

The SEC's ETF Rule Proposal: Key Issues for the Future of Exchange Traded Products

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Since the SPDR[®] debuted as the first exchange traded fund (ETF) in 1993,¹ ETFs have grown in both popularity and number at an astounding pace, particularly in recent years. In 1993, the SPDR, at that time the only ETF, had less than \$500 million in assets under management.² Yet as of the end of 2007, there were approximately 650 ETFs spread over 629 offerings³ with approximately \$580 billion in assets under management.⁴ Although the marketplace ultimately will decide the long-term viability of ETFs and related products, given their explosive growth within the last several years, and the Securities and Exchange Commission's (SEC) increased focus on inviting more competition to the benefit of investors, it is likely that more "mainstream" firms will develop ETF products.

This article provides a brief overview of the structure of a typical ETF and outlines

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the exemptive relief historically necessary to operate ETFs. The article outlines new rules proposed under the Investment Company Act to permit index based and fully transparent actively-managed ETFs to operate without the need to obtain individual exemptive orders in contrast to certain aspects of the SEC's prior exemptive orders. Finally, this article highlights key issues of interest to investment lawyers, whether their clients play a role in developing, distributing, investing in, or competing with ETF products.

Structure of ETFs and the Current Regime of Exemptive Relief

The Anatomy of an ETF

ETFs are investment companies that are legally classified as open-end management companies or unit investment trusts (UITs), but that differ from traditional open-end management companies and UITs in several respects. First, ETFs issue and redeem shares in large blocks (for example, 50,000 shares) (Creation Units). Creation Units are typically created in kind and issued to an investor—usually a large institution called an “authorized participant” who provides the ETF with a basket of securities that generally mirror the ETF’s portfolio in exchange for shares of the ETF. The list of the names and the number of shares of required basket securities is made available by the ETF or one of its service providers immediately prior to the opening of business on the exchange. Typically, a cash component and a separate fee are also required along with the basket securities. The cash component represents the difference between the net asset value of a Creation Unit and the market value of the deposit securities. The creation fee is intended to cover certain transaction costs that the ETF would otherwise incur.

Once a Creation Unit is issued by an ETF, the authorized participant breaks it into individual shares, which then trade throughout the day on securities exchanges at prices close to the net asset value (NAV) of the shares, rather than at significant discounts or premiums. Investors who want to sell their ETF shares can sell individual shares to other investors on the secondary market or sell the Creation Units back to the ETF.⁵

ETF shares trade at prices corresponding to the ETF’s NAV because of the ability of arbitrageurs to either purchase shares of the ETF in the market and then redeem them, or purchase shares from the ETF and sell them on the market, in instances in which there is a difference between the market price and the NAV. In either case, this has the effect of keeping the market price relatively close to the NAV of the ETF.

Since they were first developed in the early 1990s, ETFs have evolved. Today, ETFs have certain characteristics that have made them attractive to a diverse array of investors. Many have lower expense ratios and greater tax efficiencies than traditional mutual funds, and they allow investors to buy and sell shares at intra-day market prices. Moreover, many of the newer ETFs are based on more specialized indexes, including indexes that

are designed specifically for a particular ETF.⁶ Originally marketed as opportunities for investors to participate in tradable portfolio or basket products, ETFs are held today in increasing amounts by institutional investors (including mutual funds) and other investors as part of sophisticated trading and hedging strategies.⁷ Investors can sell ETF shares short, write options on them, and set market, limit, and stop-loss orders on them.

Prior Exemptive Relief

Since 1993, the SEC has granted 61 exemptive orders enabling the creation and operation of ETFs.⁸ The latest exemptive requests for index-based ETFs have sought exemptions from Sections 2(a)(32), 5(a)(1), 17(a)(1), 17(a)(2), 22(d), 22(e) and 24(d) of the Investment Company Act and Rule 22c-1 under the Investment Company Act.⁹ Exemptions from these provisions generally permit: index-based ETF shares to be redeemable only in Creation Units; ETF shares to trade on exchanges at market prices rather than at NAV; dealers to sell ETF shares to purchasers in the secondary market unaccompanied by a statutory prospectus (prospectus delivery relief); relief from the requirement to pay redemption proceeds within seven calendar days of a redemption request; and affiliated persons of the ETF, by virtue of owning five percent or more of an ETF, to buy securities from, and sell securities to, the ETF in connection with the in-kind purchase and redemption of the ETF’s Creation Units. Many applicants also seek exemptive relief from Sections 12(d)(1)(A) and 12(d)(1)(B) of the Investment Company Act to permit mutual funds to acquire ETF shares beyond the limits of Section 12(d)(1)(A) of the Investment Company Act.

