London Update

UK Financial Services Regulatory Developments

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May 2010

This edition covers developments between 1 March and 30 April 2010.

UK DEVELOPMENTS

Retired Senior Trader Jailed for Insider Dealing

On 11 March, Malcolm Calvert was sentenced to a jail term of 21 months. Mr. Calvert, who retired as a market maker and partner of Cazenove (a leading City of London firm) in 2000, was found guilty of five counts of insider dealing based on confidential price-sensitive information about planned takeovers received from an unnamed primary insider at Cazenove. The guilty verdict related to purchases of shares in three issuers out of a total of six relating to which charges were made concerning share purchases between April 2003 and April 2005.

Bertie Hatcher, a friend of Mr. Calvert, agreed to place share orders on his behalf in return for a one-third share of the profits. Purchases were made of shares with a total value of about £500,000 in Vernalis Group plc, Johnston Group plc and South Staffordshire plc, and a profit of about £104,000 was made by selling the shares after takeover announcements were made shortly after each purchase. Mr. Calvert was found not guilty of insider dealing relating to Mr. Hatcher's purchases of shares of three other issuers. In each case Cazenove had acted as an advisor to the issuer.

Mr. Hatcher cooperated with the Financial Services Authority (FSA) and agreed to give evidence against Mr. Calvert. Ultimately, he did not give evidence in court for health reasons. He accepted a fine of £56,098 representing disgorgement of his share of the profits made with respect to all six issuers. The FSA proceeded against him under its civil powers rather than making him the subject of criminal proceedings. The FSA issued a Final Notice with respect to Mr. Hatcher after the Calvert verdict was announced.

The FSA has had powers to proceed against insider dealing since 2001. It brought its first two criminal prosecutions in 2009. The Calvert case was its third successful criminal prosecution. The FSA has emphasised that it will not hesitate to use its criminal enforcement powers. In connection with the Calvert verdict, Margaret Cole, Director of Enforcement and Financial Crime at the FSA, said: "The guilty verdict is a shot across the bow for any city workers who may be tempted to trade using insider knowledge. Our message is simple: if you take part in such activity, you run a very real risk of the FSA taking criminal action against you."

The trial judge's decision with respect to a confiscation and costs order against Mr. Calvert will be announced in mid-May.

No charges were brought against Cazenove or any of its current employees. In a statement the firm pointed out that no breach of its systems or controls was identified by the FSA during its four-year investigation of the insider trading allegations.

To read more about the Calvert verdict and sentence, click here and here.

To read the Hatcher FSA Final Notice, click here.

FSA Publishes New Financial Penalties Framework

In early March, the FSA issued policy statement PS10/04 *Enforcement Financial Penalties* which confirms the creation of a new framework for calculating financial penalties in enforcement cases. The new regime has been brought into force with immediate effect.

Financial penalties are to be based on three principles: disgorgement, discipline and deterrence, under a five-step framework:

- removing any profits made from the misconduct;
- setting a figure to reflect the seriousness of the misconduct;
- considering any aggravating or mitigating factors;
- achieving the appropriate deterrent effect; and
- applying any settlement discount.

Under the new framework, fines will be linked more closely to firms' revenues and individuals' incomes and will be based on the following amounts:

- up to 20% of a firm's revenue over the period during which the misconduct took place from the business area linked to the misconduct;
- up to 40% of an individual's salary and benefits (including bonuses) from their job relating to the misconduct (except in serious market abuse cases); and
- for individuals in serious market abuse cases: the starting point for fines to be £100,000.

Margaret Cole, the FSA Director of Enforcement and Financial Crime, noted that there had been industry opposition to the FSA's proposals and said that the FSA had nonetheless decided to implement them as the FSA believed that the proposed enforcement penalty framework could serve as a powerful tool to help change behaviour. Ms. Cole said, "We imposed record fines in 2009, but this new approach further amplifies the deterrent effect of our penalties and sends a powerful message to firms which makes it clear that non-compliant behaviour will not be tolerated."

To read PS10/04, click here.

