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SEC Adopts “Pay-to-Play” Rules for Investment Advisers

Introduction

On July 1, 2010, the Securities and Exchange Commission (the “SEC” or “Commission”) adopted Rule 206(4)-5 (the “Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”) to address “pay-to-play” practices under which direct or indirect payments by investment advisers to state and local government officials are perceived to improperly influence the award of government investment business. The Rule, approved unanimously by the SEC’s five commissioners, adopts unmodified certain provisions of the version of the Rule proposed on August 3, 2009 (the “Proposed Rule”) ¹ while modifying others, notably rolling back the ban on using third parties to solicit government business, in response to over 250 comment letters.

Modeled on MSRB Rules G-37 and G-38, which address “pay-to-play” practices among municipal securities dealers, the Rule prohibits an investment adviser from (i) providing advisory services for compensation to a government entity client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates, (ii) providing direct or indirect payments to any third party that solicits government entities for advisory business unless this third party is a registered broker-dealer or investment adviser itself subject to “pay-to-play” restrictions, and (iii) soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business.

The Rule’s prohibitions, coupled with new recordkeeping requirements related to political contributions made by advisers or certain of their executives or employees, impose substantial new compliance burdens on advisers and provide for the loss of compensation for government advisory business for substantial periods if certain contributions are made. Advisers are required to be in compliance with most of the provisions of the Rule within six months of the effective date of the Rule, September 13, 2010 (“effective date”), except that advisers may no longer use third parties to solicit government business except in compliance with the Rule on the one-year anniversary of the effective date.

Summary of the Rule

In addressing commenters’ concerns relating to First Amendment rights, regulatory burdens and other issues, the SEC cited the rarely explicit nature of “pay-to-play” practices, the difficulty in proving such practices, and the inability of market-based approaches to address them as supporting the adoption of a broad-based and prophylactic rule. A summary of the Rule is set forth below.

¹ See “SEC Proposes ‘Pay-to-Play’ Rules for Investment Advisers,” K&L Gates Investment Management Alert, August 2009, available at <http://www.klgates.com/newsstand/Detail.aspx?publication=5859>

Advisers Subject to Rule.

The Rule applies to advisers that are registered under the Advisers Act and to those that are exempt from registration in reliance on Section 203(b)(3) of the Advisers Act, the “private adviser” exemption,² but does not apply to advisers exempted from registration in reliance on exemptions other than the “private adviser” exemption. The SEC states explicitly in the release adopting the Rule (the “Adopting Release”)³ that the inclusion of advisers exempted under the “private adviser” exemption is intended to make the Rule applicable to many advisers to private investment companies, such as hedge funds and private equity funds, that are currently exempt from registration. The Rule would not generally apply to smaller advisers that are registered with state securities authorities.

Two-Year “Time Out” for Contributions.

Rule 206(4)-5(a)(1) generally prohibits an adviser from receiving compensation for providing advice to a government entity within two years after a contribution to an official of the government entity has been made by the adviser or by any of its covered associates.⁴ This portion of the Rule is based largely on MSRB Rule G-37, under which a broker-dealer is prohibited from engaging in municipal securities business for two years after making a political contribution.

The Rule does not ban or limit the amount of political contributions that can be made by an adviser or its covered associates but rather imposes a “time out” on the ability of an adviser to receive compensation for conducting advisory business with

a government entity for two years after certain contributions are made to an official of a government entity. According to the SEC, this approach permits an adviser, consistent with its fiduciary obligations, to provide uncompensated advisory services to a government entity client for a reasonable period of time after a triggering contribution to allow the client to replace the adviser.⁵

For purposes of the Rule:

- “Official” means any person (including any election committee of the person) who was, at the time of a contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity, or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.⁶
- “Government entity” includes any state or political subdivision of a state, its agencies and instrumentalities, any pool of assets sponsored or established by any of the foregoing (including a defined benefit plan and a state general fund),⁷ and any participant-directed investment program or plan sponsored or established by any of the foregoing, such as a Section 403(b), 457 or 529 plan.