In February 2008, the SEC issued the first four orders relating to requests for exemptive relief necessary to create and operate fully transparent actively-managed ETFs. With the exception of prospectus delivery relief, the exemptive relief for the actively-managed ETFs substantially mirrored previous relief obtained by index-based ETFs already discussed.¹⁰ On March 4, 2008, the SEC voted unanimously to codify the prior ETF exemptive relief in two proposed rules (Rule Proposal).¹¹

The Proposed Rules

As proposed, two rules, Rule 6c-11 and Rule 12d1-4 under the Investment Company Act, would codify prior exemptive orders, with certain

changes, allowing the operation of both index based and fully transparent actively-managed ETFs, as well as the purchase of shares by unaffiliated funds in an amount exceeding the limits of the Investment Company Act. The Rule Proposal also contains proposed amendments to Form N-1A, which open-end funds use to register under the Investment Company Act and register their shares under the Securities Act of 1933 (Securities Act), that would accommodate the use of the form by ETFs. The proposed amendments are designed to provide key information to investors who purchase ETF shares in secondary market transactions, where most ETF investors (including retail investors) purchase their shares.

First, proposed Rule 6c-11 under the Investment Company Act would provide several broad exemptions from the Investment Company Act to permit ETFs to form and operate without the need to obtain individual exemptive relief from the SEC. Rule 6c-11 would embody the standard set of conditions now imposed on fully transparent actively-managed ETFs and would also apply to index-based ETFs. The proposed rule would not limit the types of indexes that an ETF may track or the types of securities that an ETF may hold.

Under proposed Rule 6c-11, and similar to the recent relief for actively-managed ETFs, delivery of a prospectus is required in connection with each secondary market transaction in such ETFs' shares.¹² Although the SEC has granted many index-based ETFs exemptive relief from Section 24(d) of the Investment Company Act to permit them to deliver a "product description," rather than a statutory prospectus, with respect to secondary market transactions in ETF shares, Rule 6c-11 does not include such an exemption. In addition, pursuant to Section 38(a) of the Investment Company Act, the SEC proposed to amend the exemptive orders it has issued to ETFs that are open-end funds to eliminate the Section 24(d) prospectus delivery relief. The consequence of the amendment to these orders, if adopted, would be to put open-end ETFs that have received exemptive orders on the same footing as ETFs that may in the future rely solely on Rule 6c-11, and thus eliminate any competitive advantage they might otherwise obtain by having obtained orders before adoption of the rule.

Proposed Rule 12d1-4 under the Investment Company Act would allow investment companies to make larger investments in ETFs than currently permitted under Section 12(d)(1) of the Investment Company Act, which limits one

investment company to acquiring no more than 3 percent of another investment company's shares. The exemptions in the proposed rule would be subject to several conditions designed to address the historical abuses associated with "pyramiding" schemes that historically occurred with fund investment in other funds (so-called fund of funds arrangements). Although the SEC and the Staff regarded this proposed rule as a codification of prior exemptive orders, proposed Rule 12d1-4 has fewer conditions than the 12(d)(1) relief provided in the prior orders. In discussing this change with SEC commissioners at the open meeting, the Staff noted that it took a fresh look at prior conditions and believed that the fewer conditions contained in proposed Rule 12d1-4 would achieve the same regulatory objective.

Finally, proposed amendments to Form N-1A, which open-end funds use both to register under the Investment Company Act and to register their shares under the Securities Act, would accommodate the use of the form by ETFs. The proposed amendments would limit the disclosure in the fee table to just those fees and expenses that impact a retail investor. The proposed amendments would also require performance information based on the market price of the ETF in addition to performance information based on the ETF's NAV.

