

Hedging Nonqualified Deferred Compensation Plans

Executive Summary

- Nonqualified deferred compensation (NQDC) plans are attractive savings tools for executives' long-term wealth accumulation and retirement objectives. An NQDC Plan enables an executive to defer salary and/or bonus on a pre-tax basis and earn market-based returns on the deferrals.
- In addition to being an effective way to attract and retain talent, an NQDC Plan can create economic value for a company. By retaining the after-tax capital that has been deferred by the executive, a company can invest these deferred amounts back into its core business until NQDC Plan distributions occur. The NQDC Plan will create a positive economic value if the capital invested back into the company has a greater return than the NQDC liability reference investments.
- Tax regulations discourage formally funding NQDC Plans. Formally funding plan liabilities would trigger constructive receipt and require current tax payment by the employee.
- NQDC Plans create both economic and accounting volatility; companies who sponsor plans may decide a hedge of the NQDC liability is prudent to offset these risks. The NQDC Plan appears as an operating expense on the employer's income statement (above-the-line in Selling, General and Administrative expense, "SG&A"), and creates an increasing liability on its balance sheet until benefits are paid. The eventual payment of the benefits will result in a funding requirement. The change in the size of the NQDC Plan due to change in value of the underlying reference investments creates volatility on the plan sponsor's income statement.
- Traditionally, companies have chosen one of three methods of addressing their NQDC Plan liabilities: (i) continue to leave their plan unfunded / unhedged, (ii) informally fund their plan using taxable investments (while plan sponsors cannot formally fund the NQDC Plans, they can hedge using a variety of investments which require an upfront payment, which we refer to as "informally funding") or (iii) informally fund their plan using corporate-owned life insurance (COLI).
- Informally funding an NQDC Plan using mutual funds or COLI can be expensive as these methods tie up capital that could be reinvested back into the company's business. Both methods use scarce balance sheet capacity for investments that are not directly related to the company's core business. In addition, the income or earnings on COLI and mutual funds are typically recorded below-the-line in Other or Investment Income, not SG&A.
- Use of unfunded Total Return Swaps (TRS) is an attractive NQDC Plan liability hedging strategy alternative. Rather than informally funding the NQDC Plan liabilities with direct investments like mutual funds or COLI, the TRS is unfunded and emphasizes hedging the market risk attributable to the obligation in a tax and accounting efficient manner. Using the TRS largely eliminates the need to tie up balance sheet capacity in the NQDC liability, enabling the Company to invest the after-tax deferred compensation back into its core business.
- Hedging an NQDC Plan with a TRS can greatly reduce the cost of offering the plan and neutralizes its potential financial volatility. The TRS's flexibility, unfunded nature and tax-deferred benefits permit the plan sponsor to offer a high value NQDC Plan at a lower cost and with reduced risk and leverage to the company.

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About this White Paper

This *Hedging Nonqualified Deferred Compensation Plans* white paper was developed by BNY Mellon Global Markets, a derivatives market maker, and Analect Benefit Finance (ABF), a deferred compensation plan administrator and recordkeeper. This paper explores the various methods a plan sponsor can use to hedge its market-based nonqualified deferred compensation (“NQDC”) plans, the costs and benefits of each method, and the key decision factors. This paper has been written with the needs of finance and human resource professionals in mind. We conclude that using total Return Swaps (“TRS”) to hedge NQDC Plan liabilities is an innovative, efficient and valuable strategy for plan sponsors looking to minimize volatility while retaining capital to reinvest in their businesses.

What is a Market-Based NQDC Plan?

Overview

A deferred compensation plan is an arrangement between a plan sponsor (the employer) and an executive (the employee) under which a part or all of the executive’s salary and/or bonus is deferred until a future date. A nonqualified deferred compensation plan typically permits an executive to defer these amounts on a pre-tax basis and earn market-based notional (hypothetical) returns on the deferred amounts. The executive’s deferrals mirror a selection from a range of hypothetical investments in mutual funds or exchange-traded funds (ETFs). Executives typically enter into these arrangements as a means of saving for retirement, in many cases augmenting amounts saved through 401(k) and other qualified plans¹. Limits on such qualified plans (e.g., the maximum annual contribution limit of \$17,000 for 401(k) plans in 2012) and a lengthening life expectancy, as well as the failure of qualified plan limits to generally keep up with inflation, make NQDC Plans particularly attractive savings tools for executives. Many plan sponsors view these plans as valuable tools for retaining and attracting talent.

In setting up an NQDC Plan, the plan sponsor and executive will specify the percentage of current salary and/or bonus to be deferred and how notional earnings on the deferred amounts will be computed. In most cases, plan sponsors maintain a book entry account for the executives based upon the executives’ elections. Plan sponsors must meet the “Top-Hat” plan rules under ERISA² to gain a limited ERISA exemption. Typically, these accounts are administered by a recordkeeper who maintains account data, processes investment elections and deferrals and sends account statements to the executive.

Differences between Qualified and Nonqualified Plans

The terms “qualified” and “nonqualified” relate to a plan’s tax treatment under the Internal Revenue Code (the “Code”). In addition, qualified plans meet the requirements and fall under the guidelines, rules and exceptions of The Employee Retirement Security Act of 1974 (“ERISA”); while nonqualified plans gain a limited exemption under Title I of ERISA.

Tax Treatment: Under a qualified plan, section 401(a) of the Code allows the employer to take a current deduction as contributions are made to fund the plan. Nonqualified plans do not qualify for the tax benefits granted under the Code. Accordingly, in a nonqualified plan, the employer’s tax deduction is postponed until the employee receives the compensation. Under both types of plans the employee is able to defer paying taxes until receiving distributions.

¹ A qualified plan is one that meets requirements of Section 401(a) of the Internal Revenue Code and as a result, is eligible to receive certain tax benefits. These plans must be for the exclusive benefit of employees or their beneficiaries. There are two types of qualified plans: defined benefit (pension) plans and defined contribution plans. Some examples of defined contribution plans are 401(k) plans, money-purchase pension plans and profit-sharing plans.

