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September 12, 2013

Broker-Dealer Audit and Reporting Updates


These Developments May Be Relevant for Audit Committees of Public Companies that Own Broker- Dealers

SUMMARY
The Public Company Accounting Oversight Board and the Securities and Exchange Commission have recently issued reports and taken other steps to strengthen the audit, financial reporting and risk management functions relating to broker-dealers. Broker-dealers, as well as audit committees of public parent companies that own broker-dealers significant to the parent company on a consolidated basis, should be aware of these developments as they may affect firm practices and procedures relating to the preparation of financial statements, internal controls and risk management relating to broker-dealers and, indirectly, to their public parent companies.

PCAOB Inspection Report. On August 19, 2013, the PCAOB issued its second progress report on its interim inspection program for auditors of broker-dealers. Of the portions of the 60 audits inspected, covering 43 audit firms, deficiencies were noted for all audit firms inspected and for 95% of the audits selected for inspection. Deficiencies were most frequently noted with respect to (1) the risk of material misstatements in broker-dealer financial statements due to fraud, revenue recognition, related-party transactions, financial statement disclosures and the procedures for relying on records and reports provided by service organizations; and (2) audit procedures related to the net capital and customer protection rules under the Securities Exchange Act of 1934. The PCAOB also noted that, contrary to SEC auditor independence rules, some auditors of broker-dealers were involved in the preparation of the financial statements or supporting schedules that they audited (including in cases where the auditor also audited a public parent company).
New SEC Broker-Dealer Audit, Reporting and Notification Rules. On July 30, 2013, the SEC adopted amendments to its broker-dealer audit, reporting and notification rules. The rules now require that:

- broker-dealer audits be conducted in accordance with PCAOB standards;
- carrying broker-dealers file an annual compliance report confirming, among other things, the effectiveness of their internal control over compliance and compliance with the net capital and customer protection rules;
- broker-dealers claiming an exemption from the customer protection rule (e.g., non-carrying broker-dealers) file an annual exemption report confirming their compliance with the exemption requirements throughout the most recent fiscal year;
- broker-dealers file an annual auditor’s report covering the compliance report or exemption report, as applicable;
- broker-dealers file a new Form Custody with their designated examining authority describing their practices relating to custody of customer securities and funds;
- carrying and clearing broker-dealers agree to allow the SEC and their respective DEAs to review their independent auditors’ audit documentation and allow their auditors to discuss their findings with the SEC and DEAs; and
- broker-dealers document their credit, market and liquidity risk management controls.

The new rules, other than the requirements to file Form Custody and document broker-dealer risk management controls, are effective June 1, 2014. The requirement to file Form Custody is effective December 31, 2013, and the requirement for broker-dealers to document their risk management controls is effective October 21, 2013.

Implications for Broker-Dealer Management and Parent Company Audit Committees. Management of a broker-dealer should be aware of the PCAOB’s findings when communicating with the firm’s outside auditor about the audit process and should evaluate the impact of the new SEC rules, particularly if the broker-dealer carries customer accounts or clears transactions, on the firm’s internal controls, risk management procedures and expectations with regards to the broker-dealer audit. In particular, management of a broker-dealer should consider taking the following actions:

- review the PCAOB’s results with the outside auditor and inquire whether any deficiencies might be present in the audits it performs, and discuss with the auditor whether the auditor should take any action to detect, prevent or correct deficiencies;
- confirm the auditor’s independence on an ongoing, periodic basis; and
- review the firm’s internal controls and procedures to ensure it is appropriately determining whether or not it is a carrying broker-dealer and its compliance with the net capital, customer protection and quarterly security count rules under the Exchange Act and applicable DEA rules (collectively, the “financial responsibility rules”).