² The “private adviser” exemption generally exempts from registration any investment adviser that has had fewer than fifteen clients during the course of the preceding twelve months and does not hold itself out to the public as an investment adviser. However, the “private adviser” exemption will be rescinded by The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Dodd-Frank Act provides that the “private adviser” exemption will be rescinded one year after the Dodd-Frank Act is signed into law, which is expected to occur during the week commencing July 19, 2010.

³ “Political Contributions by Certain Investment Advisers,” SEC Release No. IA-3043, available at <http://www.sec.gov/rules/final/2010/ia-3043.pdf>

⁴ Rule 206(4)-5(e) permits the SEC, upon application, to exempt an adviser from application of the two-year “time out” upon consideration of certain factors listed in the Rule.

⁵ The SEC noted, however, in the Adopting Release that some government entities are prohibited from accepting uncompensated services under state and local law. In addition, as discussed later, in some cases, such as private equity and other closed-end funds, it may be impossible for a government entity or an adviser to terminate the advisory relationship within a two-year period.

⁶ In the Adopting Release, the SEC noted that “influence” would be interpreted broadly. For example, if a state governor has the power to appoint members of the board of directors of a government entity, which board has the authority to hire an investment adviser, that governor would be deemed to be an “official” of that government entity.

⁷ Accordingly, it is possible that a “government entity” may also be a “covered investment pool,” as discussed later in this Client Alert.

- “**Contribution**” means any gift, subscription, loan, advance, or deposit of money or anything of value made for (i) the purpose of influencing any election for federal, state or local office, (ii) payment of debt incurred in connection with any such election, or (iii) transition or inaugural expenses of the successful candidate for state or local office.⁸
- A “**covered associate**” of an adviser means (i) any general partner, managing member or executive officer, or other individual with a similar status or function, (ii) any employee who solicits a government entity for the adviser and any person who supervises, directly or indirectly, such employee, and (iii) any PAC controlled by the adviser or by any such persons described in clauses (i) or (ii).⁹ A contribution by a limited partner of a limited partnership adviser, a non-managing member of a limited liability company adviser or a shareholder of a corporate adviser is not covered unless such person is also an executive officer or solicitor (or supervisor thereof), or the contribution is an indirect contribution by the adviser, executive officer, solicitor or supervisor.¹⁰
- “**Executive officer**” is defined to mean an adviser’s president, any vice president in charge of a principal business unit, division or function

(such as sales, administration or finance), any other officer of the adviser who performs a policy-making function, or any other person who performs similar policy-making functions for the adviser.

- In response to requests for guidance regarding the definition of “**solicit**,” the SEC stated that, as a general proposition, a “solicitation” includes any communication made under circumstances reasonably calculated to obtain or retain an advisory client unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client.

“Look-back” Provision. The Rule includes a “look-back” provision that attributes to an adviser contributions made by a person prior to becoming a covered associate of the adviser. This “look-back” provision, similar to that in MSRB Rule G-37, is intended to prevent advisers from circumventing the Rule by influencing the selection process by hiring persons who have made contributions. The “look-back” period is generally two years, but, in a change from the Proposed Rule, the Rule shortens the “look-back” period to six months for any natural person who becomes a covered associate and who does not, after becoming a covered associate, solicit clients on behalf of the adviser.

Exceptions for *De Minimis* Contributions. The Rule permits individuals to make aggregate contributions, without triggering the two-year “time out,” of up to \$350 per election to an elected official or candidate for whom the individual is entitled to vote, and up to \$150 per election to an elected official or candidate for whom the individual is not entitled to vote.¹¹ The *de minimis* exceptions are available only for contributions by individual covered associates, not advisers, and primary and general elections are treated as separate under both exceptions.