² ERISA: The Employee Retirement Income Security Act of 1974, is intended in large part to protect workers’ retirement benefits. ERISA contains complex rules governing participation, vesting, funding, reporting, disclosure, administration, and fiduciary activities. While ERISA governs most qualified retirement plans, NQDC Plans can have a limited exemption under Title I. See sections 4(b)(5), 201(2)+(7), 301(a)(3) and 401(a)(1).

Insolvency Risk: Another key difference between qualified and nonqualified plans is protection in the case of a bankruptcy. In a qualified plan, if the plan sponsor files for bankruptcy, the assets of the plan participants are held in a separate trust that is protected from the employer's bankruptcy. However, in a nonqualified plan, the assets are not protected in the event of the plan sponsor's bankruptcy and the plan participants become general unsecured creditors of the company in bankruptcy. Accordingly, if the plan sponsor becomes insolvent, there are no assurances that the deferred amounts will be paid to the employee.

Economic Benefits of NQDC Plans for the Executive

Figure 1

Value in 10 years of a \$100,000 Investment	
No Deferral	\$118,029.08
With Deferral (NQDC)	\$155,624.55

The tax deferral benefit of NQDC Plans has real potential financial value to executives. FIGURE 1 above illustrates the potential advantage of a \$100,000 pre-tax deferral over a 10-year period, assuming a weighted average tax rate for investments of 30%, an ordinary income tax rate of 40% and a 10% per annum pre-tax investment return.

While the executive is taxed at withdrawal, the table shows, a pre-tax deferral generates a substantial premium in wealth accumulation for the executive. Over a 10 year term, the deferral generates substantially more value than what would be accumulated if the same compensation were paid, taxed immediately, and invested in the same (taxable) investments for the same time period. Generally, the benefit to the executive is approximately equal to the product of the total return credited to the deferred compensation and the tax rate otherwise applicable to and payable in that return.

A well designed NQDC Plan can therefore be an excellent capital accumulation program for highly-valued executives, if it offers attractive reference investments. The challenge for the plan sponsor is maximizing the plan's value to its executives at a reasonable cost to its shareholders.

Economic Benefits of NQDC Plans for the Plan Sponsor

In addition to helping retain talented executives and remain competitive, sponsoring a nonqualified deferred compensation plan can add economic value to the company. By retaining the after-tax capital that has been deferred by executives, a company can invest this capital back into its core business, pay down expensive debt or initiate a share repurchase program. This capital, generally, will generate a positive net present value (NPV) if the company's weighted average cost of capital (WACC) is higher than the return of the notional investments in the NQDC Plan. NPV and WACC impacts of NQDC Plans will be discussed in detail later in this white paper.

Accounting for the NQDC Plan

The accounting for the NQDC Plan discussed in this white paper is not specifically addressed in the accounting literature. However, an analogy may be made to *Emerging Issues Task Force Issue No. 97-14, Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*. EITF 97-14 addresses the accounting for a plan that permits all or a portion of the employee account balances to be diversified out of the employer's stock. Under EITF 97-14, the plan sponsor's deferred compensation obligation to executives should be classified as a liability on the balance sheet and adjusted, with a corresponding charge or credit to compensation expense, to reflect changes in the fair value of the amounts owed to executives (or as it is commonly referred to "mark-to-market").

Assuming the plan sponsor's plan obligation is increasing, to adjust the NQDC Plan obligations to fair value, the employer would debit compensation expense and credit the NQDC Plan liability for the mark-to-market growth in the plan:

Compensation expense (income statement)	\$xx,xxx
Nonqualified deferred compensation plan obligation (balance sheet)	(\$xx,xxx)

Accounting Geography Note: Compensation expense is an operating expense of the company and is recorded above-the-line in Selling, General and Administrative expense.

The plan sponsor's accounting for obligations under the plan is not affected by the use of Total Return Swaps to hedge the plan's liabilities as will be discussed in detail in the following pages.

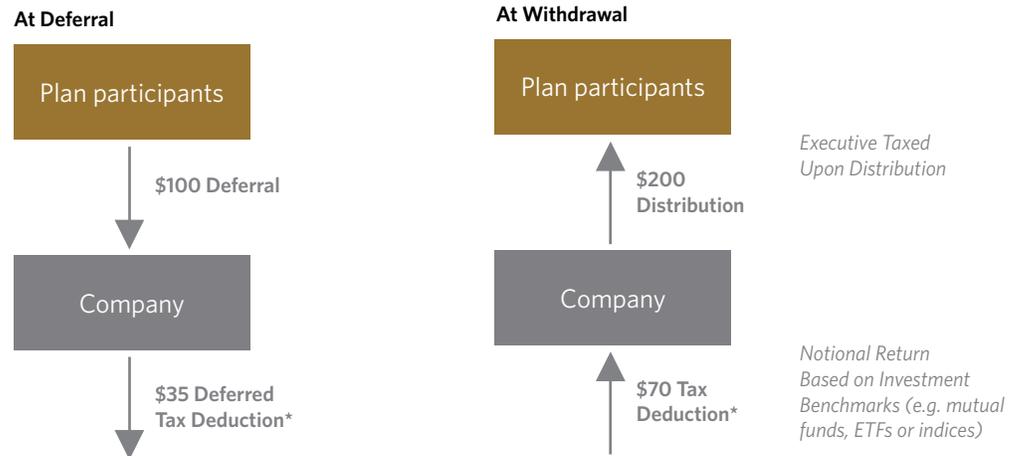
Why do Plan Sponsors Hedge

Unhedged NQDC Plans expose the plan sponsor to a number of risks. NQDC Plan balance sheet liabilities linked to the investment choices made by executives are marked-to-market on a quarterly basis. These liabilities, for most plan sponsors, are subject to market swings outside of their normal course of business. In addition, the fluctuations of the NQDC Plan liabilities due to underlying market movement creates volatility on the plan sponsor's income statement. This volatility is difficult to budget for and subjects the plan sponsor's income statement to the vagaries of the market. This can result in a company missing earnings or projections and require detailed explanations of executive compensation in financial statements and to a company's analysts.

Evaluating the Economics of Hedging NQDC Plans

The liabilities associated with NQDC Plans are recorded in the balance sheet on a mark-to-market basis. FIGURE 2 details a hypothetical \$100 deferral and the deferred tax consequences to the company.

