Investment Management Regulatory Update

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SEC Rules and Regulations

SEC Issues No Action Relief to Business Development Company Structured as Master-Feeder

On July 15, 2015, the Staff of the Division of Investment Management of the SEC (the "**Division**") issued a letter (the "**Letter**") providing no-action relief under Sections 7(a), 55(a) and 23(c) of the of the Investment Company Act of 1940, as amended (the "**Investment Company Act**") to a business development company ("**BDC**") structured in a master-feeder arrangement.

The Division based its grant of no-action relief on the following representations, each as set forth in the incoming letter requesting no-action relief (the "**Incoming Letter**"):

- Carey Credit Advisors, LLC (the "**Adviser**") and Guggenheim Partners Investment Management, LLC (the "**Sub-Adviser**") propose to offer a BDC structured in a master-feeder arrangement. The proposed BDC consists of the Carey Credit Income Fund (the "**Master Fund**") and the Carey Credit Income Fund 2016 T (together with potential future feeder funds, the "**Feeder Funds**").
- Each of the Master Fund and the Feeder Funds is or will be formed as a closed-end management investment company formed as a statutory trust under Delaware law that has elected to be regulated as a BDC.
- The Master Fund will have an indefinite life, will engage in a continuous private placement offering of its common shares (the "**Master Fund Shares**") and will allocate its income, gains, deductions, losses and distributions to its shareholders—the Feeder Funds, the Adviser and an affiliate of the Sub-Adviser—based on each such shareholder's proportionate interest.
- Each Feeder Fund will have a finite term, engage in a public offering of its common shares (the "**Feeder Fund Shares**") for a finite offering period and invest all or substantially all of its assets in the Master Fund.
- No Feeder Fund will engage in direct investment or borrowing activity.

The applicants in the Incoming Letter were concerned that the Feeder Funds would not qualify to be treated as BDCs. Section 54(a) of the Investment Company Act generally allows any company to elect to be regulated as a BDC as long as it meets the definition of a BDC set out in Sections 2(a)(48)(A) and (B) of the Investment Company Act, which generally defines a BDC as any closed-end investment company that (i) operates for the purpose of making investments in certain securities described in Sections 55(a)(1)-(3) of the Investment Company Act and (ii) makes available significant managerial assistance with respect to the issuers of those securities. According to the Incoming Letter, while the Master Fund will satisfy both prongs (i) and (ii) of this definition, the Feeder Funds may not satisfy either of the prongs because, under Section 2(a)(46) of the Investment Company Act, securities of an investment company (as defined in Section 3 of the Investment Company Act) will be excluded from the eligible securities described in prong (i) and all of substantially all of each Feeder Fund's assets will consist of Master Fund Shares. As a result, according to the Incoming Letter, absent relief from the SEC, the Feeder Funds may not satisfy the definition of a BDC, which could mean that the Feeder Funds would be in violation of Section 7(a) of the Investment Company Act.

Section 55(a) of the Investment Company Act generally prohibits a BDC from acquiring any assets (other than certain specified assets) unless, at the time of acquisition, at least 70% of the BDC's total assets (with certain exclusions) are assets described in paragraphs (1)-(6) of the section ("**Qualifying Assets**"). According to the Incoming Letter, the Master Fund intends to comply with Section 55(a), but since all or substantially all of the assets of each Feeder Fund will be invested in Master Fund Shares, no Feeder Fund will have 70% of its assets invested directly in Qualifying Assets, which could mean that the Feeder Funds would be in violation of Section 55(a) of the Investment Company Act.

According to the Incoming Letter, in order to allow the Feeder Funds to comply with Sections 7(a) and 55(a) of the Investment Company Act, each Feeder Fund intends to include its respective indirect ownership interest in the investments of the Master Fund as its own investments for purposes of the definition of a BDC and Section 55(a) of the Investment Company Act. According to the Incoming Letter, it would be consistent with the intent of these provisions for the SEC to permit the Feeder Funds to do so, since the Master Fund intends to satisfy both the BDC definition and the Section 55(a) requirements at all times. In the Incoming Letter, the applicants also argued that because each Feeder Fund will only be used to invest indirectly in the Master Fund's assets, it should be permitted to include its proportionate interest in the Master Fund's assets for purposes of satisfying the BDC definition and determining the percentage of its total assets that are Qualifying Assets.

