

Investment Management Regulatory Update

March 25, 2013

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SEC Rules and Regulations

SEC Staff Responds to Questions About Form PF

On March 8, 2013, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued additional responses (the "**Responses**") to frequently asked questions regarding Form PF. For details on previously posted SEC responses to frequently asked questions regarding Form PF, please see the [July 16, 2012 Investment Management Regulatory Update](#), the [August 22, 2012 Investment Management Regulatory Update](#) and the [December 20, 2012 Investment Management Regulatory Update](#).

Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") that advise one or more private funds (i.e., 3(c)(1) or 3(c)(7) funds) and that have at least \$150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") and are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the [November 18, 2011 Investment Management Regulatory Update](#) for a discussion of the final Form PF rules and the [June 19, 2012 Investment Management Regulatory Update](#) for a discussion of the initial Form PF deadlines.

The Responses provided guidance on a number of Form PF topics including, among other things:

General Filing Information. The Responses clarified that, in response to Question 1(b), private fund advisers are not required to identify their related persons unless information with respect to such related persons is being reported on the adviser's Form PF.

“Regulatory assets under management” and “gross asset value.” The Responses provided guidance on how to treat short positions, derivatives, repurchase agreements, total return swaps, and other financial instruments for purposes of calculating regulatory assets under management in Question 3 and for purposes of calculating a reporting fund’s gross asset value in Question 8. The Responses explained that if a private fund has a balance sheet, a private fund adviser may rely on the fund’s gross assets, as shown on the fund’s balance sheet, to calculate “regulatory assets under management” and “gross asset value.” According to the Responses, a private fund adviser does not need to calculate the value of such financial instruments differently than is required by the applicable accounting standard.

Master-Feeder Arrangement. The Responses explained that if a private fund adviser reports private funds in a master-feeder arrangement on an aggregated basis for purposes of Form ADV, then it must also report such private funds on an aggregated basis on Form PF. Further, according to the Responses, if funds in a master-feeder arrangement are being reported on an aggregated basis, then in accordance with Instruction 6, a private fund adviser must treat the aggregated funds as if they are all one private fund. Therefore, according to the Responses, the master-feeder structure should be collapsed and all investors in the master-feeder arrangement should be aggregated (while not counting the feeder funds themselves as investors) for purposes of reporting information on investors in the master-feeder structure.

Liquidity Terms. The Responses noted that the instructions to Questions 49 and 63 require a private fund adviser to make a “good faith determination” of the withdrawal and redemption provisions applicable to an investor that would likely be triggered during conditions that the adviser views as “significant market stress.” In responding to the above-mentioned questions, according to the Responses, a private fund adviser does not need to take into account every material liquidity restriction but rather only the “discretionary restrictions that the adviser or fund governing body may impose on the reporting fund above any baseline liquidity restrictions an investor is already subject to in the ordinary course as terms of its investment in the fund.” Ordinary course restrictions of this type, according to the Responses, such as an initial lock-up period or notice requirements prior to any withdrawal or redemption, should be accounted for separately in response to Question 50. The Responses also noted that assets in side pockets should not be included when responding to Questions 49 and 63 (although such assets should be included in the response to Question 48(a)). The Responses further indicated that side-letter terms should be taken into account in responding to Questions 50 and 64, which ask for a breakdown of the percentage of a fund’s net asset value that is subject to a lock-up for different periods of time.

Derivatives Trade Volume. The Responses explained that when reporting the trade volume percentage of derivatives trades for purposes of Questions 24(b) and 24(c), a private fund adviser should use the weighted-average of the notional amount of the aggregate derivatives transactions (except for options and interest rate derivatives, in which cases the delta adjusted notional value and the 10-year bond equivalent, respectively, should be used) entered into by the private fund during the reporting period.

Open Positions. The Responses noted that when reporting a private fund’s open positions in response to Question 35, a short position that represents more than 5% of the private fund’s net asset value should be reported as a negative value. The Responses also noted that a private fund adviser may not report a negative number when reporting the aggregate value of all derivatives positions of a private fund in either Question 13(b) or Question 44. Instead, according to the Responses, the responses to such questions should report the absolute value of outstanding derivatives positions.

- ▶ [See a copy of the Responses](#)

Industry Update

SEC Issues Risk Alert Identifying Significant Deficiencies in Compliance with the Custody Rule

On March 4, 2013, the staff of the SEC’s Office of Compliance Inspections and Examinations issued a National Examination Risk Alert (the “Alert”) focused on significant deficiencies observed by the SEC’s

National Examination Program (the “**NEP**”) staff related to compliance with the custody requirements of Rule 206(4)-2 (the “**Custody Rule**”) under the Advisers Act. According to the Alert, approximately one-third of recent examinations conducted by the NEP staff containing significant deficiencies included custody-related issues.