Figure 2



Assumptions: \$100 Deferral; 35% Corporate Tax Bracket; Investments double over deferral period

Using NPV, DCF and WACC in NQDC Plan Analysis

Net present value (NPV), discounted cash flow (DCF) and weighted average cost of capital (WACC) metrics [See appendix for a full discussion of these methodologies] are useful methods to calculate opportunity costs of different hedging alternatives and to determine the most economical way to hedge NQDC Plan liabilities.

By using NPV, DCF and WACC metrics, companies are able to calculate what impact the NQDC Plan and the different hedging methods will have on the economic value of the company.

From an NPV perspective, an NQDC Plan that is unfunded and unhedged will have a positive financial impact if the company's WACC is greater than the return of the assets in the NQDC Plan. This is a result of the company being able to reinvest the after-tax proceeds related to the deferred compensation into the company at a greater return (the WACC) than is generated by the underlying liabilities under the plan. The use of alternative hedging methods have different NPV (and thus economic) impacts on the NQDC Plan, which is discussed in the following section.

* Under FAS 109 (Accounting for Taxes) plan sponsors must annually assess the validity of carrying, and the possibility of using, their deferred tax asset. If at any time it becomes clear that the tax benefit cannot be used, the Company must de-reconize the asset.

Traditional Methods Used to Hedge NQDC Plans

Tax regulations require that NQDC Plans not be formally funded by assets segregated from the company's general assets. Otherwise, the participants will be deemed to be in constructive receipt of the compensation and will be taxed currently. The NQDC Plan appears as an expense on the employer's income statement and creates an increasing liability on its balance sheet until benefits are paid. The eventual payment of the benefits will result in a funding requirement.

Traditionally, plan sponsors have chosen one of three methods of dealing with these liabilities: (i) leave its plan unfunded / unhedged, (ii) informally fund their NQDC Plan using taxable investments (i.e. mutual funds), or (iii) informally fund their plan using corporate-owned life insurance (COLI).

Unfunded or Unhedged

Approach: Unfunded plans result in the NQDC Plan liabilities being paid out of company cash flow when distributions occur.

Accounting Treatment: No change to standard accounting for NQDC Plans.

Tax Treatment: No change to standard tax treatment for NQDC Plans.

Economic Impact: An unfunded NQDC liability will result in a positive long-term cash flow impact as well as a positive financial impact should the company's WACC exceed plan participant returns (e.g., if the returns under the NQDC Plan are less than the WACC earnings on the after-tax proceeds).

Funding Impact: The NQDC liability remains unfunded and company cash flow funds distributions as they occur.

Taxable Investments (Mutual Funds)

Approach: Hedge the NQDC Plan liability using taxable investments like mutual funds which informally pre-fund the deferral obligation.

Accounting Treatment: FASB Statement 115 (FAS 115) addresses the accounting for investments in equity securities that have readily determinable fair values, and for all investments in debt securities. The investments covered are to be classified in one of three categories and accounted for as follows:

1. **Held-to-Maturity:** Debt securities that the company has the positive intent and ability to hold until maturity are reported at amortized cost. Under FAS 115, this method is generally considered inappropriate to use for mutual funds financing a deferred compensation plan liability.
2. **Trading:** Debt and equity securities that are bought and held principally for the purpose of selling them in the near future are reported at fair value, with realized and unrealized gains and losses included in Investment or Other Income. This is the method generally used for mutual funds held as a hedge to NQDC Plan liabilities.

3. **Available-for-Sale:** Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholder's equity. For practical purposes gains are shown net of taxes due to the need to establish a deferred tax expense under FAS 109.

Accounting Geography Note: Unlike NQDC Plan accounting, income or earnings on mutual funds are typically recorded below-the-line in Other Comprehensive Income ("OCI") or Investment Income.

Tax Treatment: If a company purchases mutual funds, any realized investment earnings are currently taxable to the company. These investments earn dividends and interest and the plan sponsor will be taxed on those amounts as they are received. Moreover, when the plan sponsor sells its taxable investments, whether to generate cash or to pay benefits when an executive terminates employment (or is otherwise entitled to benefits under the NQDC Plan), the sale can trigger a current capital gains tax which offsets the deduction due to the additional compensation expense. However, under the circumstances where the mutual funds have lost value a capital loss is triggered while the matching reduction in the compensation deduction effectively creates ordinary income that cannot be offset against the capital loss.

Economic Impact: Hedging using taxable investments is expensive for two main reasons. First, this method uses scarce balance sheet capacity for investments that are not directly related to the company's core businesses. Second, the promise to the employee is credited with tax deferred earnings while the hedge investments are subject to taxation on realized gains and income as incurred on the investments. Taxable events occur whenever the company moves funds from one investment to another in response to employee decisions to rebalance his or her deferred account. This tax drag is a direct and significant out-of-pocket cost to the company.

Funding Impact: Taxable investments are held on the plan sponsor's balance sheet to informally fund the NQDC Plan liability.

Corporate-Owned Life Insurance (COLI)

Approach: To avoid the tax costs of hedging by purchasing direct investments, many companies have used a tax-advantaged arrangement called Corporate Owned Life Insurance (COLI), to hedge their deferred compensation obligations. COLI is life insurance purchased on the plan sponsor's employees' lives where the plan sponsor is the sole owner and beneficiary of the life insurance. COLI can be viewed as an investment contract with a life insurance wrapper.

Accounting Treatment: If a company acquires COLI, the policy is reported on the company's balance sheet under the "cash surrender value" method. FASB Technical Bulletin 85-4 states that "the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." This "cash surrender value" method will allow the value of the life insurance policy to grow on the balance sheet of the company. This is in contrast to most other assets which are recorded at historical cost on the balance sheet (until the funds are reinvested in a different asset which can then be recorded at its historical cost until it is eventually transferred). Once the cash surrender value of a life insurance policy exceeds the premiums paid by the company, the company will be entitled to record the annual increase as a revenue item in Other Income on its income statement.