According to the Incoming Letter, the Master Fund intends to repurchase a certain amount of its outstanding Master Fund Shares on a quarterly basis by means of an issuer tender offer under Rule 13e-4 under the Securities Exchange Act of 1934, as amended, using a price equal to the net asset value per share on the last day of the most recent quarterly reporting period. Each Feeder Fund, according to the Incoming Letter, will also offer a quarterly share repurchase program for its outstanding Feeder Fund Shares using the same tender offer mechanism and in parallel with the share repurchases conducted by the Master Fund. The Incoming Letter states that at the end of each Feeder Fund's finite term, such Feeder Fund will be liquidated and dissolved when the Master Fund purchases for cash of all of the Master Fund Shares owned by the Feeder Fund in accordance with Rule 23c-1 under the Investment Company Act and distributes that cash to the liquidating Feeder Fund's shareholders.

Section 23(c) of the Investment Company Act, which is applicable to BDCs, generally prohibits a BDC from purchasing its own securities, with certain limited exceptions. Rule 23c-1(a)(3) under the Investment Company Act allows a registered closed-end investment company to purchase its securities for cash, provided that if the security to be purchased is junior to any class of outstanding security of the issuer representing indebtedness, all securities of such class must have an asset coverage of at least 300% immediately after such purchase. This requirement in Rule 23c-1(a)(3) is parallel to the requirement in Section 18(a)(1)(A) of the Investment Company Act, which prohibits a registered closed-end investment company from issuing any class of senior security representing indebtedness unless it will have an asset coverage of at least 300% immediately after such issuance. Section 61(a)(1) of the Investment Company

Act, however, generally provides that for BDCs, the asset coverage requirement in Section 18(a)(1)(A) of the Investment Company Act is only 200%. According to the Incoming Letter, the Master Fund argued that because the requirement in Rule 23c-1(a)(3) is parallel to that in Section 18(a)(1)(A), it should be allowed to comply with the 200% asset coverage requirement rather than the 300% requirement. Secondly, Rule 23c-1(a)(4) under the Investment Company Act generally states that the seller of the security must not, to the knowledge of the issuer, be an affiliated person of the issuer. According to the Incoming Letter, each Feeder Fund will be an affiliated person of the Master Fund. However, the Master Fund and Feeder Funds argued in the Incoming Letter that repurchasing Master Fund Shares from a liquidating Feeder Fund does not raise the concern for abuse that Rule 23c-1(a)(4) was designed to address, since each Feeder Fund will be subject to a finite term and will be liquidated and dissolved in the same planned manner, which will be clearly disclosed to the Master Fund's and each Feeder Fund's shareholders.

According to the Letter, the Division would not recommend enforcement action, based on the facts and representations described above, against: (A) the Feeder Funds (i) under Section 7(a) of the Investment Company Act if each Feeder Fund elects to be regulated as a BDC pursuant to Section 54 of the Investment Company Act or (ii) under Section 55(a) of the Investment Company Act if each Feeder Fund includes its proportionate ownership interest in the Master Fund's assets for purposes of determining the composition of its own assets under Section 55(a); or (B) the Master Fund under Section 23(c) of the Investment Company Act if the Master Fund repurchases Master Fund Shares in a planned liquidation of a Feeder Fund in accordance with Rule 23c-1 under the Investment Company Act except as described above.

- **See a copy of the No-Action Letter**
- **See a copy of the Incoming Letter**

Industry Update

Interagency Volcker Rule FAQ #16 Addresses Treatment of RICs and FPFs as Banking Entities During Their Seeding Period

On July 16, 2015, the Federal Reserve and other Volcker Rule agencies, including the SEC (together, the "**Agencies**"), added a new question and answer to their frequently asked questions ("**FAQs**") regarding section 13 of the Bank Holding Company Act of 1956 (the "**BHCA**") and the implementing regulations promulgated thereunder (together, commonly known as the "**Volcker Rule**"). The new FAQ #16 addresses the status of registered investment companies ("**RICs**") and foreign public funds ("**FPFs**") as banking entities under the Volcker Rule during their seeding periods. For a detailed discussion of previously issued FAQs, please see the June 18, 2014 Davis Polk Client Memorandum, **Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines**, and the **March 26, 2015 Investment Management Regulatory Update**.