Audit committees of public companies that own broker-dealers that are significant to the parent on a consolidated basis should also be aware of the PCAOB’s findings and new SEC rules. These parent company audit committees should consider taking the following actions:

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- discuss with the broker-dealer’s management any issues relating to the accuracy and completeness of the broker-dealer’s financial statements and to the adequacy of its internal controls, as the financial statements of the broker-dealer will be included in the parent’s consolidated financial statements filed with the SEC (and its controls may affect the adequacy of the parent’s internal control over financial reporting);

- inquire of the outside auditor (including any separate auditor of the broker-dealer) whether any of the deficiencies noted in the PCAOB report may be present in the audits it performs and what audit procedures are used to detect, prevent or correct deficiencies;

- verify that risk management controls at the broker-dealer are appropriately documented and consistent with the parent company’s policies; and

- confirm that management is properly overseeing and planning the work of the independent auditor with regard to the broker-dealer.

BACKGROUND

On August 19, 2013, the PCAOB issued Release No. 2013-006, Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers, which covers the audit deficiencies and independence findings identified by the PCAOB in the inspections of broker-dealer audits that it conducted between March 1, 2012 and December 31, 2012. The interim inspection program was authorized under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) to (1) enable the PCAOB to assess compliance of registered audit firms conducting audits of broker-dealers with the Sarbanes-Oxley Act of 2002, SEC rules and professional standards and (2) inform the PCAOB’s eventual determination about the scope and elements of a permanent inspection program. The PCAOB currently anticipates a rule proposal for a permanent inspection program to be issued in 2014 or later.

On July 30, 2013, the SEC adopted amendments to Exchange Act Rule 17a-5, which sets forth broker-dealer financial reporting, audit and notification requirements. These changes were initially proposed in June 2011, partially in response to the Madoff scandal, in order to provide additional safeguards with respect to broker-dealer custody of customer securities and funds.

PCAOB REPORT ON INSPECTIONS OF BROKER-DEALER AUDITORS

In its second report, the PCAOB inspected 43 audit firms, covering portions of 60 audits of broker-dealers. The PCAOB inspection staff found deficiencies at all the audit firms and in 57 out of 60 (95%) of the audits inspected. Deficiencies in compliance with Exchange Act requirements were most frequently noted with respect to:

- audit procedures related to a number of financial statement areas described below;

- audit procedures related to the net capital and customer protection rules; and

- SEC auditor independence rules.
Audit Deficiencies Related to Financial Statement Areas

PCAOB inspectors found audit deficiencies in a number of financial statement areas relevant to broker-dealers and audit committees of public companies that own broker-dealers, including the following.

**Risk of Material Misstatement Due to Fraud.** In 37 of the 60 audits, the PCAOB determined that auditors failed to perform audit procedures sufficient to respond to the risk of material misstatement due to fraud. For example, the PCAOB stated that in 11 audits the auditors failed to perform audit procedures to respond to the identified risk of fraud for revenue recognition (either through overstatement or understatement of revenues). In other audits, the PCAOB asserted that auditors failed to approach the audit with sufficient professional skepticism or did not perform sufficient journal entry testing in response to the risk of management improperly recording potentially fraudulent journal entries and other adjustments.

**Revenue Recognition.** The PCAOB found revenue recognition deficiencies in 42 audits. In 18 audits, the PCAOB determined that the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue and principal transaction revenue (for instance, by failing to perform any procedures or failing to select representative revenue transactions for testing). The PCAOB also noted instances where the auditors performed substantive analytical procedures that did not provide the necessary level of assurance that the financial statements were free of material misstatement and the failure of audit firms to perform sufficient procedures to test the occurrence, accuracy, completeness or cutoff of revenues.

**Related-Party Transactions.** The PCAOB stressed that auditors should be aware of the possible existence of material related-party transactions that could affect the financial statements and of relationships for which disclosure is required. PCAOB inspectors found related-party transaction deficiencies in 25 of the 60 audits, notably where:

- no procedures were performed to test for related parties or related-party transactions, or, if performed, the procedures were insufficient to determine whether such parties existed or any material transactions occurred; and
- there was a failure to perform procedures necessary to obtain sufficient audit evidence, or auditors did not sufficiently evaluate audit evidence, concerning the purpose, nature or extent of the related-party transactions or their effect on the financial statements.