Exceptions for Certain Returned Contributions. The Rule provides for an exception to the two-year “time out” for a returned political contribution. The

⁸ The SEC also clarified in the Adopting Release that a donation of time by an individual would not be considered a contribution if the adviser did not solicit the individual’s efforts and the adviser’s resources (such as office space and telephones) were not used. A charitable donation made by an adviser to a tax-exempt organization at the request of an official of a government entity would also not be considered a contribution. Notably, contributions to political action committees (“PACs”) and local political parties are not explicitly included among those that trigger the two-year “time out,” although they may violate the provision of the Rule that prohibits indirect actions that would be prohibited if done directly (discussed below).

⁹ The SEC stated in the Adopting Release that an adviser or its covered associate would be deemed to have control over a PAC if the adviser or its covered associate has the ability to direct or cause the direction of the governance or operations of the PAC.

¹⁰ The SEC indicated in the Adopting Release that an employee would not be a covered associate if he or she provides limited factual information to a government official along with contact information for a covered associate.

¹¹ The Proposed Rule provided a *de minimis* exception of \$250 for contributions to candidates for whom the individual is entitled to vote, which tracks the exception under MSRB Rule G-37.

exception is available for aggregate contributions that do not exceed \$350 to any one official per election. The adviser must have discovered the contribution that resulted in the prohibition within four months of the date of the contribution, and the contributor must obtain the return of the contribution within 60 days after the adviser learns of the contribution. The Rule limits an adviser's reliance on the exception to no more than once for each covered associate, regardless of time period. In addition, a larger adviser (*i.e.*, one that reports on its annual updating amendment to Form ADV Part 1 that it has more than 50 employees) may rely on the exception no more than three times in any calendar year, while a smaller adviser (*i.e.*, one that reports on its annual updating amendment to Form ADV Part 1 that it has 50 or fewer employees) may rely on the exception no more than two times in any calendar year.

Restrictions on Soliciting and Coordinating Contributions and Payments.

The Rule prohibits an adviser and its covered associates from coordinating or soliciting any person or PAC to make (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide advisory services, or (ii) any payment to any state or local political party where the adviser is providing or seeking to provide advisory services to a government entity. These restrictions are intended to prevent an adviser from circumventing the Rule's prohibitions on direct contributions to certain elected officials by, among other things, "bundling" a large number of small employee contributions or making contributions indirectly through a state or local political party.

In adopting this portion of the Rule, the SEC provided the following guidance regarding the interpretation of this portion of the Rule: (i) an adviser that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate; (ii) an adviser that sponsors a meeting or conference that features a government official as an attendee or guest speaker and that involves fundraising for the government official would be soliciting contributions for that government official; and (iii) expenses (including without limitation the cost of the facility and refreshments, administrative expenses and the payment or reimbursement of any

of the government official's expenses) incurred by the adviser for hosting the event described in clause (ii) would be a contribution by the adviser that would trigger the two-year "time out" with respect to the government entity over which that official has influence for which the *de minimis* exception under Rule 206(4)-5(b)(1) is not available (because the expenses would have been incurred by the firm, not by a natural person).¹²

Application to Covered Investment Pools.

Rule 206(4)-5(c) clarifies the application of the Rule to "covered investment pools." In general, the restrictions of the Rule apply with equal force when an adviser provides advisory services to a "covered investment pool" in which a government entity invests or is solicited to invest.

Definition of "Covered Investment Pool."

A "covered investment pool" includes: (i) any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") that is an investment option of a participant-directed plan or program of a government entity (*e.g.*, a Section 529 plan, 403(b) plan or 457 plan); or (ii) any company that would be an investment company but for the exclusion provided by Section 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act (*e.g.*, many hedge funds, private equity funds, venture capital funds and collective investment trusts). In response to comments regarding the compliance challenges associated with identifying government investors in registered investment companies, the SEC modified the proposal to include a registered investment company in the definition of "covered investment pool" for purposes of the Rule's pay-to-play prohibitions *only if* the investment company is an investment option of a participant-directed plan or program of a government entity, such as a Section 403(b), 457 or 529 plan. Advisers to such registered investment companies are also being provided more time to modify current systems and processes to identify government investors in such companies, as further described below with respect to the Rule's compliance and effective dates.