Tax Treatment: The three major income tax advantages of COLI are: (i) the tax-deferred “inside build-up” in the cash surrender value of the policy, (ii) the ability to withdraw funds tax-free to the extent of the company’s basis in the policy (and the ability to make tax-free loans), and (iii) the tax-free receipt of the death benefits.

Accounting Geography Note: Unlike NQDC Plan accounting, income or earnings on COLI are typically recorded below-the-line in OCI or Investment Income.

Economic Impact: Similar to informally funding with taxable investments, COLI consumes capital that could otherwise be invested in the plan sponsor’s core businesses. Accordingly, the opportunity cost of this hedging approach is high and the capital intensity of the hedge can make the plan expensive to offer under most cost of capital scenarios.

Funding Impact: COLI is held on the plan sponsor’s balance sheet to informally fund the NQDC Plan liability. It is, however, unlikely to function as a perfect hedge and therefore has to be managed within a pre-specified tracking error (gap between the COLI’s cash value and the NQDC Plan’s liability). First, many plans allow participants to rebalance their accounts more frequently (e.g., daily) than a COLI policy administrator is willing to rebalance the COLI asset account (e.g., quarterly). Second, publicly available mutual funds and alternative investment funds cannot be used within insurance products; insurance-dedicated funds (IDFs) must be used. Not all funds that maybe used as reference investments in a deferred compensation plan are available in IDF form and where they aren’t, there is the potential to incur further tracking errors.

NQDC Hedging Plan Strategy Comparison				
	TRS Hedge	No Hedge	Corporate Owned Life Insurance	Mutual Funds
Creates Liquidity	✓	✓		
Economic Value (positive cash flows, earnings & low cost)	✓			
Optimizes Capital Structure	✓	✓		
Potential Tax Benefits	✓		✓	
Minimizes Income Statement Volatility and/or Tracking Error	✓		✓	✓
Administration	✓	✓		

Overview of Total Return Swaps (TRS)

A Total Return Swap (TRS) is an unfunded position economically equivalent to borrowing capital and investing in an asset. A TRS is an over the counter (OTC), bilateral financial contract where the counterparties agree to exchange (or “swap”) the total return (cash flows plus capital appreciation/depreciation) of an asset or basket of assets for periodic cash flows, typically a floating interest rate such as LIBOR plus a spread.

Figure 4:



Market Participants

One of the historical uses for Total Return Swaps was among commercial banks where one party (Bank A) had exceeded its balance sheet limits, and the other (Bank B) had balance sheet capacity available. Bank A could shift assets off its balance sheet “synthetically” and gain additional income. Bank A could “lease” the assets on Bank B’s balance sheet by paying some regular cash flows and offering an assurance against any capital losses.

A TRS can be structured on any type of reference asset, including single equities, indexes, leases, oil-backed credit obligations, baskets of corporate bonds, mortgages, municipal bonds, other swaps or derivatives, real property, credit card ABS, residential MBS, CDO notes, investment grade convertible bonds, etc. This makes the range of potential market participants extremely broad.

The Total Return Swap market is primarily institutional and over the counter (OTC) however, many swaps will be required to be executed on swap execution facilities and cleared at a central clearinghouse once the relevant rules relating to The Dodd-Frank Wall Street Reform and Consumer Protection Act have been finalized. Market participants include investment banks, commercial banks, mutual funds, hedge funds, funds of funds, private equity funds, pension funds, university endowments, credit card lenders, insurance companies, governments, non-governmental organizations (NGO), home loan banks, and the treasury departments of large multinational corporations.

TRS Transaction Structure

A TRS is made up of two legs, the Return Leg and the Funding Leg. The performance of the reference asset or basket of assets determines the Return Leg. The floating interest rate cash flow payment stream determines the Funding Leg.

The Return Leg is generally made up of two components: cash flows and capital appreciation of the reference asset(s). The Funding Leg also has two components: floating coupons based on LIBOR plus a spread and payments to offset any capital depreciation of the reference asset(s).

Swap Counterparty

The Return Leg counterparty is called the Swap Counterparty. Swap Counterparties are usually large institutions with big balance sheets such as commercial banks, investment banks, and insurance companies. Swap Counterparties generally have lower cost of funding than plan sponsors, but their returns are often limited by capital requirements or conservative strategies. To hedge its TRS position, the Swap Counterparty generally may establish a long position in the reference asset or basket of assets on its balance sheet. The Swap Counterparty has agreed to pay the total future returns of the reference asset(s) in exchange for a floating interest stream of payments and any capital depreciation of the reference asset. Thus, the Swap Counterparty has leased its inexpensive balance sheet to increase returns while adding only interest rate and counterparty credit risk (limited by monthly or quarterly rolls and resets) and avoiding the market risk inherent in the underlying reference asset.

Swap Counterparty Position

- Lower cost financing
- Pays total return of asset(s)
- Receives LIBOR plus spread
- Receives payments to offset any capital losses
- Takes interest rate risk and credit risk
- Transfers away asset return risk

Plan Sponsor

The Funding Leg counterparty is the plan sponsor. The plan sponsor seeks exposure to the returns of the reference asset or basket of assets, but does not want to purchase and hold them on its balance sheet. The TRS puts the plan sponsor in a “synthetic” long position in the asset(s) in exchange for regular floating cash flow payments and any capital loss payments to the Swap Counterparty.

Plan Sponsor Position:

- Wants to, but does not own reference asset(s)
- Has higher cost financing
- Receives total return of the reference asset(s)
- Pays LIBOR plus spread
- Pays any capital losses on the reference asset(s)
- Takes on asset market risk and counterparty credit risk

TRS transactions are typically structured with a notional amount, start date, end date, and periodic settlement dates where asset returns and interest are paid. The notional amount is defined at the start as the market value of asset(s) on the Return Leg. The parties establish a regular payment calendar for transfer of net returns. For example, the parties may set a monthly or quarterly payment calendar defined by LIBOR coupon dates. On those dates, the Swap Counterparty will mark-to-market the capital appreciation/depreciation and accumulated cash flows of the Return Leg asset(s). The plan sponsor will calculate the required interest coupon consisting of LIBOR plus a spread. Values of the reference asset(s) are determined on a periodic basis by using dealer quotations, independent pricing data, or independent valuation. The parties will then exchange the net difference between the values of the two legs. At the expiration date of the TRS, the parties will exchange the remainder of net returns.