The Custody Rule requires an SEC-registered investment adviser with custody of client assets to take specific measures to safeguard such assets from loss, theft or misappropriation. These measures include, subject to certain exceptions, maintaining client assets with a “qualified custodian” that the investment adviser has a reasonable basis to believe provides account statements directly to the investment adviser’s clients, notifying the client of certain information about the “qualified custodian” that maintains client assets and undergoing an annual surprise examination by an independent public accountant to verify client assets. If the qualified custodian is a related party to the investment adviser (or the investment adviser itself serves as the qualified custodian), then the annual surprise examination must be conducted by an independent accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the “**PCAOB**”), and the investment adviser must obtain a report on the internal controls relating to the custody of client assets from the accountant at least annually. In addition, if an investment adviser to pooled investment vehicles distributes audited financial statements to investors at least annually (the so-called “audit approach”), it does not have to comply with certain notice and account statement delivery requirements of the Custody Rule nor does it have to undergo a surprise examination. For more information on the Custody Rule, please see the [January 7, 2010 Investment Management Regulatory Update](#) and the [April 6, 2010 Investment Management Regulatory Update](#).

According to the Alert, the significant deficiencies observed by the NEP staff during examinations can be grouped into the following four categories:

Failure by Advisers to Recognize They Have Custody. The Alert stated that recent examinations have revealed that some investment advisers have failed to recognize that they had custody of client assets and were therefore not complying with the requirements of the Custody Rule. The Risk alert identified specific fact patterns that were common, including situations in which (i) an investment adviser’s personnel served as trustee or were granted power of attorney for client accounts, (ii) an investment adviser had authorization to withdraw funds from clients’ accounts (e.g., through bill-paying services or through having access to clients’ online accounts), (iii) the investment adviser served as the general partner (or comparable position) to a fund, (iv) an investment adviser had physical possession of client assets (such as stock certificates) and (v) the investment adviser had check writing authority for client accounts or received clients’ checks but failed to promptly return them to the sender.

Surprise Exam Requirement. According to the Alert, the NEP staff observed that investment advisers were not filing the required Form ADV-E within 120 days after the date of the exam (as required by Rule 206(4)-2(a)(4)(i) under the Advisers Act) and/or such examinations were not being conducted on a surprise basis (e.g., exams were being conducted at the same time each year such that investment advisers could predict when the exam would occur).

Qualified Custodian Requirements. The Custody Rule requires that advisers maintain client assets with a “qualified custodian” for which the adviser has a reasonable basis to believe provides account statements directly to the adviser’s clients. According to the Alert, the NEP staff has observed that certain investment advisers are holding client assets in accounts bearing the investment adviser’s name and not in their capacity as agent or trustee for the client. The Alert also stated that certain investment advisers were commingling proprietary assets with client assets, were maintaining client assets in a safe deposit box controlled by the investment adviser or the investment adviser did not have a reasonable basis for believing, after due inquiry, that a qualified custodian was sending quarterly account statements to clients.

In addition, the Alert noted that, although the Custody Rule does not require an investment adviser that opens a custodial account on the client’s behalf to send account statements to the client separate and apart from those sent by the qualified custodian, if the investment adviser does send the client account

statements, then the investment adviser must include a notice in the statements urging the client to compare the account statements from the qualified custodian with those from the investment adviser.

Audit Approach Issues. As discussed above, investment advisers to pooled investment vehicles can avoid certain obligations imposed on them by the Custody Rule if such advisers rely on the audit approach and deliver audited financial statements to their investors at least annually. According to the Alert, the NEP staff observed that certain investment advisers had failed to utilize an auditor that was independent and registered with the PCAOB, failed to ensure audited financial statements were prepared in accordance with generally accepted accounting principles or failed to distribute audited financial statements to all investors within the required time period (i.e., within 120 days of the fiscal year end for private funds and 180 days for fund of funds).

- ▶ [See a copy of the Alert](#)

SEC's National Examination Program Releases its Examination Priorities for 2013

On February 21, 2013, the National Examination Program (the "NEP") published its examination priorities for 2013 (the "Exam Priorities"). The NEP identified several market-wide priorities that address issues relevant to nearly all SEC registrants, as well as specific priorities for each of the NEP's distinct program areas, including, among other programs, the program applicable to investment advisers and investment companies.