Key Issues

As Commissioner Casey stated, the Rule Proposal reflects "real-time rulemaking." The timeliness of the Rule Proposal is impressive, particularly because it would provide relief to fully transparent actively managed ETFs, which received exemptive relief for the first time just a few weeks prior to the SEC's approval of the Rule Proposal. While the ETF industry likely will welcome new rules that facilitate the creation of more ETFs, the Rule Proposal does not seek to address, or resolve, all ETF related issues. Given that the Staff anticipates that the rules, if adopted, will spur competition and involve more firms in the development, distribution, investment in, or competition with, ETF products, ETF issues will become more important. Some of those key issues are discussed below.

A New Regime for Funds Investing in ETFs

Currently, Section 12(d)(1)(A) of the Investment Company Act prohibits an investment company

from acquiring more than 3 percent of the total outstanding voting stock of another investment company, investing more than five percent of its total assets in a single investment company, or investing more than 10 percent of its total assets in two or more investment companies. Under proposed new Rule 12d1-4, acquiring funds would be permitted to invest in ETFs in excess of the limits of Section 12(d)(1), subject to four conditions that are designed to address the historical abuses that result from pyramiding, the threat of large-scale redemptions that may otherwise arise in connection with investments in ETFs.

This proposed relief is subject to fewer conditions than prior exemptive orders but, unlike the orders, would add a new condition that would prohibit an acquiring fund's ability to redeem ETF shares. Second, the proposed Rule 12d1-4 would prohibit an ETF, its principal underwriter, and a broker or a dealer that relies on the rule to sell ETF shares in excess of the limitations of Section 12(d)(1)(B) from redeeming those shares acquired by another fund that exceed the 3 percent limit in Section 12(d)(1)(A)(i).

While the SEC and its Staff should be commended for streamlining the conditions of this new rule, at least one condition from the exemptive relief, which may be problematic, remains. The proposed rule would, much like the prior exemptive relief, restrict an investing fund from controlling an ETF. Specifically, an investing fund, together with its affiliates, may not control an ETF. If, as a result of a decrease in the number of outstanding shares of the ETF, an investing fund and its affiliates owned more than 25 percent of an ETF, that fund and its affiliates would be required to vote their shares of the ETF in the same proportion as all other voting shares of the ETF (mirror voting). While this should not present a problem for the investing fund, it may be a problem for its affiliates. The affiliates of the investing fund may be holding shares of the ETF in a fiduciary capacity that requires them to actively, rather than passively, vote those shares. Thus, an investing fund with such affiliates may not be able to commit to the mirror voting requirement.

Further, the SEC did not address hedge funds, or other private funds, investing in ETFs beyond the Section 12(d)(1) limits.¹³ Presumably the same rationale that would support a registered fund investing beyond the 12(d)(1) limits would be equally applicable to a private fund. Nonetheless, the SEC did not even raise the question of whether the relief should be expanded to include investments by private funds. Consequently, absent a

major revision in any adoption of proposed Rule 12d1-4, hedge funds investing in ETFs will remain subject to the 12(d)(1) limits.

In any event, until the new rule is adopted, all funds investing in ETFs must continue to invest within the limits of Section 12(d)(1) and the rules thereunder, or rely on an exemption obtained by the underlying ETF in which the investing fund wishes to invest. However, as the SEC pointed out in the Rule Proposal, compliance with these conditions is quite cumbersome. Once more, an investing fund may be unaware that it is approaching the limits of Section 12(d)(1)(A) without proper policies and procedures in place to regularly review the asset levels of the ETFs in which it invests. This problem will likely continue, if not increase, as more "niche" ETFs with smaller asset levels come to market, and is particularly problematic with respect to ETFs during their startup period.