Hedging NQDC Plans Using Total Return Swaps

The TRS Hedge Alternative takes a completely different approach to managing the accounting and cost impact of an NQDC Plan liability hedging. Rather than funding the deferral obligation with direct investments or COLI, the TRS Hedge Alternative is an unfunded solution which eliminates the need to use expensive capital to complete the hedge. In addition, the TRS Alternative provides a highly correlated hedge with efficient and attractive tax and accounting treatment.

Accounting Treatment: The TRS Hedge Alternative is marked-to-market and thus, directly offsets changes in the NQDC Plan liability on the income statement. Plan sponsors are typically allowed to record gains and losses for the swap in the same income statement line item, "Compensation Expense", as the changes in the NQDC Plan liability. Income related to mutual funds and COLI is typically recorded in "Investment or Other Income" and cannot be netted against the cost of the NQDC Plan.

Total Return Swaps are derivative financial instruments that should be accounted for under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities. The Statement requires all derivatives to be recorded on the balance sheet at fair value. One of the criteria that must be met for a derivative instrument to qualify for hedge accounting is that the hedged item (i.e., the employer's obligation under the plan) cannot be re-measured with changes in fair value recognized currently in earnings. Because the employer's NQDC Plan obligations are marked-to-market, with changes in fair value reported currently in earnings as discussed above, the plan obligation does not qualify as a hedged item and the derivative cannot be designated as a hedge of the obligation. However, to the extent changes in the fair values of the TRS and the reference fund's portion of the plan obligation offset, there will be no net effect on earnings.

Assuming the value of the total Return Swap is increasing, to adjust the carrying value of the TRS to fair value, the employer would record the following entry each time a balance sheet is prepared:

Unrealized Gain on Total Return Swap (balance sheet)	\$xx,xxx
Compensation Expense (income statement)	(\$xx,xxx)

As discussed earlier, under the same assumptions, to adjust the NQDC Plan obligations to fair value, the employer would record the following entry each time a balance sheet is prepared:

Compensation Expense (income statement)	\$xx,xxx
Nonqualified Deferred Compensation Plan Obligation (balance sheet)	(\$xx,xxx)

Accounting Geography Note: Unlike Mutual Funds or COLI, a company, in consultation with its accountants, typically records the fair value of the swap gains, losses and expenses above-the-line in SG&A.

Tax Treatment: The TRS Hedge Alternative may be designated as a hedge for tax purposes and, accordingly, the tax treatment of gains, losses and costs (including the LIBOR payments) of the TRS Hedge Alternative will match the tax characteristics of the underlying NQDC Plan liability. Specifically, the plan sponsor can utilize the hedging rules under Treasury Reg. 1.1221-2(b)(2) and section 1221(b)(2) of the Code to defer the taxable event for gains/losses and dividends attributable to the swap until distributions are made to participants under the NQDC Plan. In other words, taxable swap gains are allocated to each distribution and taxed in the year of each distribution which matches when the company receives the tax deduction for the distributions.

Economic Impact: The unfunded nature of the swap means that the after-tax deferred compensation is available for use by the company to invest in its operations for the duration of the deferrals. If the cost of the swap (typically a LIBOR-based rate plus a spread) is lower than the company's WACC (the rate at which the company can invest this capital back into its business) the TRS will create a positive NPV for the company.

Funding Impact: The underlying deferral remains unfunded. However, since the TRS is marked-to-market for accounting purposes (which corresponds precisely to the accounting treatment of the NQDC obligation) it is possible to perfectly match increases and decreases of the plan's liabilities with zero tracking error. Additionally, since the TRS is settled regularly (e.g. monthly) the company receives cash equal to the appreciation in the NQDC Plan's liabilities.

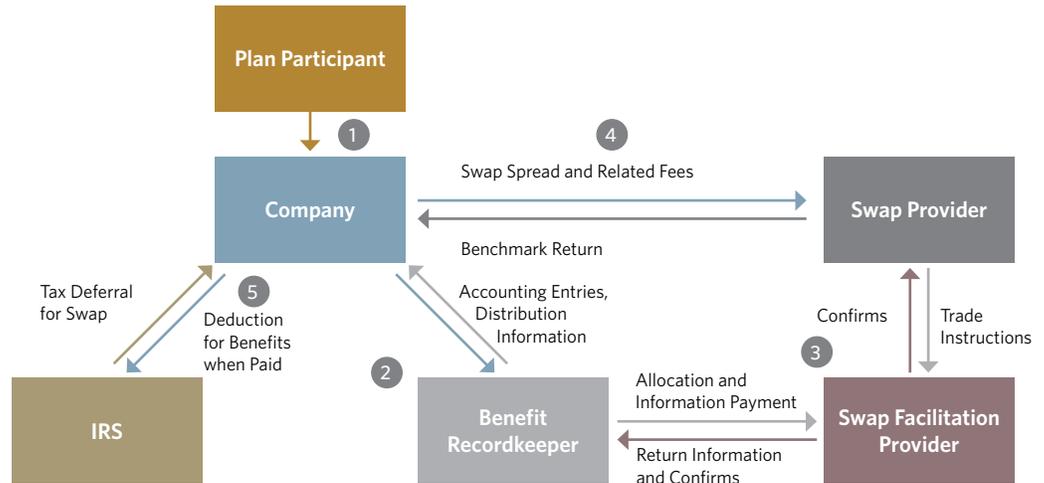
Mechanics of the TRS

FIGURE 5 on the following page illustrates the structure of an NQDC TRS hedge which is an exchange of returns between a plan sponsor and a Swap Counterparty (referred to as the Swap Provider in the Figure). In effect, the plan sponsor is simply renting the Swap Provider's balance sheet at a rate equal to LIBOR plus a spread. In return for these interest payments, over the term of agreement, the plan sponsor will receive any gains of the underlying reference asset. Effectively, these payments from the Swap Provider will offset the increased value of the NQDC liability.