According to the Exam Priorities, the NEP will focus examinations on several key risk areas applicable to the entire market, including:

- **Fraud Detection and Prevention.** The NEP will seek out fraudulent and unethical behavior of market participants through the continued use and enhancement of its quantitative and qualitative tools and analyses.
- **Corporate Governance and Enterprise Risk Management.** The NEP will initiate meetings with senior management and boards of SEC registrants to discuss and assess registrants' governance and management of financial, legal, compliance, operational and reputational risks, which, according to the Exam Priorities, allow the NEP to better assess overall risk management at such firms and conduct more informed examinations.
- **Conflicts of Interest.** The NEP will focus on registrants' conflicts of interest and the steps registrants have taken to mitigate their conflicts, as well as whether registrants have sufficiently disclosed their conflicts to investors and the registrants' overall risk governance framework.
- **Technology.** The NEP may conduct examinations on registrants' governance and supervision of information technology systems, including with respect to operational capability, market access and the security of information (such as risks of system outages and data integrity).

The NEP also identified specific examination priorities for investment advisers and investment companies, including certain ongoing focus areas and certain new and emerging focus areas.

Ongoing Focus Areas. According to the Exam Priorities, the NEP's ongoing focus areas will include an emphasis on: (i) the custody and safety of client assets, including compliance with Rule 206(4)-2 under the Advisers Act, (ii) identifying undisclosed compensation arrangements and related conflicts of interest, (iii) the accuracy of advertised performance (including as it relates to changes in advertising practices that may result from the Jumpstart Our Business Startups Act signed into law in 2012), (iv) ensuring investment advisers have controls in place to monitor the allocation of investment opportunities, including in situations in which an investment adviser manages funds with similar investment objectives but where one fund pays performance fees and the other fund does not and (v) ensuring investment advisers make full and accurate disclosures to fund boards and that fund boards conduct reasonable reviews of such information when approving contracts, overseeing service providers, valuing fund assets and assessing expenses or viability.

New and Emerging Focus Areas. According to the Exam Priorities, the NEP intends to launch a two-year national examination initiative focused on newly registered investment advisers. The NEP will also focus on dually registered investment advisers and broker-dealers and the attendant conflicts of interests raised by such businesses. According to the Exam Priorities, the suitability obligations related to recommendations of brokerage or advisory accounts, the adequacy of related policies and procedures and the disclosure of conflicts of interest by such dually registered firms will be reviewed by the NEP during examinations.

According to the Exam Priorities, the NEP will also focus on the increasing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds and variable annuity structures, including an assessment of whether (i) leverage, liquidity and valuation policies and practices comply with regulations, (ii) compliance personnel, back-office support and board oversight are in place for such strategies and (iii) applicable regulations are being followed as it relates to the marketing of such funds. Also, the Exam Priorities specified that examinations of investment advisers will focus on so-called “revenue sharing” payments and similar payments to distributors and intermediaries, including a focus on the disclosure of such payments to a fund’s board and the board’s oversight of such payments, as well as whether such payments comply with applicable regulations.

In addition, according to the Exam Priorities, the NEP will also seek to review certain “policy topics,” including whether (i) money market funds are conducting stress testing of their ability to maintain stable share prices based on hypothetical events (as well as the factors considered for and the results of such tests), (ii) SEC exemptive orders (including with respect to co-investments by fund advisers and their affiliates) are being followed and (iii) investment advisers are complying with the SEC’s pay-to-play rules.

According to the NEP, the focus areas identified in the Exam Priorities are not exhaustive, although the NEP expects to use a significant portion of its resources to focus examinations on the issues identified in the Exam Priorities.

- ▶ [See a copy of the Exam Priorities](#)

NFA Proposes Amendment to Clarify Rule Prohibiting Loans by Commodity Pools to CPOs

On March 4, 2013, the National Futures Association (the “**NFA**”) submitted a proposed amendment (the “**Proposed Rule**”) to the CFTC to clarify that certain transactions are not barred as a result of NFA Rule 2-45, which generally prohibits registered CPOs from using “any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.” The Proposed Rule would also amend the companion interpretive notice to NFA Rule 2-45, titled “Prohibition of Loans by Commodity Pools to CPOs and Related Entities,” to specify that certain transactions engaged in by commodity pools would not violate NFA Rule 2-45, including short sale, cash financing, guarantee obligation, repurchase or reverse-repurchase agreement and certain tax-related distribution transactions between a CPO (or its related person) and a commodity pool. In addition, the Proposed Rule would provide that transactions engaged in by a CPO operating a commodity pool that is a registered investment company or business development company pursuant to (i) a loan arrangement permitted by the Investment Company Act of 1940 (the “**Investment Company Act**”), (ii) exemptive rules under the Investment Company Act or (iii) an exemptive order issued by the SEC or in accordance with a no-action letter issued by SEC would not violate the prohibition on loans or advances under NFA Rule 2-45.