Generally, under the Volcker Rule, a fund that is not a "covered fund" will be a banking entity, and itself subject to the Volcker Rule's restrictions on proprietary trading and covered fund activities, if the fund is controlled by a banking entity. Funds such as RICs and FPFs that are excluded from the definition of covered fund will be controlled and therefore banking entities if a banking entity owns 25 percent or more of the fund's equity. During the seeding period of a fund that is sponsored by a bank-affiliated asset manager, it is common for the fund to be wholly, or almost wholly, owned by the asset manager, by virtue of the asset manager providing the seed capital to the fund. Thus, without specific guidance, RICs and FPFs that are seeded by bank-affiliated asset managers or otherwise by banking entities could have been deemed to be controlled by the seeding banking entity and thus themselves banking entities subject to the Volcker Rule's restrictions on proprietary trading and covered fund activities.

FAQ #16 acknowledges that a banking entity may own a significant portion of the shares of a RIC or FPF during the fund's seeding period, when the banking entity is testing the fund's investment strategy, establishing the fund's track record for marketing purposes and attempting to distribute the fund's shares. The staffs of the Agencies clarify that they would not advise the Agencies to treat a RIC or FPF as a banking entity solely on the basis of the level of ownership of the RIC or FPF by a banking entity during its seeding period, unless there is evidence that the fund is being used to evade the Volcker Rule. The FAQ also generally provides a period of up to three years (or potentially longer, under very limited circumstances) for banking entities to hold seed investments in RICs and FPFs without the funds being viewed as banking entities. Importantly, the FAQ provides that a banking entity does not need to submit an application to the Federal Reserve to determine the length of the seeding period for RICs or FPFs.

Consistent with how the seeding period is generally determined for covered funds under the Volcker Rule, FAQ #16 states that the applicable seeding period for RICs and FPFs would generally be measured from the date on which the investment adviser or similar entity begins making investments pursuant to the written investment strategy of the fund. Finally, the FAQ confirms that a vehicle that is a covered fund (not a RIC or FPF) during its seeding period and that is formed and operated pursuant to a written plan to become a RIC must still apply to the Federal Reserve for an extension if it intends to go beyond the one-year seeding period already granted to such covered funds.

- **See a copy of the FAQ**

Litigation

SEC Charges Deloitte with Auditor Independence Violations

On July 1, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Deloitte & Touche LLP ("**Deloitte**") for violating auditor independence rules. The SEC charged Deloitte in connection with its consulting affiliate's Deloitte Consulting LLP's ("**Deloitte Consulting**") maintenance of a business relationship with a trustee of three registered investment companies (the "**Funds**") to which Deloitte served as an auditor. The SEC also charged the administrator of the three Funds, ALPS Fund Services, Inc. ("**ALPS**"), and the trustee with related violations.

Rule 2-02(b) of Regulation S-X requires, among other things, an accountant's report to state whether the report was made in accordance with generally accepted accounting standards ("**GAAS**"). GAAS requires auditors to maintain independence both in fact and in appearance. Furthermore, Rule 2-01(c)(3) of Regulation S-X generally defines an auditor independence violation as an independence-impairing relationship that exists during all or part of the period covered by the audit or the audit work, followed by the issuance of an audit report asserting the independence of the auditor from the client. The prohibition includes business relationships with persons connected to the audit client in a decision-making role.

