquidity and transparency and substantially mitigated credit risk.

While there are no certainties in the uncertain world of structured finance, the unit investment trust warrants a closer look by those eager to embrace the possible. Still, those excited by this Article's ideas would do well to recall the old adage: a million dollars of ideas ain't worth a dollar of execution!

242. *See generally*, Investment Management, About the Office, *supra* note 213.