Government Consults on Security Interests Registration Regime

On 12 March, the Department for Business, Innovation and Skills (BIS) published a consultation paper on the UK regime for the registration of security interests created by companies and limited liability partnerships (LLPs). Under English law, where a company or LLP uses its assets as security, it is required to register the security interest in accordance with the scheme now set out in the Companies Act 2006 but deriving essentially unchanged from the Companies Act 1900. This scheme has been subject to criticism on several grounds.

BIS is consulting on a number of areas in an effort to try to improve the security registration regime, including:

- What security interests should be registrable
- Abolishing the existing 21-day time limit for registration of a security interest and aspects of the consequences of registration or failure to register
- The registration procedure, including the possibility of introducing electronic filing
- Whether registration of security interest in a special register (such as for charges over land) might be treated as registration of that security interest on the Companies House register
- The application of the regime to non-UK companies

The consultation is open until 18 June. BIS has indicated that it expects a further round of consultation before the preparation of draft regulations later in the year.

To read the consultation paper in full, click here.

FSA Bans Trader for Mismarking Positions

On 16 March, the FSA announced that it had imposed a five-year prohibition order on Alexis Stenfors, a former proprietary trader with the London branch of Merrill Lynch International Bank Limited (MLIB) banning him from performing any function in relation to any regulated activity on the grounds that he is not a fit and proper person.

Mr. Stenfors was found to have deliberately mismarked the positions he traded on behalf of MLIB between mid-January 2009 and mid-February 2009 by around $100 million in order to avoid showing increasing losses in his books. The mismarking was discovered by MLIB, Mr. Stenfors was suspended and, after an internal investigation, dismissed by MLIB. The FSA's Decision Notice did not criticise MLIB.

To read the Final Notice in full, click here.

FSA Publishes its 2010-11 Business Plan

On 17 March, the FSA published its Business Plan for 2010-2011. The document sets out the FSA's priorities for the coming year. The FSA characterised the Plan as "a demanding programme of work for the year requiring greater policy and supervisory resources." Its key areas of focus are:

- Delivering effective supervision, backed by the use of its enforcement powers, as a means to achieve credible deterrence
- Making the cultural and organisational changes to the FSA needed to implement intensive supervision
- Taking forward the policy reform agenda of the FSA's Turner Review and the wider policy agenda mandated by the European Union
- Fulfilling its role in promoting financial stability under the new Financial Services Bill—if that Bill is passed by Parliament

In developing intensive supervision, the FSA's regulatory approach has moved to a more proactive stance. Supervisors are now making judgements on firms' business models and intervening earlier than was previously the case if they anticipate any risks that may arise from regulated firms' conduct, sales practices, senior management competence or product development.

The FSA considers that credible deterrence underpins its supervisory approach and emphasises the number of criminal prosecutions for insider dealing prosecutions, and proceedings against a number of other individuals for insider dealing and making false or misleading statements to the market. (See above and the March 2010 edition of *London Update*).

To read the Plan in full, click here.

Scope of Bank Payroll Tax Clarified

In December 2009, the Government introduced a Bank Payroll Tax (BPT) applicable in the UK to certain employees of banks and banking groups. It requires employers to pay BPT at 50% of any bonus over £25,000 paid to certain classes of employees between 9 December 2009 and 5 April 2010.

In March, the Government confirmed that BPT will not apply to:

- any group which obtains 90% or more of its income from asset management activities; or
- any firm (or UK branch) which is not a deposit-taker in the UK and whose capital resources requirement (as defined in FSA's rules) is less than £100 million.

For more details, click here.

Government Announces 2010/2011 Tax Proposals and Budget

The Government announced its proposed budget and tax proposals for the fiscal year 2010/2011 on 24 March.

Most of the key changes, such as the new 50% rate of personal income tax on incomes over £150,000 a year and certain changes to limit the application of the UK's Bank Payroll Tax, had already been announced. However, the Government also announced:

- Its intention to consider establishing a new type of UK-domiciled tax-transparent investment fund.
- A review of the existing rules for investment trust companies.