According to the Order, the trustee served on the boards and audit committees of the three Funds when Deloitte Consulting entered into a business relationship with the trustee. Deloitte Consulting purchased the trustee's intellectual property rights to a brainstorming business method and engaged him as a consultant to Deloitte Consulting to assist it in employing the business method and training its personnel. The initial consulting engagement lasted three years, with sporadic contact for two years thereafter, during which time the trustee's remuneration exceeded 10% of his earnings and net worth. The SEC found that Deloitte failed to follow its internal policy requiring an independence consultation prior to Deloitte Consulting entering into a business engagement with the trustee, and it did not perform such a review for almost five years after the relationship had been established. During the business engagement, Deloitte represented that it was independent in its audit reports for the three Funds, and the

Funds filed those reports with SEC in their annual reports on Form N-CSR and proxy statements. The SEC also found that Deloitte failed to disclose the relationship on its annual independence confirmations required by the Public Company Accounting Oversight Board Rule 3526.

The Order further states that the Funds had contracted with ALPS to assist with their obligations under Rule 38a-1 under the Investment Company Act, which requires written policies and procedures reasonably designed to prevent the violation of the federal securities laws by registered investment companies. The SEC found that none of the Funds adopted policies and procedures reasonably designed to prevent violations of the auditor independence rules. Although ALPS circulated trustee and officer questionnaires to identify potential conflicts of interest, neither the questionnaires nor any other policy or procedure addressed potential business relationships with auditor affiliates. The Order further states that the trustee failed to disclose his relationship with Deloitte Consulting to the Funds.

The SEC found that Deloitte violated Rule 2-02(b) of Regulation S-X by representing that it was independent while its consulting affiliate was engaged in a business relationship with the trustee. It also found that Deloitte caused the Funds to violate the reporting rules under Sections 30(a) and 20(a) of the Investment Company Act and Rule 20a-1 thereunder which require disclosure of information relating to auditor independence. Additionally, the SEC censured Deloitte for improper professional conduct under the SEC's Rules of Practice. As to ALPS, the SEC found that it caused the Funds' violation of Rule 38a-1 under the Investment Company Act since it failed to implement the policies and procedures it had contractually agreed to assist in implementing. The SEC further found that trustee caused the Funds' reporting violations.

Deloitte agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered Deloitte to disgorge its audit fees in the amount of $497,438 and to pay prejudgment interest of $116,478 and a civil money penalty of $500,000. It ordered ALPS to pay a $45,000 civil money penalty and the trustee to pay disgorgement of $30,000, plus $5,329 of pre-judgment interest and a civil money penalty of $25,000.

- **See a copy of the Press Release**
- **See a copy of the SEC Order**

SEC Charges Investment Advisory Firm with Fraudulent Valuation Scheme

On July 1, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against AlphaBridge Capital Management, LLC ("**AlphaBridge**") and its two owners for fraudulently inflating the valuations of certain securities in hedge fund portfolios managed by AlphaBridge, in violation of Sections 206(1), 206(2), 206(4), and 207 of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rules 206(4)-7 and 206(4)-8 thereunder.

The SEC alleged that since 2001, AlphaBridge has provided investment advisory services to three private investment funds (the "**Funds**"). AlphaBridge collected a monthly management fee equal to 2% per annum of the Funds' assets, as well as an annual performance fee equal to 20% of the Funds' net profits. According to the Order, the Funds invested primarily in a broad range of fixed income securities, including interest-only ("**IO**") and inverse, interest-only ("**IIO**") floaters, which are classes of pools of mortgage loans known as collateralized mortgage obligations ("**CMOs**"). CMOs are organized into different payment classes based on the characteristics of the underlying mortgages, and the IO and IIO classes receive a coupon payment based on changes in prevailing interest rates.

The SEC alleged that from 2001 to 2013, AlphaBridge made representations to the Funds' investors, administrator and auditor regarding AlphaBridge's valuation process for IOs and IIOs. AlphaBridge, according to the SEC, stated that its process consisted of obtaining monthly price quotes from two independent broker-dealers and taking the arithmetic average of those quotes as the price for the IOs and IIOs. The SEC alleged that since 2001, AlphaBridge had in fact consistently obtained quotes from the