As new deferrals occur, or amounts are distributed, or employees make NQDC Plan reallocation decisions, the swap notional is adjusted accordingly to mirror the NQDC Plan's liabilities. A deferral distribution triggers a tax deduction for the plan sponsor and creates a taxable event attributable to the amount of swap gains distributed, net of the LIBOR-based costs.

The NQDC Plan administrator (or benefit recordkeeper) will continue to manage and track the liability information and required transactions needed to administer the NQDC Plan, communicate account information to the participant, support implementation of participant deferral decisions, and track the tax, accounting, and other information needed to effectively manage all aspects of the plan. The Swap Facilitation Provider will manage and track the required transactions needed to administer the swap, communicate this information to the swap provider, communicate net exposure and P&L to the plan sponsor, and track the tax, accounting, and other information needed to manage all aspects of the NQDC Plan and TRS Hedge Alternative.

Figure 5



1. Employee defers compensation
2. Recordkeeper collects benefits-related information and provides Company with statements, accounting and distribution information
3. Swap facilitation provider receives investment allocation information and aids the Company in generating trade instructions for swap providers. Also provides Company with net exposure statements, accounting and distribution/tax information
4. Company periodically pays swap fee in exchange for a benchmark return¹ on NQDC Plan
5. At plan maturity date or termination of employment, benefits (deferral +/- return) paid by Company to employee. Upon payment, company realizes cumulative gains/losses on the swap, net of interest paid to swap provider, and realizes tax deduction for compensation amount

¹ Benchmarks must be based on publicly-available investment alternatives.

Illustrative Example

Assume that a plan sponsor's employees defer \$10mm, which is allocated to a range of hypothetical mutual fund investments available for election under the plan. The company hedges the plan with a \$10mm swap at a rate of 1-month LIBOR plus a spread of 150 bps, which equals approximately 1.75% annually. For simplicity, also assume no further deferrals during, or any distributions prior to the end of, the 10- and 40-year deferral terms. Also assume that the weighted average annual return credited to the plan's liability is 8.0%, the company's weighted average cost of capital (WACC) is 10.0% and the company's marginal income tax rate is 35.0%.

As a result of the deferral, the company's taxable earnings increase by \$10mm, on which it will pay \$3.5mm in taxes, creating \$6.5mm for other uses. At the end of the deferral period, the company will pay participants the \$10mm plus credited returns (or losses) and will take a tax deduction on the total amount paid. The \$6.5mm is invested and earns the WACC throughout the deferral period.

In FIGURE 6, the net present value (NPV) over 10 and 40 years of the TRS is compared to: leaving the plan unhedged, funding the plan with taxable investments (mutual funds), and funding the plan with COLI. The COLI policy invests in funds that mirror the reference

investments utilized by plan participants. The all-in costs of COLI are assumed to be approximately 100bps per annum of the funded amount, resulting in a net earnings rate of 7.0%, no upfront premium load, and a maturity consistent with a structure that is redeemable only upon death of the insureds. All other parameters are the same in both scenarios.

Figure 6 (in thousands):

NPV Results of NQDC Alternatives	Gain / (Loss)		
	NQDC Plan	Hedge	Total
10 YEAR Deferral Period			
TRS Hedge Alternative	\$1,090	\$4,273	\$5,362
Unfunded / Unhedged	\$1,090	\$0	\$1,090
Taxable Mutual Fund Investments	\$1,090	(\$4,138)	(\$3,038)
40 YEAR Deferral Period			
TRS Hedge Alternative	\$3,380	\$13,253	\$16,633
Unfunded / Unhedged	\$3,380	\$0	\$3,380
Taxable Mutual Fund Investments	\$3,380	(\$12,835)	(\$9,455)
Corporate-Owned Life Insurance	\$3,380	(\$6,155)	(\$2,775)

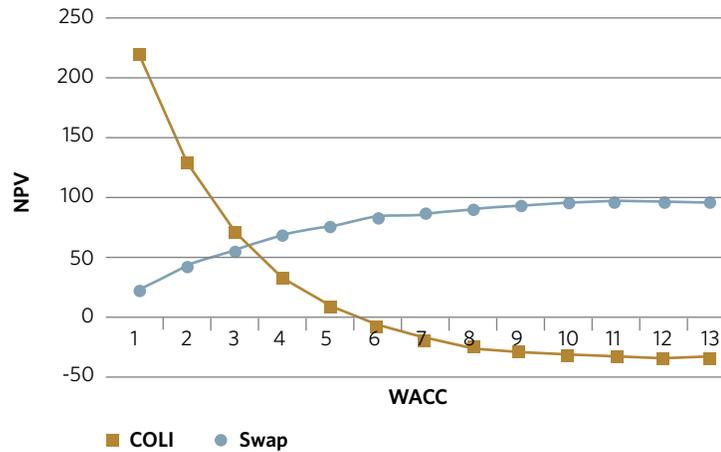
In FIGURE 7, the attribution (sources) of the NPV gains/losses for the 10 year deferral period are shown.

Figure 7 (in thousands):

	TRS Hedge Alternative	Unfunded / Unhedged	Taxable Mutual Funds Investment
NQDC Program	1,090	1,090	1,090
Hedge			
Gain / (loss) from Investment	7,033	0	(4,468)
Cost of Hedge	(1,538)	0	(6,144)
Pre-Tax Gain / (Loss) of Hedge	<u>5,494</u>	<u>0</u>	<u>(1,676)</u>
Taxes	<u>(1,222)</u>	<u>0</u>	<u>(2,462)</u>
Total Gain / (Loss) Hedge	4,273	0	(4,138)
Total	5,362	1,090	(3,038)

Finally, as FIGURE 8 below illustrates, when a company's cost of capital is low, the opportunity cost of direct investing is also low, and therefore, pre-funding the plan is favorable. However, when a Company's cost of capital rises above the swap rate, the opportunity cost of a COLI or direct investment strategy makes the TRS hedge more attractive.

