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## Introduction to the Commercial End-User Exception to Mandatory Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act

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This practice note (i) provides an introduction to the commercial end-user exception to clearing of swaps and security-based swaps (the “Commercial End-User Exception”), (ii) explains the scope and basic requirements of the Commercial End-User Exception, (iii) provides considerations for commercial and manufacturing companies in determining whether to elect the Commercial End-User Exception, (iv) addresses corporate governance considerations implicated by the decision whether to use the Commercial End-User Exception, and (v) addresses disclosure implications of the Commercial End-User Exceptions for Securities and Exchange Commission (“SEC”) registrants.

For the reasons described below, this practice note will focus principally on the application of the Commercial End-User Exception to swaps rather than security-based swaps. See “Introduction to the United States Regulation of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act” for more information on distinguishing between swaps and security-based swaps.

### Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) amended the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (the “Exchange Act”) to provide for clearing of swaps and security-based swaps (collectively, “Title VII Instruments”) to the extent required by the Commodity Futures Trading Commission (“CFTC”) and the SEC, respectively. If the CFTC or the SEC determines that a Title VII Instrument must be cleared, it is generally unlawful for any person to engage in such a swap or security-based swap transaction unless the relevant swap or security-based swap is submitted for clearing to a derivatives clearing organization (“DCO”) or securities clearing agency. 7 U.S.C. §2(h)(1)(A); 15 U.S.C. §78c-3(a)(1). To date, the CFTC has issued one group of clearing determinations for certain interest rate swaps and credit default swaps, but the SEC has not issued any clearing determinations for security-based swaps. For more information on clearing, see “Introduction to Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act.”

In conjunction with the clearing requirement, the Dodd-Frank Act also amended the CEA and the Exchange Act to provide the Commercial End-User Exception so that nonfinancial entities that use Title VII Instruments to hedge or mitigate commercial risks associated with their underlying business (“Commercial End-Users”) would not be required to clear such Title VII Instruments. 7 U.S.C. §2(h)(7); 15 U.S.C. §78c-3(g). (The two statutory provisions are largely identical, except that one deals with swaps and the other deals with security-based

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swaps.) Congress provided for a Commercial End-User Exception in recognition that mandatory swap clearing could have a disruptive effect on the hedging activities of Commercial End-Users by adding unnecessary expense that is disproportionate to the risks that the Dodd-Frank Act seeks to address.

The Commercial End-User Exception must be implemented by regulations of the CFTC or SEC, respectively, in order to become effective. The CFTC has issued final rules to implement the Commercial End-User Exception for swaps. 17 C.F.R. 50.50. In 2010, the SEC proposed a rule that would implement the Commercial End-User Exception for security-based swaps, but that proposed rule has not been finalized. 75 Fed. Reg. 79992 (Dec. 21, 2010). The CFTC action was necessary because the clearing determinations described above made it important to implement the Commercial End-User Exception for swaps. The rest of this practice note will focus on the Commercial End-User Exception for swaps because that is the only currently effective clearing regime for Title VII Instruments.

### Scope of the Commercial End-User Exception for Swaps

Under the Commercial End-User Exception, any applicable clearing requirement of the CFTC will not apply to a swap if at least one of the parties to the swap meets each of the following requirements:

1. it is not a “financial entity”;
2. it is using the swap to “hedge or mitigate commercial risk”; and
3. it notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps.

7 U.S.C. §2(h)(7)(A).

### *Financial Entity*

Excluding “financial entities” from the Commercial End-User Exception is consistent with the Congressional policy of the Dodd-Frank Act mandate that such entities be fully subject to swap clearing requirements. The term “financial entity” is broadly defined for this purpose. It includes (i) regulated swap entities such as swap dealers and major swap participants; (ii) registered funds, private funds and commodity pools; (iii) employee benefit plans; and (iv) entities that are predominantly engaged in the business of banking or in activities that are financial in nature. See 7 U.S.C. §2(h)(7)(C)(i).

Despite the broad exclusion of financial entities, it does not cover certain entities that provide crucial sources of finance to commercial, manufacturing or other companies that enter into swaps as end-users. These include (i) certain affiliates of nonfinancial entities, (ii) captive finance companies, and (iii) certain banking institutions with less than \$10 billion in assets. 7 U.S.C. §2(h)(7)(C)(ii) and (iii); §2(h)(7)(C)(D). The CFTC has also decided not to apply the clearing requirement to foreign governmental entities and international financial institutions. 77 Fed. Reg. 42559, at 42561 (July 19, 2012). These categories of financing conduits are excluded from the term “financial entity” and, therefore, are permitted to use the Commercial End-User Exception.