**Auditing Financial Statement Disclosures.** The presentation of financial statements in accordance with generally accepted accounting principles requires adequate disclosure of material matters affecting the financial statements. In 29 of the 60 audits, the PCAOB found deficiencies primarily related to:

- inaccurate or incomplete disclosures;
- omitted disclosures; and
- the failure to sufficiently test disclosure of securities within the fair value hierarchy required by FASB ASC 820.
Reliance on Records and Reports. The PCAOB identified deficiencies in 30 audits related to procedures to establish reliance on records and reports, such as trade blotters, account statements and other schedules, provided by third-party service organizations\textsuperscript{11} or by the broker-dealer subject to the particular audit. For example, the PCAOB observed instances where the auditors did not perform sufficient procedures on reports prepared by service organizations, including instances where the auditor either did not perform procedures to evaluate the accuracy or completeness of these reports or did not obtain a service organization’s auditor’s report for purposes of testing commission revenue and the related commission receivable. In audits where the auditor did obtain a service organization’s auditor’s report, the PCAOB observed instances where the auditor did not sufficiently evaluate the report, failed to consider whether the report provided evidence about the design and operating effectiveness of the controls being relied upon or failed to perform additional procedures when the service organization’s auditor did not test controls over relevant financial statement assertions.

On occasions where the records and reports were produced by the broker-dealer subject to the audit, the PCAOB observed that the auditors failed to perform sufficient procedures to evaluate the accuracy and completeness of records and reports that were used in the performance of tests of controls or substantive tests.

Audit Deficiencies Related to Net Capital and Customer Protection Rules

In 41 audits, PCAOB inspectors determined that the audit firms failed to perform sufficient procedures to obtain reasonable assurance that any material inadequacy existing at the examination date and relating to compliance with the net capital and customer protection rules would be disclosed in the auditor’s report. The PCAOB found that the auditors (1) did not sufficiently test controls related to the broker-dealer’s accounting system, internal accounting controls or procedures for safeguarding customer securities; and (2) did not adequately test procedures relating to the broker-dealer’s claimed exemption under the customer protection rule from the requirement to maintain a special reserve bank account for the exclusive benefit of customers (for instance, several audit firms limited their procedures to management inquiries alone and did not perform sufficient other procedures).

Net Capital Rule. Regarding the net capital rule, deficiencies were noted with respect to:

- the failure to assess the nature of the broker-dealer’s operations in relation to the required minimum net capital;
- the failure to perform sufficient procedures to test the broker-dealer’s classification of allowable and non-allowable assets when computing net capital;
- the failure to perform sufficient procedures to evaluate the appropriateness of the haircuts applied to securities positions in computing net capital; and
- the failure to perform sufficient procedures to test the completeness and accuracy of operational charges deducted from the broker-dealer’s net capital.
Customer Protection Rule. Regarding the customer protection rule, notable deficiencies cited by the PCAOB included (1) the failure to sufficiently test the completeness and accuracy of customer credits or debits used in the customer reserve computation; and (2) the failure to verify the existence of the special reserve account or that account agreements contained the required restrictive provisions.

Failure to Satisfy Independence Requirements. Exchange Act Rule 17a-5(f)(3) requires broker-dealers to comply with the SEC’s auditor independence requirements in Rule 2-01 of Regulation S-X. In 22 audits, the PCAOB ascertained that the auditor independence rules were violated and communicated the violations to the particular audit firms in writing. According to the PCAOB, these audit firms assisted in preparing the broker-dealer’s financial statements or supporting schedules and prepared trial balances of source data underlying the financial statements. Nineteen of the firms notified of the independence findings did not previously audit public companies; however, three of them also audited public companies in addition to broker-dealers.

NEW SEC BROKER-DEALER AUDIT, REPORTING AND NOTIFICATION RULES

On July 30, 2013, the SEC amended certain broker-dealer audit, reporting and notification requirements set forth in Exchange Act Rule 17a-5. Notably, these changes require that broker-dealers file new types of reports with the SEC and their respective DEAs (the contents of which depend upon whether or not the broker-dealer is a carrying broker-dealer), that broker-dealer audits be conducted in accordance with PCAOB standards (effective for fiscal years ending on or after June 1, 2014) and that both carrying and clearing broker-dealers allow the SEC and the DEAs to review the independent auditor’s audit documentation and discuss their findings with the auditor in connection with regulatory examinations. The SEC also amended Exchange Act Rules 17a-3 and 17a-4 to require that broker-dealer risk management controls be documented.