Authorized Participants Take Note: Prospectus Delivery and Due Diligence

Because new ETF shares are created and issued on an ongoing basis, at any point during the life of a fund a "distribution," as defined by the Securities Act, may occur. If a firm is an authorized participant, purchasing Creation Units and selling individual shares in the secondary markets, these activities may, depending on the circumstances, result in the firm being deemed a participant in a distribution and therefore a statutory underwriter, thus subject to the prospectus delivery and liability provisions of the Securities Act.¹⁴

For delivery of prospectuses to exchange members, the prospectus delivery mechanism of Rule 153 under the Securities Act is only available with respect to transactions on a national securities exchange. Prior exemptive orders generally have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions, by allowing broker-dealers to instead deliver a shorter "product description" document. Under the Rule Proposal, Rule 6c-11 would not include a similar exemption, and thus broker-dealers would be required to deliver a prospectus, meeting the requirements of Section 10(a) of the Securities Act, to investors purchasing ETF shares. One reason for this is the Staff's belief that the product description is too rarely used due to operational barriers and risk concerns within the industry. However, in light of the SEC's recent proposal to revive the "summary prospectus," the Rule Proposal would allow a person to satisfy its prospectus delivery obligations

under the Securities Act by sending or giving a summary prospectus and providing a prospectus that meets the requirements of Section 10(a) of the Securities Act on an Internet Web site. If adopted, broker-dealers selling ETF shares could therefore deliver a summary prospectus in secondary market transactions.

At the risk of being deemed participants in a distribution and therefore a statutory underwriter, authorized participants should continue to closely review the registration statements of ETFs in which they are investing, particularly as more sophisticated ETF products, such as leveraged, commodity-linked and actively-managed ETFs, come to market. Authorized participants take differing approaches as to the level of diligence conducted before purchasing Creation Units of an ETF. Nevertheless, a firm's diligence process and results should be well documented. Among other things, authorized participants should review the ETF's registration statement, all related agreements and exemptive orders, index licensing agreements, custody arrangements and securities lending practices. Additionally, the ETF's underlying index methodology, if applicable, as well as the ETF's investment adviser, its code of ethics and Form ADV should be reviewed to ensure that the adviser can properly manage the ETF's strategy. For more exotic products, authorized participants should also consider involving tax counsel, obtaining an opinion from outside counsel and comfort letters from the ETF. Finally, ongoing due diligence of an ETF should be continued so long as an authorized participant agreement is in place with the ETF.

Developing Exchange Traded Products: A Changing Landscape?

The proposed rules, if adopted, may cause a shift in the competitive forces existing in the ETF marketplace. There has been significant activity within the ETF industry in launching non-ETF exchange traded vehicles, such as exchange traded notes designed to track the performance of commodities or currency indexes.¹⁵ The exchange traded note (ETN) market has grown rapidly, with about \$4 billion in such instruments having been issued as of the end of 2007.¹⁶ Shares of ETNs generally must be registered under the Securities Act and trading of the notes in the secondary market is subject to the Securities Exchange Act of 1934. ETNs are not required to register under, and thus not been required to seek exemptions from, the Investment Company Act.

ETNs were first marketed in 2006, but other investment firms have since offered their own variants.¹⁷ Unlike a mutual fund, which pays dividends or other returns to investors through the course of the year, thereby triggering a tax obligation, many ETNs collect the return over the course of the year, but do not pay it out until the investor disposes of the investment. The result is that the investor delays paying taxes, and then pays only at the low capital gains rate of 15 percent, instead of potentially higher rates incurred by a mutual fund investor during the life of an investment. However, this preferential treatment may be in jeopardy.¹⁸ Earlier this year, a bill was introduced in Congress that would remove this tax treatment based on the notion that the economic position of the investor in an ETN can be viewed as similar to that of an investor who pursued the underlying investment strategy by buying the actual "cash" securities that comprise an index.¹⁹ Combined with the proposed rules allowing ETFs to come to market much faster and more privately, this may tip the competitive advantage to ETFs.

Traditional Mutual Funds vs. Actively Managed ETFs: What Next?

Many investors who currently invest in ETFs do so through financial advisors, with whom index-based ETFs have been most popular, in part because they use ETFs to invest in market niches (for example, China) or use a combination of sector ETFs and individual stocks to implement an asset allocation strategy.²⁰ These financial advisors may not embrace many of the fully transparent actively-managed ETFs as they have index-based ETFs because actively-managed ETFs will likely play a differing role in a client's portfolio. Other financial advisors who have relied on traditional mutual funds as part of their clients' portfolios, however, likely will embrace actively-managed ETFs. In competing, actively-managed ETFs should be expected to market, among other things, the ability to buy and sell their shares at intra-day prices on an exchange, any tax advantages of their structure and the transparency of their portfolios.