The Proposed Rule would also provide that a CPO that was exempt from registration with the CFTC prior to December 31, 2012 and that caused a commodity pool it operated to make loans or advances that would have been prohibited by NFA Rule 2-45 prior to such CPO becoming registered with the CFTC (and therefore subject to NFA Rule 2-45) would be required to notify the NFA of any such loan or advance arrangements within 30 days of either (i) the effective date of the Proposed Rule or (ii) the date on which such CPO becomes registered with the CFTC, whichever is later. According to the Proposed Rule, such CPOs would be required to ensure that any such loan or advance arrangements are disclosed in the disclosure documents or offering materials of the commodity pools operated by such CPOs and

that the loans or advances and any conflicts of interest raised by such arrangements are disclosed to investors. The Proposed Rule would also require any such loans or advances to be secured by marketable, liquid assets such that the loans or advances could have no effect on the commodity pool's ability to meet its obligations to investors.

- ▶ [See a copy of the Proposed Rule](#)

Litigation

Supreme Court Overturns Second Circuit Ruling and Confirms that the Statute of Limitations for SEC Penalty Claims Begins when the Fraud Occurs

On February 27, 2013, in *Gabelli v. Securities Exchange Commission*, No. 11-1274, the U.S. Supreme Court unanimously concluded that the five-year statute of limitations applicable to actions brought by the SEC seeking civil penalties begins to run when the alleged fraudulent activity occurs rather than when it is discovered. The Supreme Court's ruling overturned the August 1, 2011 decision by the U.S. Court of Appeals for the Second Circuit which held that the statute of limitations does not begin to run for such actions until the SEC discovers, or could have discovered with reasonable diligence, the alleged fraud (the so-called "discovery rule"). In its opinion, the Supreme Court reasoned that it had never applied the discovery rule "where the plaintiff is not a defrauded victim seeking recompense, but is instead the Government bringing an enforcement action for civil penalties." According to the Supreme Court's opinion, the discovery rule aims to protect private parties who may be unaware that they have been harmed. However, the Supreme Court's opinion stated that the SEC, whose purpose is to discover wrongdoings, has many tools to aid in the pursuit of such actions and that the SEC is not a defrauded victim, which the discovery rule is intended to protect. The Supreme Court's opinion noted that the decision did not address doctrines that toll the statute of limitations when a defendant takes steps to conceal its allegedly fraudulent conduct from the SEC. For a further discussion of the Supreme Court's decision, please see the March 5, 2013 Davis Polk Client Memorandum, [U.S. Supreme Court Confirms that Limitations Period for Certain Federal Enforcement Actions Begins When Fraud Occurs; Application In FCPA Matters Remains Unclear](#).

The Gabelli Case

The SEC filed a complaint in April 2008 claiming that Marc Gabelli, the portfolio manager of a mutual fund advised by Gabelli Funds, LLC (the "**Adviser**"), and Bruce Alpert (together with Marc Gabelli, the "**Petitioners**"), the chief operating officer of the Adviser, secretly permitted an investor in the mutual fund to engage in market timing transactions from 1999 until 2002 to the detriment of other fund investors. The SEC claimed that, because of the secret nature of the Petitioners' wrongdoing (as well as misrepresentations made by the Petitioners to the mutual fund's board of directors and the other mutual fund investors), the SEC did not discover the fraud until late 2003. The SEC's complaint sought, among other things, civil penalties in connection with the Petitioners' alleged aiding and abetting violations of the antifraud provisions of the Advisers Act. The Petitioners moved to dismiss the Advisers Act claims on the grounds that the alleged violations occurred (and therefore the related claims first accrued) more than five years before the SEC filed its complaint and, therefore, the claims were time-barred under 28 U.S.C. §2642. For a further discussion of the Gabelli Case, please see the [October 17, 2012 Investment Management Regulatory Update](#).

- ▶ [See a copy of the Supreme Court's opinion](#)

SEC Charges Hedge Fund Adviser with Fraudulently Raising Capital by Misrepresenting a Fund's Structure to Investors

On February 26, 2013, the SEC charged David A. Bryson ("**D. Bryson**") and Bart C. Gutekunst ("**Gutekunst**"), the lead principals and co-owners of New Stream Capital, LLC ("**New Stream**"), a

Connecticut-based unregistered investment adviser, as well as New Stream's Cayman Islands advisory affiliate (which was controlled, managed and indirectly owned by D. Bryson and Gutekunst, the "**Cayman Affiliate**"), Richard Pereira ("**Pereira**"), New Stream's former CFO, and Tara Bryson ("**T. Bryson**"), New Stream's former director of marketing and investor relations, for perpetrating a scheme to mislead investors about the capital structure and financial condition of a fund managed by New Stream (the "**Fund**").