- Certain amendments to the offshore funds rules. These rules mean that UK investors in offshore funds are charged income tax (at 50%) rather than capital gains tax (at 18%) on a redemption of units in an offshore fund unless the fund opts into a special regime of "tax-reporting" fund. This regime was already in place. The changes are extremely technical and are designed to avoid penalising funds of funds which invest partly in non-tax reporting funds and partly in tax-reporting funds.
- Its intention to abolish Stamp Duty Reserve Tax (SDRT) on the acquisition of shares in UK-domiciled investment funds by other investment funds where the underlying fund is mainly invested in UK equities. Generally, SDRT is payable at the rate of 0.5% of the purchase price by the buyer of shares in any UK-domiciled fund (but not on a redemption of shares or units).
- An increase in stamp duty (real estate transfer tax) to 5% on the purchase of any residential property for more than £1 million.

To read more, click here.

HFSB Publishes Revised Best Practice Standards

On 1 April, the Hedge Fund Standards Board (HFSB) published a revised version of its Best Practice Standards for hedge funds. The HFSB was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to those Standards. It is also responsible for ensuring that the Standards are amended and updated as appropriate in light of market and other developments. Over 50 hedge fund managers have so far signed up to the Standards, accounting for, in total, over $215 billion in assets under management.

The HFSB had consulted in July 2009 about proposed revisions to the Standards in the areas of disclosure of exit terms and independent administration and safekeeping. As a result, amendments have been made to Standard 2 (commercial terms disclosure) and by introducing a new Standard 17a (operational risk—governance standards and guidance).

The revised Standards will come into effect on 1 August. Accordingly, HFSB signatories will need to revisit and adapt their disclosure statements in light of the amendments where necessary.

To read the updated Standards in full, click here.

FSA Consults on Enhancing Client Asset Protection

On 30 March, the FSA published consultation paper CP10/9 *Enhancing the Client Assets Sourcebook*. Issues arising from the administration of Lehman Brothers' London affiliates and other issues which have arisen since mid-2008 have highlighted a number of areas where the FSA considers that investor protection aspects of CASS need to be strengthened. The FSA has engaged in pre-consultation with regulated firms over a period of nearly 18 months, and it has also included proposals based on the Treasury's 2009 consultation relating to effective resolution arrangements for investment banks.

The proposals in the consultation paper include the following:

- Increasing rehypothecation transparency and disclosure to prime brokerage clients, requiring prime brokerage agreements to contain a disclosure annex highlighting contractual rehypothecation provisions. The FSA also proposes to require daily reporting on client money and assets holdings to all prime brokerage clients so that they will know which of their assets, if any, have been rehypothecated.
- Restricting the use of group company banks for client money bank accounts to 20% of the firm's total client money so as to reduce the exposure to group credit risk.
- Prohibiting the use of general liens in custodian agreements. The FSA objects to client assets held with a custodian being subject to a lien due to the debt to the custodian arising from unrelated business of a group entity of the customer to the relevant custodian.
- Creating a new significant influence controlled function within regulated firms holding responsibility for oversight and protection of client assets and money.
- Requiring a client money and asset return, which will be reviewed and authorised on a monthly basis for medium and large regulated firms and twice annually for small regulated firms.

Some of these proposals are subject to discussions with the European Commission. The deadline for receiving comments on the proposals has been set at 30 June. The FSA has identified the work on strengthening its client assets regime as a priority and expects to finalise the revised CASS rules during the third quarter of this year.

To read the consultation paper in full, click here.

More FSA Criminal Insider Dealing Cases

The FSA has continued to use its criminal prosecution powers against insider dealing. On 31 March it announced that seven men had been charged with criminal conspiracy to deal on inside information—one of the accused was also charged with money laundering. These charges follow arrests which took place in July 2008.

The charges against the seven men relate to trading in the shares of 12 companies between 1 May 2006 and 31 May 2008. The companies were all takeover targets during this period and were advised by one of two London investment banks. Two of the men charged worked in the print rooms of those investment banks, where they could have had access to confidential price-sensitive information about takeover bids. The investment banks are not themselves the subject of the FSA's investigation.

To read more, click here.