ETFs have historically conducted most Creation Unit transactions in kind, and in so doing, they have avoided certain taxes that traditional mutual funds incur as a result of portfolio transactions in cash. Several newer index-based ETFs and some of the actively-managed ETFs, however, have abandoned the in-kind approach and transact primarily or exclusively in cash. This approach

likely will have an effect on the tax efficiencies traditionally associated with ETFs. To the extent that redemptions of their Creation Units are honored in cash and, therefore, necessitate sales of portfolio securities, their tax situation may be more like that of traditional mutual funds than that of previous ETFs. This may diminish their appeal for certain investors who have chosen ETFs for their tax advantages.

With respect to non-transparent actively-managed ETFs, the SEC Staff was not ready to include them in the Rule Proposal because of the differing approaches that product sponsors wish to take to provide necessary information about portfolio components and characteristics.²¹ The SEC Staff acknowledged that it is working with proponents of such products, but has not had the opportunity to resolve these issues, and thus did not view it as timely to bring to the SEC at this point.²²

NOTES

1. On October 26, 1992, the Securities and Exchange Commission issued an order to SPDR Trust, Series 1 and PDR Services Corporation permitting SPDR Trust, Series 1, a unit investment trust under Sections 6(c) and 17(b) of the Investment Company Act of 1940 (Investment Company Act) and exempted the trust and PDR Services Corporation from Sections 4(2), 14(a), 17(a), 22(d), 22(e), 24(d), 26(a)(2)(C), and Rule 22c-1, and under Rule 17d-1 permitted them to engage in certain affiliated transactions otherwise prohibited by Section 17(d) and Rule 17d-1. Investment Company Act Rel. Nos. 19055 (Oct. 26, 1992) (order) and 18959 (Sept. 17, 1992) (notice). The exemptive order allowed the trust to issue non-redeemable securities, now known as SPDRs, that would trade in secondary market transactions at negotiated prices. SPDRs were developed in response to the suspension of trading in index participations, which were deemed to be within the exclusive jurisdiction of the Commodity Futures Trading Commission by the Seventh Circuit in *Chicago Mercantile Exchange v. SEC*.

2. SPDR Trust Series 1 Form S-6 (Jan. 19, 1996). SPDRs are designed to track the S&P 500 Index, trade like shares of common stock, and pay quarterly dividends proportionate to those paid by the portfolio of stocks constituting the S&P 500 Index. As of December 31, 1993, the SPDR had net assets of \$461,557,000. *Id.*

3. John Spence, "Dreyfus Lends Its Clout to Foreign Bond, Cash ETFs—WisdomTree Gains Powerful Partner for New Products," *The Wall Street Journal*, Jan. 28, 2008.

4. *Exchange Traded Funds*, Investment Company Act Release No. 28193 (Mar. 11, 2008) [ETF Release]. See also Joe Morris, "New-ETF Euphoria Wanes," *Ignites.com*, Jan. 2, 2008. This growth has been achieved exclusively by index-based ETFs.

5. However, as discussed in greater detail below, acquired funds seeking to rely on Rule 12d1-4 would be prohibited from redeeming creation units from the ETF and must instead dispose of ETF shares by trading them in the secondary market.

6. ETF Release, *supra* n.4, at 6-7.

7. *Id.*

8. Andrew Donohue, Remarks at the Open Meeting of the Securities and Exchange Commission (Mar. 4, 2008) available at <http://www.connectlive.com/events/secopenmeetings/>.

9. ETFs organized as UITs have also sought and received exemptive relief from sections 4(2), 14(a) and 26(a)(2)(C). See, e.g., SPDR Trust Series 1. In addition, because the ETFs sponsored by Vanguard are organized as a separate share class of a mutual fund, Vanguard has sought and received exemptive relief from sections 18(f)(1) and 18(i).