same two registered representatives (the "**Representatives**"), both of whom had long-term business relationships with AlphaBridge. The Representatives, according to the SEC, provided monthly price quotes to the Funds' administrator and annual price quotes to the Funds' auditor and received as compensation commissions for transactions executed on behalf of AlphaBridge or the Funds. According to the Order, commissions received from AlphaBridge made up 10% to 60% of one Representative's commissions from 2001 to 2011. The SEC alleged that between 2008 and 2010, AlphaBridge began providing its own valuations to the Representatives, who then provided the valuations to the Funds' administrator and auditor. Although AlphaBridge initially told the Representatives to review the prices AlphaBridge provided, the SEC alleged that AlphaBridge was at least reckless in not knowing that the Representatives "did little or nothing" to verify the validity of the prices, and by 2010, the prices that the Representatives sent to the Funds' administrator and auditor were in fact AlphaBridge's prices. According to the SEC, this practice was not disclosed to the Funds' investors, administrator or auditor, nor were the respective broker-dealer employers of the Representatives told that the Representatives were providing price quotes to the AlphaBridge Funds.

According to the Order, from at least 2006 to 2013, AlphaBridge's majority owner signed annual management representation letters, which included representations about the independence of the Representatives. In 2011 and 2012, AlphaBridge provided memoranda to the Funds' auditor that included representations about the reputability of the Representatives, as well as an analysis that concluded that quotes from the Representatives were reasonable (despite the fact that by this time, the Representatives were largely transmitting AlphaBridge's prices to the Funds' administrator and auditor). At all times, according to the SEC, the Funds' financial statements and offering documents stated that the value of assets not traded on a ready market would be determined in accordance with fair value principles and its valuation policy provided that the Funds' assets would generally be valued in accordance with fair value standards. However, according to the SEC, AlphaBridge did not obtain independent price quotes or otherwise comply with fair value standards. In connection with the 2011 and 2012 audits, the Funds' auditor noticed significant divergences between AlphaBridge's IIO prices and the prices in the internal database of a professional valuation team hired by the Funds' auditor. The Funds' auditor posed a series of email and phone queries to one of the Representatives, whose responses were, unbeknownst to the Funds' auditor, prepared beforehand by AlphaBridge's minority owner and only transmitted to the Funds' auditor after his approval. In 2012, the Funds' auditor suspended the 2012 audit in light of increasing divergence in IIO prices. AlphaBridge retained an outside consultant and, after adopting a new valuation methodology, the Funds' NAV for 2012 was written down more than 65%. As a result of the overstated NAVs, AlphaBridge and its two owners collected excessive management fees and performance fees and misreported AlphaBridge's total assets under management in its Form ADV.

The SEC alleged that in engaging in the conduct described above, AlphaBridge violated Sections 206(1) and 206(2) of the Advisers Act, which generally prohibit fraud against any client or prospective client. The SEC further alleged that, because AlphaBridge failed to comply with its own valuation policy, it violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which generally require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. The SEC further alleged that AlphaBridge violated Rule 206(4)-8 under the Advisers Act, which generally prohibits any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements not misleading to any investor or potential investor. The SEC also stated that by misstating its assets under management in its Form ADV, AlphaBridge violated Section 207 of the Advisers Act, which generally prohibits any person willfully to make any untrue statement of a material fact or omit any material fact in any report filed with the SEC.

According to the Order, AlphaBridge agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered AlphaBridge and its two owners to pay over $4 million in disgorgement and nearly $1 million in civil money penalties, and to cease and desist from any violations or future violations of 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The

SEC also ordered AlphaBridge to engage, at its own expense, an independent monitor to oversee the winding down of the Funds.

- See a copy of the Press Release
- See a copy of the SEC Order

SEC Charges Registered Investment Adviser for Failure to Adequately Disclose Conflict of Interest Relating to Compensation Arrangements

On July 24, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Dion Money Management, LLC (renamed Atlas Private Wealth Management, LLC in January 2014) ("**DMM**"), a Massachusetts-based registered investment adviser, for failing to completely and accurately disclose its conflicts of interest with respect to certain compensation arrangements with third parties that were calculated based on DMM client assets invested in specific mutual funds, thereby violating Section 206(2) of the Advisers Act. DMM was also charged with violating Section 207 of the Advisers Act for omitting certain material facts from its SEC filings concerning such compensation arrangements.