In an unconnected development, the FSA had announced on 23 March the arrests of six men including senior professionals at leading investment banks and a hedge fund on suspicion of being involved in what the FSA described as "a sophisticated and long-running insider dealing ring" and the FSA's largest-ever operation against insider dealing. The arrests (the fifth set of FSA insider dealing arrests since the first use of its criminal powers in 2008) resulted in the first joint arrests between the FSA and the Serious Organised Crime Agency. The joint investigation commenced in late 2007.

To read more, click here.

FSA Fines Three Firms a Total of £4.2 Million for Transaction Reporting Failures

On 8 April, the FSA announced that it had fined three firms (a bank, a market maker trading on electronic markets and an agency broker) a total of £4.2 million for multiple breaches that resulted in failures to provide transaction reports promptly and correctly to the FSA.

The FSA found that each of the three firms could have prevented the rule breaches by carrying out regular reviews of its data. Despite repeated reminders from the FSA during the course of 2007 and 2008, none of the firms did this. Firms are required to have systems and controls in place to ensure they submit accurate data for reportable transactions by close of business the day after a trade is executed.

The FSA's Director of Markets said, "Firms and their management must ensure they implement and operate systems and controls that are able to ensure quality transaction reporting. The standard of regulatory reporting by these firms fell far short of what the FSA expects and requires."

To read more, click here.

Financial Services Act 2010 Passed

The Financial Services Act 2010 received Royal Assent on 8 April. The Act has made a number of changes to certain objectives, powers and duties of the FSA.

These include:

- Financial stability—The new financial stability objective for the FSA includes a duty for the FSA to determine and review its financial stability strategy, in consultation with the Treasury.
- Consumer education—The FSA is required to establish a new consumer financial education body. When this body becomes operational, it will take over the FSA's current responsibilities in relation to financial education.

- Enforcement powers—Key changes include the power to suspend individuals, and firms, along with the ability to fine those who are carrying out a role that needs FSA approval without the necessary approval being in place. The time limit to issue a warning notice against an individual in relation to misconduct has been increased from two years to three years from the time the FSA first becomes aware of it.
- Remuneration—The FSA will have the power to specify that remuneration agreements in breach of its remuneration rules are void.
- Consumer redress scheme—The FSA is given the power to introduce a consumer redress scheme. It will come into effect only by order of the Treasury.

Some of the new powers require the FSA to make rules or publish statements of policy. The FSA published consultation paper CP10/11 *Implementing aspects of the Financial Services Act 2010* on 26 April. Generally, the Act's changes were anticipated in the FSA's Business Plan for 2010-2011, published in March (see above).

To read more, click here.

FSA Fines London Stockbroker for Penny Stocks Failings

On 15 April, the FSA announced that it had fined Hythe Securities Limited, a London-based stockbroker, £200,000 for failings in its systems and controls relating to the sale of higher risk securities, including penny stocks. The FSA also fined Hythe's senior director, Meenaz Mehta, £35,000 and banned him indefinitely from holding any significant influence function with any firm marketing penny stocks to retail customers.

Hythe was found to have breached FSA Core Principle 3 (exercising due skill, care and diligence) as well as several specific FSA rules by:

- using aggressive sales practices, including recommending penny stocks to customers against their wishes and exceeding agreed trading limits;
- providing customers with misleading information about penny stocks and failing to disclose all commissions and charges; and
- failing to ensure that suitable advice was given to customers, particularly by failing to carry out a proper "know your customer" fact-finding exercise.

During the relevant period, Mr. Mehta as the chief executive was responsible for the day to day running of Hythe. He also held the compliance oversight function. The FSA found that, despite recognising the potential risk to customers, Mr. Mehta failed to take sufficient action to ensure that Hythe complied with the relevant FSA rules. Further, as a result of failing to implement adequate reporting procedures, Hythe was unable to identify or control many of the regulatory risks arising from the firm's business model, particularly those relating to the fair treatment and protection of retail customers.

When setting the fine, the FSA took into account improvements which Hythe had made in its sales and compliance procedures, and also that Hythe has since varied its permissions so that it can no longer have retail customers.