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### *Hedge or Mitigate Commercial Risk*

In order for a swap to qualify for an exemption from clearing under the Commercial End-User Exception, the nonfinancial entity must have entered into it in order to “hedge or mitigate commercial risk.” Whether a swap is used to hedge or mitigate commercial risk is generally determined on a swap-by-swap basis based on the facts and circumstances at the time that the swap is entered into, taking into account, among other matters, the Commercial End-User’s overall hedging and risk mitigation strategies.

In order for a swap to be used to “hedge or mitigate commercial risk,” (i) it must not be used for a purpose of speculation, investing, or trading and (ii) it must not be used to hedge or mitigate the risk of another swap, unless that other swap itself is used to hedge or mitigate commercial risk. 17 C.F.R. 50.50(c)(2). In addition, the swap must meet one of the following requirements: (1) it must be “economically appropriate” to reduce risks in the conduct and management of a commercial enterprise; (2) it must qualify as “bona fide hedging” for purposes of an exemption from position limits under the CEA; or (3) it must qualify for hedge accounting treatment under the Financial Accounting Standards Board Accounting Standards Codification Topic 815 or Government Accounting Standards Board Statement 53. 17 C.F.R. 50.50(c)(1).

### *Notification and Reporting Requirements*

The CFTC must be notified, in a manner prescribed by it, when a counterparty to a swap elects to avail itself of the Commercial End-User Exception (the “electing counterparty”). The electing counterparty does not have to directly notify the CFTC; rather, the notification requirement can be satisfied if either one of the counterparties notifies a swap data repository (“SDR”). 17 C.F.R. §50.50(b). Typically, the party to the swap that is designated as the “reporting counterparty” is the one to notify the CFTC. While the electing counterparty could be the reporting counterparty, it is unlikely that it would have that status.

On a swap-by-swap basis, the notice submitted to the SDR must contain certain basic information: (i) notice of the election of the Commercial End-User Exception; (ii) the identity of the electing counterparty; and (iii) the following information:

1. Whether the electing party is a “financial entity,” and whether the financial entity is electing the exception on behalf of an affiliate or as a small financial institution or captive finance company;
2. Whether the electing counterparty is using the swap to hedge or mitigate commercial risk;
3. Information regarding how the electing counterparty generally meets its financial obligations associated with entering into non-cleared swaps (e.g., a credit support agreement, pledged or segregated assets, third-party guarantee, available financial resources, or some other means); and
4. Information as to whether (x) the electing counterparty is an issuer of securities registered under Section 12 of the Exchange Act, or is required to file Section 15(d) Exchange Act reports (“an SEC Filer”), (y) if so, such SEC Filer’s Central Index Key number, and (z) information as to whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved generally the decision to enter into swaps that are exempt from the clearing requirements. It is worth noting that a party

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is considered an SEC Filer for this purpose if it is controlled by an SEC Filer. 77 Fed. Reg. 42559, at 42570.

17 C.F.R. §50.50(b).

The CFTC permits the electing counterparty to report the required information on an annual basis. 17 C.F.R. §50.50(c). However, the reporting counterparty remains obligated to report, on a swap-by-swap basis, that the Commercial End-User Exception has been elected and to provide the name of the electing party. The final rule does not specify the format by which the information must be reported to the SDR; however, the CFTC has indicated that a “check-the-box” approach is an appropriate method. 77 Fed. Reg. 42559, at 42567. If a Commercial End-User has made the annual filing with an SDR to claim the Commercial End-User Exception, the reporting counterparty to the swap can simply “check the box” to indicate that the electing counterparty has made its annual filing and provided all of the necessary information.

### Considerations in Determining Whether to Use the Commercial End-User Exception

The clearing mandate for swaps marks a significant shift in the use of derivatives to hedge and mitigate commercial risk. Both private and public companies, particularly those with large international operations, have traditionally used swaps to hedge against currency and interest rate risk, in addition to managing risk exposure from volatility in commodity prices and credit markets.

Companies faced with the choice of whether to enter into a cleared swap or a non-cleared swap will likely make such a decision on the basis of commercial considerations of margin, liquidity and credit risk, all of which impact the risk and cost associated with a swap.