Annual Compliance and Exemption Reports. Exchange Act Rule 17a-5 generally requires a broker-dealer to file annually with the SEC audited financial statements, supporting schedules and a report prepared by the independent auditor covering the filed statements and schedules. The new rules also require a broker-dealer to provide a new report to the SEC, the contents of which depend on whether the broker-dealer is a carrying broker-dealer. The new report must be filed with respect to fiscal years ending on or after June 1, 2014, and within 60 calendar days after the end of each fiscal year.

Carrying broker-dealers must file a compliance report that, among other things:

- states whether the broker-dealer has established and maintained internal control over compliance;
- states whether such internal control over compliance was effective both during and as of the end of the most recent fiscal year;
- states whether the broker-dealer was in compliance with the net capital rule and requirements for maintaining a special reserve account for the exclusive benefit of customers under the customer protection rule.
protection rule, and whether such statement was based on information derived from the books and records the broker-dealer is required to keep and maintain under SEC rules; and

- describes (1) each identified material weakness in the broker-dealer’s internal control over compliance during the most recent fiscal year; and (2) any instance of non-compliance with the net capital rule or special reserve account requirements as of the end of the most recent fiscal year.\(^{15}\)

If the broker-dealer is not a carrying broker-dealer, it must file an exemption report identifying the particular exemption from Exchange Act Rule 15c3-3(k) that it is relying on and include statements that it is exempt from the special reserve account requirements.\(^{16}\) These statements must be made to the broker-dealer’s best knowledge and belief and must identify and describe any exceptions to the claimed exemptions.

**Annual Auditor Examination Report.** A broker-dealer is now required to engage its independent auditor to prepare an annual report based on an examination of the broker-dealer’s financial statements, supporting schedules and either an examination of certain enumerated statements of the broker-dealer in the compliance report\(^{17}\) or a review of the statements made by the broker-dealer in the exemption report, as applicable. The examination must be made in accordance with PCAOB standards and the report must be filed by the broker-dealer with respect to fiscal years ending on or after June 1, 2014 along with the broker-dealer’s financial statements, supporting schedules and compliance or exemption report.

If the independent auditor’s report covering the compliance report identifies the existence of one or more material weaknesses, the broker-dealer must include a statement in the financial information it sends to its customers that material weaknesses have been identified and that a copy of the auditor’s report is available for customers’ inspection at the SEC’s principal office and the regional office in which the broker-dealer has its principal place of business.

**Notification Requirements.** Under the new rules, Exchange Act Rule 17a-5(h) provides that if during the course of the preparation of the examination report the auditor determines that the broker-dealer is not in compliance with the financial responsibility rules or a material weakness exists, the auditor must immediately notify the broker-dealer’s chief financial officer. Where the broker-dealer is required to notify the SEC, the broker-dealer must provide a copy of the notice to the auditor. If the auditor does not receive the notice within one business day or disagrees with the notice’s statements, the auditor is required to report this to the SEC. This requirement is effective June 1, 2014.

**SEC and DEA Communication with Auditors.** Effective June 1, 2014, both carrying and clearing broker-dealers must represent in their notices designating their independent auditors that they agree to allow staff of the SEC and their DEA to review the audit documentation associated with their annual audit reports and allow the auditors to discuss their findings with SEC and DEA staff in connection with broker-dealer regulatory examinations.
Form Custody. Effective December 31, 2013, all registered broker-dealers must file a new Form Custody with their respective DEAs when they file their quarterly FOCUS Reports. Form Custody is designed to elicit information about the broker-dealer’s custodial activities, including whether it maintained custody of customer and non-customer assets and, if so, how such assets were maintained. Form Custody must be filed within 17 calendar days after the end of each calendar quarter.

Risk Management Documentation. The SEC amended Exchange Act Rule 17a-3 to require certain broker-dealers to make and keep current a record documenting the credit, market and liquidity risk management controls established and maintained by the broker-dealer to assist in analyzing and managing the risks associated with its business activities. This documentation requirement applies only to broker-dealers that have more than (1) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Exchange Act Rule 15c3-3, or (2) $20,000,000 in capital, including subordinated debt. Amended Exchange Act Rule 17a-4 requires that the written controls must be retained for three years after the termination of the risk management controls documented therein.