10. However, the SEC did impose three new conditions not included in exemptive relief requests for index-based ETFs. First, the adviser and/or sub-adviser to an actively-managed ETF must not cause any authorized participant (or any investor on whose behalf an authorized participant may transact with the fund) to acquire any portfolio security or deposit security for the ETF through a transaction in which the ETF could not engage directly. Second, on each business day, before the commencement of trading in an ETF's shares on each ETF's Exchange, the ETF must disclose on its Web site the identities and quantities of the portfolio securities and other assets held by the ETF that will form the basis for the ETF's calculation of NAV at the end of the business day. Third, each request for exemptive relief provides that the requested order will expire on the effective date of any SEC rule under the Investment Company Act that provides relief permitting the operation of actively-managed ETFs.

11. The SEC also proposed amendments to disclosure Form N-1A to include additional information for ETF investors who purchase shares in the secondary markets. Interestingly, the Staff also proposed an amendment to Rule 12d1-2 to fix a "glitch" in the original rule adopted in June 2006 so that funds of funds would now be allowed to invest in unaffiliated mutual funds, securities, and other instruments, such as futures and swaps.

12. As open-end investment companies, ETFs should be able to satisfy any prospectus delivery requirement with a "summary" prospectus if the SEC's recent summary prospectus rule is adopted. Investment Company Act Release No. 28064 (Nov. 21, 2007).

13. Funds that would be investment companies but for the provisions of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are nonetheless deemed to be investment companies for purposes of the limitations in Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i).

14. While the authors do not agree or disagree with this position, nonetheless, any determination of whether one is an "underwriter" for purposes of the Securities Act must take into account all the relevant facts and circumstances of each particular case. Additionally, dealers who are not "underwriters," but are participating in a distribution (instead of ordinary secondary transactions), and thus dealing with shares that are part of an "unsold allotment" within the meaning of Section 4(3)(C) of the Securities Act, would be unable to take advantage of the prospectus delivery exemption provided by Section 4(3) of the Securities Act.

15. See, e.g., John Spence, "Exchange-Traded Notes Seek Their Niche—Lehman Takes On ETFs With Three New Securities Seen as 'Better Wrappers'," *The Wall Street Journal*, March 4, 2008 (announcing the launch of three ETNs—two for commodities and another designed to track the global

private-equity market, as well plans to launch many more ETNs); Shefali Anand, "Investing in Funds: A Quarterly Analysis—Talking About ETFs: A top Barclays executive predicts what's in store for 2008—and reveals what worries him," *The Wall Street Journal*, Jan. 3, 2008 (quoting Lee Kranefuss of Barclays Global Investors, "And you will see us also extending the iPath line. [iPath is an exchange-traded note, a close variant of the ETF, in which the issuer promises to pay a certain return of an index, minus a fee. Investors take on the credit risk of the issuer, in this case Barclays Bank PLC.]").

16. Jesse Drucker, "A Tax-Deferral Program Is Likely to End—Regulators Move to Halt Capital Gains Benefits Of Exchange-Traded Notes," *The Wall Street Journal*, Dec. 11, 2007.

17. *Id.*

18. Rachel McTague, "Outlook: Congress Unlikely to Move Major Securities Legislation in 2008," *BNA Securities Law Daily*, Jan. 18, 2008. For example, the ICI continues to strongly

support a proposed bill that would tax ETNs more similarly to mutual funds by approximating for ETNs the tax an investor would pay on a mutual fund. *Id.*

19. Joe Morris, "ETN Tax Reform Revs Up in Congress," *Ignites.com*, Feb. 15, 2008.

20. *See, e.g.*, iShares FTSE/Xinhua China 25 Index Fund, which seeks investment results that correspond to the FTSE/Xinhua China 25 Index.

21. *See, e.g.*, Vanguard Fixed Income Securities Funds, et al., Application Pursuant to Section 6(c) for an Order of Exemption From Sections 2(a)(32), 18(f)(1), 18(i), 22(d), and 24(d) and Rule 22c-1, and Pursuant to Sections 6(c) and 17(b) for an Order of Exemption From Sections 17(a)(1) and (a)(2), File No. 812-13362 (Feb. 9, 2007).

22. *See* Open Meeting of the Securities and Exchange Commission (Mar. 4, 2008) available at <http://www.connective.com/events/secopenmeetings/>.

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