#### *Margin Requirements for Cleared Swaps*

In addition to legal fees for the negotiation of cleared swaps documentation, Commercial End-Users availing themselves of the Commercial End-User Exception will be required to post initial and variation margin, as determined by the applicable clearinghouse, together with any additional margin required by the clearing broker above clearinghouse minimums. Commercial End-Users will not be required to post margin for non-cleared swaps under the regulations beyond any margin required by its counterparty in the course of negotiating the non-cleared swap relationship.

#### *Liquidity and Transparency Considerations*

Enhanced liquidity and transparency are two of the principal expected benefits of swap clearing. In addition to mitigating risk, these benefits may help reduce the costs associated with cleared swaps by, for example, narrowing bid-offer spreads. While Commercial End-Users may find that those benefits are of paramount importance in certain circumstances, they may also determine that other considerations outweigh those benefits in certain types of swap transactions that are otherwise required to be cleared. For example, a Commercial End-User that pursues a hedging strategy that is bifurcated between cleared and non-cleared swaps may find that having two books may adversely affect liquidity. This may be especially true in the short term. Commercial End-Users may develop a preference for

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clearing certain products as clearing is more fully implemented across categories of swaps, and as the cleared market evolves and liquidity increases.

### *Credit Risk Mitigation*

Another key benefit of central clearing is the reduction of counterparty risk, as the likelihood of loss from a counterparty default is reduced to the extent that a derivatives clearing organization is interposed as the central counterparty to swap transactions cleared by it. However, Commercial End-Users will still face certain risks associated with the clearinghouse and the Commercial End-User's clearing brokers. These include risks to the recovery of excess collateral in the case of a clearing firm or DCO bankruptcy under the CFTC's margin segregation rules known as "legal segregation with operational commingling" and risk to portability, which is described in the "Introduction to Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act."

While clearing may mitigate credit risk, there is some concern that DCOs may also exacerbate credit risk as they become increasingly important financial system utilities and may themselves be "too big to fail" centers of financial instability. In any event, the credit risk mitigation provided by clearing would be offset for parties that enter into bilateral over-the-counter swaps in bifurcated trading strategies, as they would still have to face the credit risk of bilateral counterparties.

## Corporate Governance Considerations

### *Corporate Governance Implications for SEC Filers Under the CEA*

As mentioned above, an SEC Filer that wishes to avail itself of the Commercial End-User Exception must have an "appropriate committee" of its board of directors (or equivalent body) review and approve the decision to enter into swaps exempt from the clearing requirements. 7 U.S.C. §2(j). As noted above, entities controlled by such SEC Filers are considered SEC Filers for this purpose and would therefore, also be subject to this requirement.

### *Appropriate Committee*

The CFTC has indicated that an "appropriate committee" for purposes of the board approval requirement is one that is specifically authorized by the board to review and approve the issuer's decision to enter into non-cleared swaps. 77 Fed. Reg. 42559, at 42569. For example, a board resolution may authorize the committee to review and approve the decisions of the SEC Filer not to clear the swap being reported (whether by expanding the authority of an existing board committee or by the creation of a new board committee). In turn, such board committee could adopt policies and procedures to review and approve decisions not to clear swaps, on a periodic basis or subject to other conditions determined to be satisfactory to the board committee. The approval may apply generally to all swaps, provided that it is reviewed and renewed at least annually, or it can be limited in time or to particular categories of transactions. A sample board resolution can be found [here](#).

Whether the board of the SEC Filer should establish a new committee to review and approve the decision to enter into non-cleared swaps, or whether the board should delegate such authority to a currently existing committee of the board, such as the audit committee, would depend on the facts and circumstances of the SEC Filer and its hedging strategies. Factors

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that an SEC Filer may consider include the size and available resources of the SEC Filer and the relative size and nature of the commercial risk and related hedging activities.

### *Scope of Committee Approval*

The appropriate committee (or equivalent body) must generally review and approve the decision to enter into swaps that are exempt from clearing, but is not required to approve each swap that the SEC Filer enters into. 77 Fed. Reg. 42559, at 42569. However, it is not sufficient for the appropriate committee to provide a blanket approval. Instead, the appropriate committee should establish suitable policies governing its use of swaps subject to the Commercial End-User Exception and review those policies at least annually and, as appropriate, more often upon a triggering event (e.g., the adoption of a new hedging strategy that was not contemplated in the original board approval). While the CFTC's final rule does not mandate such a policy review, the board of an SEC Filer may as a prudential matter wish to review risk management and/or trading policies in light of the SEC Filer's hedging activities generally.