Figure 8: COLI vs Swap NPV-by WACC



Plan Characteristics and Strategies That Work with the TRS

- \$2 million or more in NQDC Plan liabilities
- Investment options that are market based or publicly available (mutual funds, ETFs, etc.) or liquid hedge funds

Other Topics

Rabbi Trusts

Overview

Rabbi Trusts are usually irrevocable grantor trusts which are often used to hold assets set aside to aid a company in meeting its obligations under an NQDC Plan. The term comes from a ruling by the Internal Revenue Service involving a rabbi whose congregation had made contributions to such a trust for his benefit. Rabbi Trusts are considered grantor trusts, in which income is taxed to the grantor or employer. The employer receives no deduction for payments to the trust but receives a deduction when the trust pays funds to the employee. A Rabbi Trust may protect the employee's benefits from some Company hazards, but not, as many believe, from insolvency or bankruptcy.

Rabbi Trusts are used to set aside corporate assets for the benefit of participants in an NQDC Plan. Under these arrangements, covenants are made with a trustee which specify that any assets held in the trust will be used for the benefit of plan participants. However, the assets remain as assets of the corporation for tax and accounting purposes. Rabbi Trusts generate no tax benefits and assets of the trusts remain assets of the Company for corporate credit purposes. Trusts may protect participants in the event of a Company's change of heart, for example, as may happen in a change of control. Additionally, Rabbi Trusts do not change NQDC Plan economics. In the event of the plan sponsor entering bankruptcy, the assets in the trust are subject to the claims of all general unsecured creditors of the employer and plan participants have no greater claim on the assets.

Funding a Rabbi Trust

Instead of merely a book entry, generally Company assets are transferred (usually irrevocably, meaning that the employer must give up all rights to the assets and may not terminate the trust) to a trustee who has a duty to pay benefits to the employee at the time designated for distribution. Taxable assets, or tax-sheltered assets, such as COLI, are among the assets the trustee may hold. Often, Company stock is used to fund the trust.

Rules for Rabbi Trusts

To qualify as a Rabbi Trust, and to gain partial exemption from ERISA's "Top-Hat" plan rules, the trust must benefit a select group of employees, limited by both number and rank, and the plan must define the events that allow employees to receive benefits. Although employers cannot access funds in an "irrevocable" or "locked" Rabbi Trust (contrasted with a "revocable" or "unlocked" Rabbi Trust) until all benefits have been paid, the funds must be subject to claims of the employer's general unsecured creditors in the event of the employer's bankruptcy or insolvency. The funds cannot be secured - that is, employees must have the same status vis-à-vis the funds as the employer's general unsecured creditors. In addition, employees cannot assign their rights under the trust.

The IRS has set forth specific criteria that need to be met in order for there to be a favorable ruling on a Rabbi Trust. IRS Revenue Procedure 92-64 details what these criteria are and also contains a model Rabbi Trust that is intended to serve as a safe harbor for taxpayers who adopt and maintain the model trust in connection with a nonqualified plan. By using the model trust, a plan participant will not be deemed in constructive receipt of the assets in the trust.

The Rabbi Trust does not affect the tax treatment. The trust is taxed like a grantor trust, with taxable income attributed to the employer, because funds in the Rabbi Trust are assets of the employer subject to claims of the employer's creditors. The employee pays no income tax on the benefits until they are received. Payments from a Rabbi Trust are deductible by the employer for income tax purposes when distributions are made, not when the trust is funded.

Accounting for Rabbi Trusts

Compensation that is 100% vested when it is received by a Rabbi Trust must be expensed on the Company's books in the year the compensation is deferred. If amounts vest over time, the expense is booked over the vesting period. When Company stock is used in a Rabbi Trust, the Company is only required to book an expense and liability based on the value of the stock at the time of grant, additional increases in the value of stock would not be booked as an expense.

Managing Away From Existing Rabbi Trusts

In situations where plan sponsors currently utilize a Rabbi Trust but want to change their hedging alternative, there are options. If the executives or the plan sponsor feel strongly that the Rabbi Trust brings value (or the trust has been drafted to prevent its termination), then the plan sponsor can fund the trust with operating assets of the Company as a replacement for the COLI or other asset. Possible assets the plan sponsor can use are corporate real estate, intellectual property, plant, equipment, factored receivables or leasing agreements. This would eliminate the economic cost caused by tying up financial assets in a Rabbi Trust.

Limitations of COLI

As a hedge of NQDC Plan liabilities that are diversified across a range of funds, COLI has a number of notable limitations-while there are ways to reduce the severity of the limitations, they are difficult to eliminate entirely.

- COLI is a long-term investment, the full benefit of the policy is only appreciated when death benefits are paid. A deferred compensation obligation has a shorter duration, typically from 5 to 20 years. It is conceivable that a plan sponsor will continue to carry COLI on its balance sheet for many years after all NQDC obligations are met and will, at that point, be exposed to fluctuations in the value of the COLI assets.
- COLI is unlikely to function as a perfect hedge for a number of reasons. First, many plans allow participants to rebalance their accounts more frequently (e.g. daily) than a COLI policy administrator is willing to rebalance the COLI asset (e.g. quarterly). Second, publicly available mutual funds and alternative investment funds cannot be used within insurance products; insurance-dedicated funds (IDFs) must be used. Not all funds that could be used as reference investments in an NQDC Plan are available in IDF form and where proxies must be used there is the potential to incur tracking error. Therefore COLI must be managed within a pre-specified tracking error (gap between the COLI's cash value growth and the NQDC Plan liability's growth).
- COLI is an inflexible investment. It is generally difficult to change investment choices offered inside the policy as circumstances change and therefore, it is difficult to hedge an NQDC liability with changing investment menus.
- The life insurance component of the COLI policy is not free. The plan sponsor will typically need to pay up-front premium loads and on-going asset-based fees to finance the death benefit and other policy-related expenses.
- The costs of COLI are difficult to predict. On-going insurance-related charges are dependent on a number of factors such as the demographics of the group and indirectly, the performance of the assets inside the policy. Performance below expectations will increase the cost of the death benefit because the cost of insurance is dependent upon both the difference between the aggregate death benefit less the cash value of the policy as well as the demographics of the population insured.