To read the decision in full, click here.

FSA Announces Market Abuse Fines and Bans

As reported in the February 2010 edition of *London Update*, on 11 January, the FSA had announced that Sameer Patel and Robin Chhabra had been found to have committed market abuse by using inside information to carry out a series of profitable spread bets.

On 16 April, the FSA announced that it had banned both men from working in the financial services industry and fined Mr. Patel £180,541 and Mr. Chhabra £95,000. Mr. Patel's fine comprises a punitive element of £95,000 and disgorgement of profits of £85,541. Mr. Chhabra's fine comprised a punitive element only.

To read the decision in full, click here.

FSA Fines Commerzbank for Transaction Reporting Failures

On 27 April, the FSA announced that it had fined the London branch of Commerzbank AG £595,000 for failing to provide transaction reports promptly and correctly to the FSA. This is the fifth substantial fine imposed by the FSA for transaction reporting breaches since August 2009 and follows the three fines reported above.

Under FSA rules, firms are required to submit accurate data for reportable transactions by close of business the day after a trade is executed.

The FSA found that Commerzbank had either failed to report or reported inaccurately almost all of its reportable transactions for a two-year period. This occurred despite the FSA sending repeated reminders to firms of their obligations to provide accurate data and the importance of compliance with transaction reporting rules, as well as sending specific requests to Commerzbank for the firm to check its data.

Commerzbank has since taken a number of steps to address the concerns raised, including commissioning a review of its transaction reporting process and committing extensive resources to improve its processes and resolve the errors.

The FSA's Director of Markets said, "Complete and accurate transaction reports are an essential component of the FSA's market monitoring work. Commerzbank's reporting failures could have a damaging impact on our ability to detect and investigate suspected market abuse. Firms and their management must ensure they submit quality transaction reporting data."

To read more, click here.

EU DEVELOPMENTS

CESR Publishes European Short Selling Disclosure Regime

On 2 March, the Committee of European Securities Regulators (CESR) published proposals for a pan-European short selling disclosure regime. The proposals result from CESR's consultation process, which began in July 2009 (see the August 2009 edition of *London Update*).

CESR has proposed a two-tier model (private and public disclosure) for short positions in shares admitted to trading on any European Economic Area (EEA) regulated market or multilateral trading facility (MTF). The regime will not apply to shares whose primary listing is not on an EEA market or MTF. The measure of whether disclosure is required will be based on economic exposure (calculated on a net basis) which is the economic equivalent of a short position. Positions in all financial instruments, including derivatives and cash market positions, will be aggregated to determine whether applicable thresholds are met.

Market participants with short positions will be required to make a non-public disclosure (to the national regulator of the relevant issuer's primary market) of any position in an issuer's share capital reaching 0.2%—an increase from the originally proposed 0.1%. Further non-public disclosures will be required as each successive 0.1% threshold is crossed after the initial disclosure requirement has been triggered. If the higher threshold of 0.5% is reached, a public disclosure will also be required. Further public disclosures will be required for each 0.1% change thereafter. Disclosure filings will be required on T+1. Intra-day positions are not required to be disclosed. Market making activities will be exempt.

CESR has recommended that the new regime be implemented as soon as possible. Its view is that there should be new European legislation in this area, either (preferably) through the enactment of a new directive or regulation or alternatively through amendments to the Transparency Directive. It recommends that those CESR members that already have powers to implement a permanent disclosure regime should begin the process of implementing the proposals, while those members not having the necessary legal powers should aim at implementation on a best efforts basis.

To read the proposals in full, click here.

Presidency Withdraws AIFM Directive Compromise Draft

On 16 March, the Spanish Presidency announced the withdrawal of its compromise Alternative Investment Fund Manager Directive (AIFM Directive) proposal following the failure ahead of the March European Council of Ministers Ecofin meeting of finance ministers to reach a sufficient level of agreement on the detailed provisions of the proposal. The Presidency stated that further discussions were "postponed until a meeting to be held at a later, still undefined, date, but will definitely take place during the six-month period of the Spanish Presidency, which finishes at the end of June."