### *Basis of Committee Approval*

The review and approval of the use of the Commercial End-User Exception by the appropriate committee of the board would be based on the facts and circumstances of each particular SEC Filer, including its present and planned hedging strategies. In light of these circumstances, an SEC Filer should analyze the advantages and disadvantages of a third-party central clearinghouse and trading on newly regulated exchanges or swap execution facilities, as compared to bilateral execution.

Margin, liquidity, cost and credit considerations described above may factor into this analysis. While clearing swaps is intended to, among other matters, reduce counterparty credit risk, the margin requirements for cleared swaps may have the effect of increasing the cost of conducting swaps. An additional potential factor for evaluation may be an SEC Filer's obligation to establish new relationships with clearing members and other swap intermediaries if it elects to engage in cleared swaps. These new arrangements would invariably require the need for drafting, negotiating and executing new documentation, and be accompanied by related legal fees and expenses.

In determining whether to approve the decision to enter into non-cleared swaps, a board committee may evaluate risks related to an SEC Filer potentially limiting the terms of its cleared swaps to those that are acceptable to the relevant derivatives clearing organizations. This may potentially result in a less effective swap strategy than a strategy using non-cleared bilateral swaps. Conversely, if an SEC Filer continues to enter into non-cleared swaps on a bilateral basis, new requirements being promulgated and implemented under Dodd-Frank Act, such as reporting, record-keeping, documentation and minimum margin requirements will be unavoidable.

As permitted under most board committee charters, the committee responsible for review and approval of the use of non-cleared swaps may wish to obtain professional guidance in reaching its fully informed resolution, the same as with other vital corporate decisions.

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### Corporate Governance Implications of the Commercial End-User Exception Under State Law

Compliance with any duties, standards or conduct requirements that may be relevant under state law is another important consideration for a commercial end-user when obtaining appropriate committee approval to avail itself of the Commercial End-User Exception. While corporate governance laws will vary from state to state, generally speaking, directors owe fiduciary duties, such as the duty of care and duty of loyalty, to the corporation and its stockholders.

In order to satisfy its fiduciary obligations, a director must exercise a certain degree of care when making decisions and act on an informed basis. For the purposes of this discussion, the appropriate committee may want to consider the following when evaluating the corporation's decision to elect the Commercial End-User Exception:

1. Timely receiving information regarding the Dodd-Frank Act, the clearing requirement, the Commercial End-User Exception and the advantages and disadvantages of using the Commercial End-User Exception;
2. Timely receiving information related to the Commercial End-User's use of the Commercial End-User Exception, including the Commercial End-User's policies and procedures governing the use of derivatives to hedge or mitigate commercial risk;
3. Convening multiple meetings and discussing the election of the Commercial End-User Exception;
4. Receiving objective advice about its responsibilities from independent legal and financial advisors; and/or
5. Making deliberate inquiries into the use of non-cleared swaps under the Commercial End-User Exception.

### Disclosure Implications of Electing the Commercial End-User Exception Under the Exchange Act

Although the CFTC's regulations do not prescribe disclosure standards for SEC Filers, an SEC Filer's decision to avail itself of the Commercial End-User Exception may necessitate disclosure in the SEC Filer's Exchange Act filings depending on the circumstances.

The potential materiality to a Commercial End-User of the compliance obligations under the clearing mandate and of an election to avail itself of the Commercial End-User Exception must be assessed on a case-by-case basis. To the extent that the potential advantages and disadvantages discussed above relating to clearing or to the continued use of non-cleared swaps are material to an SEC Filer, it may be required to provide enhanced disclosure of its hedging activities in filings under the Exchange Act. The United States Supreme Court has established standards for materiality in a line of cases that begins with *Basic v. Levinson*, 485 U.S. 224 (1988). Disclosure obligations that may be triggered by material changes resulting from an SEC Filer engaging in non-cleared swaps or cleared swaps include:

1. Risk factor disclosures;

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2. Qualitative and quantitative disclosure regarding market risk (Item 305 of Regulation S-K);
3. Role of the board in risk oversight (Item 407(h) of Regulation S-K);
4. Management's discussion and analysis (Item 303 of Regulation S-K);
5. Notes to financial statements (Regulation S-X); and
6. Internal control over financial reporting (Item 308 of Regulation S-K).

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### Corporate Governance Checklist

This checklist is a corporate governance tool for certain nonfinancial entities that wish to elect the commercial end-user exception to the clearing requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The commercial end-user exception provides an exception to the clearing requirement so that certain nonfinancial entities that use swaps and security-based swaps to hedge or mitigate commercial risks associated with their underlying business are not required to submit such instruments for clearing. In order to rely on the commercial end-user exception, such entities must have an "appropriate committee" of its board of directors' review and approve the decision to enter into swaps exempt from the clearing requirements. For more information on the commercial end-user exception, see "Introduction to the Commercial End-User Exception to Mandatory Clearing of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act."