- COLI consumes capital that might otherwise be invested in the plan sponsor's core businesses. Accordingly, the opportunity cost of the COLI hedging approach is high. The cost of capital can make the plan expensive to offer under most scenarios.
- Financial services firms who include their own funds within their NQDC Plan options will be limited or even precluded from doing so within the COLI due to insurance regulations.
- Non-public investment funds, especially alternative investments, are difficult to support and are rarely found in plans hedged with COLI.

Things to Consider if You Already Have COLI

- Other hedging alternatives can be used to augment existing COLI if the Company does not want to make continued purchases.
- COLI can be converted to an investment strategy that can be managed by a plan sponsor's Treasury Department while alternative hedges can be added as an overlay to hedge the NQDC Plan liabilities.

Common Concerns and Responses related to the NQDC Swap Hedge Alternative

We are flush with cash and do not have new investment opportunities.

We can only reinvest in instruments that return LIBOR or less (and would not benefit from freeing up cash)

- Companies are under increasing pressure to use their cash for dividend payments, mergers and acquisitions (M&A) and share buybacks.
- Cash reserves allow a Company to better ride out the current economic storm, and give management more flexibility.
- Having corporate capital wrapped up in non-operating assets like COLI or mutual funds deprives management of a key tool (cash) and does not address a real problem-directly hedging the income statement volatility related to the NQDC Plan (COLI and mutual funds result in less favorable economic and accounting geography outcomes).

If LIBOR increases, the swap will become very expensive

- If LIBOR increases, the return on cash has the potential to increase as well.
- As cost of debt increases, the Company's WACC will also increase. If debt costs increase, the Company should want to use generated cash to pay down debt.
- The Company can cancel the swap any time it wishes. If it decides LIBOR costs are too high, it can move into non-operating asset strategies like COLI or mutual funds.
- And, the Company can choose a fixed rate option instead of the floating LIBOR leg in the TRS.

Our plan participants would feel very uncomfortable if the Rabbi Trust were not funded

- Under the Internal Revenue Code, plan participants must be general unsecured creditors of the Company with respect to the plan liabilities.
- Rabbi Trusts, established and holding assets to pay plan obligations, do not afford any protection to the participants from bankruptcy.
- The Rabbi Trust was likely marketed to provide comfort and also to protect against a “change of heart”, for example, where the Company is acquired or there is new management and the new management team attempts to claw back the deferred amounts.
- If participants maintain that the Rabbi Trust brings value (or the Rabbi Trust has been drafted to prevent its termination), then the Company should consider funding the Rabbi Trust with operating assets as discussed above (i.e. corporate real estate, intellectual property, plant, equipment, factored receivables or leasing agreements).

We are not sure if the Rabbi Trust can be unwound

- Depending on how the trust was created and whether or not it has been funded, some trusts can and some cannot be unwound. However, in the case of irrevocable trusts which are funded and which may not be unwound, there are simple strategies which can be implemented to allow plan sponsors to change their hedging strategies.
- One strategy that allows plan sponsors to change their hedging methods when a Rabbi Trust exists, is to replace the assets in the Trust with operating assets like real estate. See the section above, “Managing Away from Existing Rabbi Trusts”.

Our NQDC Plan is not big enough to have a material impact on our income statement

- Unbudgeted swings in quarterly compensation expenses due to unhedged NQDC Plans may not have a material income statement impact - but it will most certainly be visible to analysts, board members, major shareholders and others who keep an eye on a Company's compensation expense.

Conclusion

Total Return Swaps have become an increasingly important tool in hedging nonqualified deferred compensation plans because of their ability to reduce income statement volatility, free up corporate balance sheet capacity and provide preferable tax treatment. The attraction of this hedging method is driven primarily by the swap's flexibility, unfunded nature and tax-deferred benefit which permit the plan sponsor to offer a high value NQDC Plan at the lowest (perhaps even negative) cost with reduced risk and leverage to the Company. As discussed earlier, a total Return Swap may not be practical for every issuer due to factors such as: deferred compensation plan size, Company WACC rates, tax consequences from liquidating current hedging methods, and Rabbi Trust restrictions. However, for many plan sponsors this hedging alternative should be the most practical, economical and efficient.

The use of total Return Swaps, we believe, will become the preferred method for companies to hedge their deferred compensation liabilities. Plan sponsors will be well-served to consider such a program with their bank, legal counsel, and tax and accounting advisors.

Appendix

Net Present Value (NPV)

NPV compares the value of a dollar today to the value of that same dollar in the future, taking inflation and returns into account. NPV is associated with the concept of the time value of money, a core principal of finance, which states that money available at the present time is worth more than the same amount in the future due to its potential earning capacity. Typically, if the NPV of a prospective project is positive, it should be accepted. However, if NPV is negative, the project should probably be rejected because cash flows will be negative. NPV is a central tool in discounted cash flow analysis, and is a standard method for using the time value of money to appraise long-term projects.

Discounted Cash Flow (DCF)

DCF is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them (most often using the Company's weighted average cost of capital, or WACC) to arrive at a present value, which is used to evaluate the potential for investment. If the value arrived at through DCF analysis is higher than the current cost of the investment, the opportunity will most likely increase shareholder value.

Weighted Average Cost of Capital (WACC)

WACC is the overall return that a corporation must earn on its existing assets and business operations in order to increase or maintain the current value of its stock. Companies raise money from a number of sources: common equity, preferred equity, straight debt, convertible debt, exchangeable debt, warrants, options, pension liabilities, executive stock options, governmental subsidies, etc. Different securities, which represent different sources of finance, are expected to generate different returns. A firm's WACC is the overall required return on the firm as a whole and is the appropriate discount rate to use for cash flows with risk similar to that of the overall firm, typically defined as the blended rate of the cost of debt and return on equity. Oftentimes, WACC rates can reach as high as 12%.

Acknowledgements

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Analect Benefit Finance LLC (ABF) specializes in the design, implementation, funding, hedging and ongoing administration of nonqualified deferred compensation (NQDC) Plans. ABF pioneered the development of the NQDC Total Return Swap™ program, a proprietary, low-cost offering that dynamically hedges income statement volatility created by NQDC Plans. ABF established a joint venture in 2008 with Pen-Cal to deliver the NQDC Total Return Swap™ program to some of the world's largest companies.

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