According to the Order, DMM researched portfolios of mutual funds and recommended the same to its clients, offering a variety of different risk profiles and other fund options. In addition, according to the Order, DMM constructed for its clients model portfolios of mutual funds, as well as individualized portfolios based on specific client preferences. According to the SEC, although DMM's clients were free to select any custodian for their assets, most clients selected one of the two SEC-registered broker-dealers recommended by DMM ("**Broker A**").

According to the SEC, DMM entered into three contracts that are relevant to the Order (together, the "**Service Agreements**"):

- (1) DMM entered into an agreement with an adviser and administrator ("**Adviser B**") of a family of mutual funds ("**Fund Family B**") pursuant to which, in exchange for certain recordkeeping and administrative services, DMM received a quarterly fee based on the percentage of DMM client assets invested in certain mutual funds within Fund Family B. According to the Order, by 2005, the fee paid to DMM by Adviser B ranged from 0.20% to 0.30% of applicable client assets, based on the amount of DMM client assets invested in the funds enumerated in the agreement with Adviser B.
- (2) DMM entered into an agreement with the distributor ("**Distributor C**") for a certain family of mutual funds ("**Fund Family C**") advised by an affiliate of Distributor C pursuant to which, in exchange for certain account maintenance services, DMM received a quarterly fee based on the percentage of DMM client assets invested in certain mutual funds within Fund Family C. According to the SEC, the maximum fee payable to DMM under its agreement with Distributor C was 0.30% of applicable client assets.
- (3) DMM entered into an agreement with Broker A pursuant to which, in exchange for certain account recordkeeping services, DMM received a quarterly fee based on the percentage of DMM client assets held in custody with Broker A that were also invested in mutual funds available on Broker A's no-transaction fee platform (the "**Platform**"). The Platform, according to the Order, included a large selection of funds, including mutual funds within Fund Family B and Fund Family C. According to the SEC, DMM's fee under its agreement with Broker A reached 0.095% of applicable client assets after several amendments.

According to the SEC, although DMM included certain disclosures regarding its Service Agreements, DMM failed to disclose to its clients, in its Form ADV or otherwise, certain material terms of such Service Agreements. For example, in 2011, 2012 and 2013, DMM disclosed in its Form ADV Part 2 that its annual compensation under the Service Agreements could reach up to 0.30% of a mutual fund's average

daily net asset value of shares held by its clients. However, the SEC alleged that such disclosure was incomplete, since, under certain circumstances, DMM received fees at a rate greater than 0.30% and payments based on the same client assets from Broker A and either Adviser B or Distributor C. Finally, according to the SEC, over different time periods, DMM incorporated mutual funds from both Fund Family B and Fund Family C into the model portfolios it constructed and recommended to its clients. The SEC alleged that approximately 50%-55% of DMM's total client assets were invested in mutual funds from Fund Family B and Fund Family C, and of that amount, investments in Fund Family C funds represented approximately 40%-45%. Considering the concentration of its client assets invested in Fund Family B and Fund Family C and that such funds were among those recommended to its clients, the SEC concluded that DMM was at least negligent in its failure to completely and accurately disclose to its clients the terms of its compensation arrangements under the Service Agreements and the potential conflicts of interest arising thereunder.

DMM agreed to settle the charges without admitting or denying the SEC's findings. In addition, DMM agreed to certain undertakings, including (i) amending certain provisions of its Form ADV, Part 2, to include additional disclosures regarding the Service Agreements and other matters alleged in the Order, (ii) providing its clients with a copy of the Order within 30 days of entry of the same and (iii) certifying in writing to its compliance with the undertakings in (i) and (ii) above. The SEC censured DMM and ordered DMM to cease and desist from committing or causing any violations or future violations of Sections 206(2) and 207 of the Advisers Act. Finally, the SEC ordered DMM to pay a civil money penalty of $50,000.

- **See a copy of the SEC Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Beth M. Bates	**212 450 4062**	**beth.bates@davispolk.com**
Alison M. Hashmall	**212 450 4681**	**alison.hashmall@davispolk.com**
Jai R. Massari	**202 962 7062**	**jai.massari@davispolk.com**

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