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The CFTC must be notified, in a manner prescribed by it, when a counterparty to a swap elects to avail itself of the commercial end-user exception. The notice contains certain basic information including information as to whether an appropriate committee of the board of directors (or equivalent body) has reviewed and approved generally the decision to enter into swaps that are exempt from the clearing requirements. Accordingly, prior to relying on the commercial end-user exception, nonfinancial entities must obtain the proper board approval. The checklist below outlines steps to follow to obtain board approval.

1. Determine whether you are (i) an issuer of securities registered under Section 12 of the Securities Exchange Act or (ii) are required to file Section 15(d) Securities Exchange Act reports (referred to herein as an "SEC Filer")
  - An SEC Filer that wishes to avail itself of the commercial end-user exception must have an "appropriate committee" of its board of directors (or equivalent body) review and approve its decision to enter into swaps exempt from the clearing requirements. 7 U.S.C. §2(j).

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- Entities controlled by SEC Filers are considered SEC Filers for this purpose and are subject to this requirement.
- 2. Determine the “appropriate committee” of the board of directors (or equivalent body) to review and approve the decision not to clear certain swaps**
  - The CFTC has indicated that an “appropriate committee” for purposes of the board approval requirement is one that is specifically authorized by the board to review and approve the SEC Filer’s decision to enter into non-cleared swaps. 77 Fed. Reg. 42559, at 42569.
  - Whether the board should establish a new committee to review and approve the SEC Filer’s decision to enter into non-cleared swaps, or whether the board should delegate such authority to a currently existing committee of the board, such as the audit committee, depends on the facts and circumstances of the SEC Filer and its hedging strategies.
  - A board resolution may authorize a committee to review and approve the SEC Filer’s decisions not to clear the swap being reported (whether by expanding the authority of an existing board committee or by the creation of a new board committee).
- 3. Submit your decision not to clear certain swaps to the “appropriate committee” for approval**
  - Information that companies should consider providing to its “appropriate committee” include but is not limited to:
    - i. The company’s derivatives or swap policy that permits the company to enter into swap transactions;
    - ii. Information related to Title VII of the Dodd-Frank Act;
    - iii. Information related to the mandatory clearing requirements under the Dodd-Frank Act; and
    - iv. Information relating to Section 2(h)(7) of the Commodity Exchange Act, which provides the commercial end-user exception.
- 4. The “appropriate committee” shall review and determine whether to approve your decision not to clear swaps**
  - The “appropriate committee’s” review and approval will be based on the facts and circumstances of each particular SEC Filer, including its present and planned hedging strategies.
  - The SEC Filer should analyze the advantages and disadvantages of a third-party central clearinghouse and trading on newly regulated exchanges or swap execution facilities, as compared to bilateral execution. Factors to consider: margin, liquidity, cost and credit considerations, as well as evaluating obligations to establish new relationships with clearing members and other swap intermediaries if the company elects to engage in cleared swaps
  - The SEC Filer should evaluate risks related to potentially limiting the terms of its cleared swaps to those that are acceptable to the relevant derivatives clearing organizations. This may potentially result in a less effective swap strategy than a strategy using non-cleared bilateral swaps. Conversely, if a SEC Filer continues to enter into non-cleared

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swaps on a bilateral basis, new requirements being promulgated and implemented under Dodd-Frank Act, such as reporting, record-keeping, documentation and minimum margin requirements will be unavoidable.

- The SEC Filer should consider whether obtaining professional guidance before reaching fully informed resolution.

### 5. The “appropriate committee” must determine the scope of its approval

- Approval may be provided on a swap-by-swap basis or on a general basis if approved on an annual basis.
- If done on a general basis, the “appropriate committee” should establish suitable policies governing the SEC Filer’s use of swaps subject to the commercial end-user exception and review those policies at least annually and, as appropriate, more often upon a triggering event (e.g., the adoption of a new hedging strategy that was not contemplated in the original board approval).

### 6. Document the “appropriate committee’s” review and approval

- The SEC Filer should document the “appropriate committee’s” review and approval of the decision not to clear swaps, as well as the decision to use the commercial end-user exception.
- These documents should be retained pursuant to the Dodd-Frank recordkeeping requirements.
- A sample board resolution can be found [here].

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