¹² Apart from the provisions of the Rule, the payment or reimbursement of a government official's expenses may be prohibited by state or local law.

Guidance Regarding Application of Rule to Covered Investment Pools.

The SEC provided guidance regarding the options available to an adviser to a covered investment pool if a contribution is made that triggers the two-year “time out” with respect to a government entity invested in such pool. If an adviser seeks to cause a private covered investment pool, such as a hedge fund, to redeem the investment of a government entity investor in these circumstances, the adviser should consider disclosing this as an investment risk in the pool’s disclosure documents.¹³ In the case of a private pool, such as a private equity fund, where a government entity’s withdrawal of capital or cancellation of its commitment could adversely impact other investors, the adviser could comply with the two-year “time out” by waiving or rebating the portion of its fees and performance allocations or carried interest attributable to the assets of the government investor. For registered investment companies, which generally cannot rebate fees to some but not all of their investors under the Investment Company Act and applicable tax requirements, an adviser to such a company that is subject to the two-year “time out” could waive its advisory fee to the investment company as a whole in an amount approximately equal to fees attributable to the government entity, or the investment company could permit the government entity to continue to pay its portion of the advisory fee but require the adviser to rebate that portion of the fee to the investment company as a whole.

Guidance Regarding Subadvisory Arrangements.

Although it determined not to exclude subadvisers from the Rule’s requirements, the SEC clarified that, if an adviser or subadviser makes a contribution that triggers the two-year “time out,” the subadviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity, unless the arrangement constituted a means to do indirectly what could not be done directly under the Rule. In addition, advisers to underlying funds in a fund of funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing

¹³ An adviser should determine whether its pools’ operative documents would permit a compulsory redemption in this circumstance.

fund unless the investment were made in that manner as a means for the adviser to do indirectly what it could not do directly under the Rule.

Restrictions on Indirect Contributions and Solicitations.

Rule 206(4)-5(d) prohibits an adviser subject to the Rule and its covered associates from doing anything indirectly that, if done directly, would result in a violation of the other provisions of the Rule.

Modification of Ban on Third-Party Solicitors to Permit Use of “Regulated Persons.”

Rule 206(4)-5 prohibits an adviser subject to the Rule, or any of the adviser’s covered associates, from providing or agreeing to provide, directly or indirectly, payment¹⁴ to any person to solicit¹⁵ government entities for advisory services on behalf of the adviser unless such person is (i) a “regulated person” that itself is subject to prohibitions against engaging in “pay-to-play” practices or (ii) an executive officer, general partner or managing member (or, in each case, a person with a similar status or function) or an employee of the adviser.¹⁶

Based on numerous concerns raised by commenters, including that a full ban on the use of third-party solicitors for government business would be particularly harmful to smaller advisers and government plans with limited resources that often rely on legitimate research, marketing and similar services of solicitors, the Rule does not implement the full ban on the use of third-party solicitors set forth in the Proposed Rule. Rather, the Rule permits certain “regulated persons” to provide such services, as described more fully below.

As noted above, an adviser subject to the Rule may pay its executive officers, general partners or

¹⁴ “Payment” is defined more broadly than “contribution” to mean any gift, subscription, loan, advance or deposit of money or anything of value.

¹⁵ The definition of “solicit” for these purposes is the same as the approach adopted under Rule 206(4)-5(a)(1), as described above.