Meanwhile the ECON committee of the European Parliament is continuing its deliberations on the Gauzes Report proposing amendments to the European Commission's proposed draft AIFM Directive and the amendments to the Gauzes Report's proposals (numbering over 1,400) which have been tabled. The ECON Committee's latest discussions on 17 March indicated that there remains a wide divergence of views on matters of principle and of detail; so the final shape of ECON's report remains uncertain.

To read more, click here.

CESR Publishes Call for Evidence on European Equity Market Issues

On 1 April, the CESR published a Call for Evidence on micro-structural issues of the European equity market. Its reason for so doing is that there have been a number of technology-driven developments since CESR last evaluated the impact of the Markets in Financial Instruments Directive (MiFID) on the European equity markets in early 2009, particularly in the areas of high frequency trading, sponsored access and co-location.

CESR now wishes to assess these developments in greater depth due to their potential effect on the structure and efficiency of the European equity markets. To assist this process, CESR is undertaking this evidence collecting exercise, seeking information on the following issues:

- high frequency trading,
- sponsored access,
- co-location services,
- fee structures,
- tick size regimes, and
- indications of interest.

The Call for Evidence takes the form of a number of questions to which CESR invites interested parties to submit responses as well as addressing any related micro-structural issues that respondents consider that CESR should address. Responses are required to be submitted via CESR's website by 30 April.

To read the Call for Evidence in full, click here.

CESR Consults on Technical Advice for the European Commission Review of MiFID

On 13 April, the CESR published three consultation papers on its technical advice to the European Commission for the Commission's review of the MiFID. The Commission will be conducting a review to assess the effectiveness of MiFID throughout 2010.

The CESR consultation paper on transaction reporting focuses on the following key areas:

- the introduction of a third trading capacity (riskless principal);
- the collection of client and meaningful counterparty identifiers;
- standards for client and counterparty identifiers;
- client ID collection when orders are transmitted for execution; and
- transaction reporting by market members that are not authorised as investment firms.

The main points of the investor protection consultation include:

- requirements relating to the recording of telephone conversations and electronic communications—CESR is considering a pan-European regime for recording all transaction orders received or transmitted over the telephone or through electronic communications; and
- execution quality date—CESR is also considering whether regulatory intervention is necessary to ensure that the necessary information is available in the market to select appropriate execution venues.

The equity markets consultation paper follows on from CESR's other work in this area, including its focus on dark pools. The main topics covered in the paper include:

- pre-trade and post-trade transparency regimes for regulated markets and MTFs;
- the definition of and obligations for systematic internalisers;
- application of transparency obligations to equity-like instruments;
- regulatory framework for consolidation and cost of market data; and
- regulatory boundaries and requirements.

The comment period for each of the three consultation papers ends on 31 May.

To read the consultation paper on transaction reporting, click here.

To read the consultation paper on investor protection, click here.

To read the consultation paper on equity markets, click here.

INTERNATIONAL DEVELOPMENTS

IOSCO Publishes Template for Hedge Fund Data Collection

On 25 February, the International Organization of Securities Commissions (IOSCO) published a template for the global collection of hedge fund data by regulators to facilitate international cooperation in identifying and assessing systemic risks which might arise from the hedge fund sector.

The purpose of the template is to enable the collection and exchange among regulators of consistent and comparable data from hedge fund managers and advisors about their trading activities, the markets they operate in, funding and counterparty information. There are 11 proposed categories of information which incorporate both supervisory and systemic data. The template is not intended to be a comprehensive list of all of the types of information and data which regulators might want to collect; therefore, regulators are not restricted from requiring additional information at a domestic level.

IOSCO stated that it was publishing the template to help inform any planned legislative changes being considered in various jurisdictions, as well as to provide securities regulators with examples of the type of information they could find useful to collect. IOSCO recommends that the first data gathering exercise should be carried out on a best efforts basis in September 2010. As reported in the March 2010 edition of *London Update*, the FSA has just released its own surveys of hedge fund activity which were conducted in October 2009.

To read the publication in full, click here.

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