According to the SEC, in order to appease the Fund's largest investor, which had threatened to redeem its investment in the Fund because (without the large investor's knowledge) New Stream had restructured the Fund a few months earlier (the "**First Restructuring**") by creating two new feeder funds and granting equal liquidation rights to all investors (thereby eliminating the preferential status previously enjoyed by the existing feeder fund through which the large investor had invested), D. Bryson and Gutekunst decided to again revise the Fund's capital structure (the "**Second Restructuring**") to give the large investor and certain other preferred investors priority over other investors in the event of a liquidation.

The SEC alleged that, after the Second Restructuring, D. Bryson and Gutekunst directed New Stream's marketing department (led by T. Bryson) to continue to market the Fund as if all investors had equal liquidation rights, which led to New Stream fraudulently raising nearly \$50 million from new investors because the Second Restructuring was not disclosed to such investors. In addition, the SEC claimed that New Stream misled investors about the increased level of redemptions following the First Restructuring by not including the redemption request of the large investor and that Pereira falsified the Fund's financial statements to conceal the Second Restructuring. According to the SEC, disclosure of the Second Restructuring would have made it more difficult for New Stream to raise additional capital and led to further redemptions by existing investors in the new feeder funds.

Based on such conduct, the SEC charged D. Bryson, Gutekunst, Pereira, T. Bryson and the Cayman Affiliate with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. D. Bryson and Gutekunst were also charged with violating Sections 206(1), 206(2) and, along with the Cayman Affiliate, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC is also seeking claims against D. Bryson, Gutekunst and Pereira under Section 20(a) of the Exchange Act as controlling persons for New Stream's alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and D. Bryson and Gutekunst as controlling persons for the Cayman Affiliate's alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition, the SEC charged D. Bryson, Gutekunst, Pereira and T. Bryson for aiding and abetting the alleged securities laws violations of each other, New Stream and the Cayman Affiliate, as applicable.

According to the SEC's complaint, the SEC is seeking to permanently enjoin the defendants from committing future violations of the federal securities laws and ordering them to disgorge any ill-gotten gains received as a result of the alleged violations, to pay prejudgment interest and to pay civil monetary penalties.

- ▶ [See a copy of the SEC's complaint](#)
- ▶ [See a copy of the SEC's press release](#)

FINRA Orders Broker-Dealer to Pay more than \$11 Million in Restitution and Fines for Late Pricing of Paper Mutual Fund Orders

On December 26, 2012, the Financial Industry Regulatory Authority ("**FINRA**") announced that it ordered Pruco Securities, LLC ("**Pruco Securities**"), a New Jersey based registered broker-dealer, to pay nearly \$11 million in restitution and \$550,000 in fines for failing (i) to timely process written mutual fund orders received by mail or fax, (ii) to have in place an adequate supervisory system designed to detect and prevent the mispricing of paper mutual fund orders and (iii) to have written procedures for handling paper mutual fund orders.

According to the Letter of Acceptance, Waiver and Consent (the "**AWC**"), dated December 21, 2012, from late 2003 to June 2011, COMMAND, one of Pruco Securities' retail brokerage business units, processed

and priced complete paper mutual fund orders received prior to 4:00 p.m. on the day of receipt, on average, within one or two business days, rather than processing and pricing such orders prior to 4:00 p.m. on the date of receipt, as required by Rule 22c-1 of the Investment Company Act. According to the AWC, this practice resulted in thousands of Pruco Securities' customers receiving inferior prices for paper mutual fund orders.

Based on such conduct, FINRA charged Pruco Securities with violating Rule 22c-1 of the Investment Company Act, National Association of Securities Dealers ("**NASD**") Rules 3010(a) and 2110 and FINRA Rule 2010 (for its failure to maintain an adequate system to ensure compliance with Rule 22c-1 of the Investment Company Act) and NASD Rules 3010(b) and 2110 and FINRA Rule 2010 (for its failure to establish, maintain and enforce written procedures for pricing paper mutual fund orders).

According to the AWC, in sanctioning Pruco Securities, FINRA took into consideration that Pruco Securities self-reported the pricing issues, undertook an internal review, implemented changes to its policies and procedures and commenced the payment of restitution to the affected customers. According to FINRA's press release, Pruco Securities accepted and consented to the entry of FINRA's findings, without admitting or denying the charges.

- ▶ [See a copy of the AWC](#)
- ▶ [See a copy of FINRA's press release](#)

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.

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