¹⁶ The SEC also amended Rule 206(4)-3, the “cash solicitation rule,” to cross-reference the restrictions on solicitation activities involving government entity clients under Rule 206(4)-5. The compliance date for the amendment to the cash solicitation rule is one year from the effective date.

managing members (or, in each case, persons with a similar status or function) or employees to solicit a government entity. Contributions by these persons may, however, trigger the two-year “time out.” In addition, the SEC noted in the Adopting Release that non-affiliated persons providing legal, accounting or other professional services in connection with specific advisory business would not be subject to the ban on payments by advisers to third-party solicitors so long as they are not being paid directly or indirectly by an adviser for communicating with a government entity or its representative for the purpose of obtaining or retaining advisory business for the adviser (that is, they are paid solely for the provision of their professional services with respect to the business).

“Regulated Persons” are not Subject to Ban on Use of Third-Party Solicitors.

“Regulated person” is defined to include a broker-dealer that is registered with the SEC and is a member of a registered national securities association that has a rule (i) that prohibits members from engaging in distribution and solicitation activities if certain political contributions have been made, and (ii) that the SEC finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than the Rule imposes on advisers and to be consistent with the Rule’s objectives. The Financial Industry Regulatory Authority, Inc. (“FINRA”), the sole registered national securities association, has communicated to the SEC that FINRA is preparing a rule for consideration that would impose “pay-to-play” requirements on its members that are similar to those imposed on advisers by the Rule. The one-year delay of the effectiveness of the prohibition on compensating third-party solicitors, discussed below, is intended to give FINRA time to propose, and the SEC to adopt, such a rule for broker-dealers.

In addition to a broker-dealer described above, a “regulated person” also includes a registered investment adviser that, along with its covered associates, has not, within two years of soliciting a government entity, (i) made a contribution to an official of a government entity (other than a permitted *de minimis* contribution) and (ii) coordinated or solicited any person (including a PAC) to make any contribution to an official of a government entity to which the adviser that hired the solicitor is providing or seeking to provide advisory

services, or any payment to a state or local political party where the adviser that hired the solicitor is providing or seeking to provide advisory services to a government entity. In adopting this portion of the Rule, the SEC noted that an adviser compensating another adviser that qualifies as a “regulated person” and solicits government business on behalf of the first adviser must adopt policies and procedures designed to prevent violations of the Rule, which should include vetting of candidates and ongoing review of “regulated persons” to determine whether the solicitor and its covered associates had made certain political contributions or otherwise engaged in conduct that would disqualify the solicitor from meeting the definition of “regulated person.”

In the Adopting Release, the SEC stated that a solicitor that no longer meets the definition of a “regulated person” must immediately cease being compensated at the time the solicitor no longer meets the conditions of such definition.¹⁷

As a result of these provisions of the Rule, advisers should check each existing solicitation arrangement to determine (i) whether such solicitor may solicit government entities and (ii) if so, whether the solicitor is a “regulated person.” It is likely that most solicitation agreements will need to be amended to, at a minimum, incorporate a requirement that the solicitor be a “regulated person” in order to solicit government entities and to further provide that the solicitor will not be compensated if it ceases to be a “regulated person,” even if the compensation is based on solicitation activities that occurred while the solicitor was a “regulated person.”

Recordkeeping Requirements Accompanying Rule.

The SEC has also amended the recordkeeping rule under the Advisers Act to require the maintenance of certain records by registered investment advisers to permit verification of compliance with the Rule. Under amended Rule 204-2, a registered adviser

¹⁷ One implication of the SEC’s position is that solicitors that cease to qualify as “regulated persons” would no longer be entitled to receive “trailing commissions” for introducing government entity clients to an adviser, even if the solicitation activities relating to that client occurred prior to the adoption of the Rule.

that provides advisory services to a government entity or to a covered investment pool in which a government entity invests must maintain records of the names, titles and business and residence addresses of all covered associates of the adviser. In addition, such an adviser must maintain records of all direct or indirect contributions made by the adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a state or local political party or a PAC. Such records of contributions and payments must be listed in chronological order and indicate (i) the name and title of each contributor, (ii) the name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment, (iii) the amount and date of each contribution or payment, and (iv) whether any such contribution was the subject of the exception for certain returned contributions under Rule 206(4)-5(b)(2).

Amended Rule 204-2 requires each registered investment adviser to maintain records of all government entities to which the adviser provides or has provided advisory services, or which are or were investors in any covered investment pool to which the adviser provides or has provided advisory services in the prior five-year period. The SEC clarified that an adviser to a registered investment company must maintain records identifying government entity investors *only if* the investments are made as part of a participant-directed plan or program of a government entity or provide participants in the plan or program with the option of investing in the investment company. Amended Rule 204-2 requires an adviser to maintain a list of those government entities to which the adviser provides, or has provided, advisory services in the past five years, but not prior to the effective date. In addition, each registered investment advisor is required to maintain records of the name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for advisory services on its behalf.

An adviser is required to maintain records of its covered associates, and its own and its covered associates' contributions, *only if* the adviser provides advisory services to a government entity or to a covered investment pool in which a government entity is an investor. However, the Rule's look-back

requirements continue to apply to an adviser that does not currently have any government entity clients. As a result, an adviser that has not maintained records of its, and its covered associates', contributions would have to determine whether any contributions by the adviser, its covered associates, and any former covered associates would subject the adviser to the two-year "time out" prior to accepting compensation from a new government entity client. The same applies to newly formed advisers. The records such an adviser develops during this determination process would fall under the adviser's obligation to maintain records of all direct or indirect contributions made by the adviser or its covered associates to an official of a government entity, or payments to a state or local political party or a PAC.

An adviser should of course also adopt policies and procedures to comply with the Rule in the adviser's code of ethics and its compliance manual.

Effective and Compliance Dates.

The Rule and the amendments to Rule 204-2 are effective on September 13, 2010. Investment advisers subject to the Rule must be in compliance with the Rule within six months of the effective date. The Rule's prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the Rule's prohibition on soliciting or coordinating contributions will not be triggered by, contributions made before the date that is six months after the effective date.

Advisers must comply with the Rule's prohibition on making payments to third parties to solicit government entities for advisory services within one year of the effective date. According to the SEC, this transition period will permit FINRA to propose a rule that would meet the requirements for broker-dealers to fall within the definition of "regulated persons" under the Rule and for the SEC to consider such a rule. If, after one year, FINRA has not adopted such a rule, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities with respect to government entities; however, the SEC has indicated it would consider further action if such FINRA rule has not been adopted.

Advisers with clients who are government entities must comply with the amendments to Rule 204-2

within six months of the effective date, except as noted below. Within six months of the effective date, these advisers must begin to maintain records of all persons who are covered associates under the Rule and to keep records of political contributions they make on and after that date. Advisers must also maintain records of all government entities to which they provide advisory services on and after the date that is six months after the effective date. Advisers are not, however, required to look back for the five-year period prior to the effective date to identify former government entity clients. Advisers that pay regulated persons to solicit government entities for advisory services on their behalf must maintain a list of those persons beginning on and after that date that is one year after the effective date.

Advisers to registered investment companies that are “covered investment pools” under the Rule must comply with the Rule with respect to those covered pools within one year after the effective date. During the transition period, contributions by the adviser or its employees to government entity clients

that have selected an adviser’s registered investment company as an investment option of a plan or program will not trigger the prohibitions of the Rule.

This transition period is intended to provide sufficient time to an adviser to a registered investment company in order to identify government entities that have selected that investment company as an investment option when shares of the investment company are held through omnibus arrangements such that the identity of the investor is not readily available to the adviser. In addition, advisers to covered investment pools must maintain records of all government entity investors in such pools on and after the date that is one year after the effective date.

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Please contact the authors of this Client Alert or your K&L Gates Investment Management Group attorney contact with any questions or comments you may have regarding the Rule.

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