The risk management documentation requirement is effective October 21, 2013. The SEC makes clear in the release adopting the new rule that it is not mandating any specific controls, procedures or policies. Rather, the SEC states that it is requiring only that the controls, procedures and policies in place be documented.

IMPLICATIONS FOR BROKER-DEALER MANAGEMENT AND PARENT COMPANY AUDIT COMMITTEES

Management of broker-dealers should be aware of the PCAOB and SEC developments described above as they may affect firm practices and procedures relating to the preparation of financial statements, internal controls and risk management. Similarly, the audit committee of a public company that owns a broker-dealer may wish to consider these developments if the broker-dealer has a significant impact on the parent company’s consolidated financial statements. Management may find taking the following actions helpful in light of these developments:

- Review the PCAOB’s findings with its auditor and address how the areas of concern in the PCAOB report are being appropriately addressed in the broker-dealer’s audit, including inquiring as to whether the PCAOB provided any written communication to the audit firm regarding the inspection;18
- Discuss with the auditor whether any audit deficiencies might be present in the audits it performs, and whether the auditor should take any action to detect, prevent or correct the deficiencies;
- Confirm the auditor’s independence on an ongoing, periodic basis in connection with the broker-dealer’s audit; and
- Review the firm’s internal controls and procedures on an ongoing basis to ensure it is appropriately determining whether or not it is a carrying broker-dealer and its compliance with the financial responsibility rules.
Audit committees of public companies that own broker-dealers significant to the parent company on a consolidated basis may find taking the following actions helpful in response to these developments:

- engage with management of the broker-dealer to ensure proper oversight of the broker-dealer’s financial statements and audit, particularly because broker-dealer financial statements are consolidated with the parent company and any deficiencies or inadequate controls, if unaddressed, could have a material effect on the presentation of the parent company’s financial statements and footnotes (and the broker-dealer’s controls may affect the adequacy of the parent’s internal control over financial reporting);

- inquire of the outside auditor (including any separate auditor of the broker-dealer) whether any of the deficiencies identified by the PCAOB may be present in the audits it performs and what audit procedures it uses to detect, prevent or correct deficiencies;

- discuss with the auditors and management the preparation and presentation of the broker-dealer’s financial statements, as the PCAOB noted in the report that when it comes to the PCAOB’s attention that financial statements of a broker-dealer appear not to present fairly in all material respects the financial position, results of operations or cash flows, the PCAOB’s practice is to report the information to the SEC, and information suggesting violations of law or rules, including independence rules, by a broker-dealer may be reported to the SEC or the DEA;

- verify that risk management policies have been appropriately documented, and are consistent with the parent company’s risk management policies (to the extent this is not a function of the audit committee, the board committee charged with overseeing risk management policies should consider this point); and

- confirm that management of the broker-dealer is properly overseeing and planning the work of the independent auditor.
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ENDNOTES


2. The term “broker-dealer” as used in this memorandum refers to broker-dealers registered with the SEC.

3. The net capital rule (Exchange Act Rule 15c3-1) generally requires a broker-dealer at all times to maintain more than one dollar of liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties and creditors). This requirement is intended to ensure that, if the broker-dealer fails, it will have sufficient liquid assets to pay all liabilities to its customers, counterparties and creditors.

4. The customer protection rule (Exchange Act Rule 15c3-3) is intended to protect customers of a broker-dealer by restricting the ability of the broker-dealer to use customer funds and securities to finance its proprietary business activities.


6. Carrying broker-dealers generally are broker-dealers that maintain custody of customer funds and securities.

7. Clearing broker-dealers generally are broker-dealers that clear transactions as members of security exchanges, The Depository Trust & Clearing Corporation and the Options Clearing Corporation. Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and funds.

8. In a separate action on July 30, 2013, the SEC also adopted changes relating to its net capital (Exchange Act Rule 15c3-1), customer protection (Exchange Act Rule 15c3-3), record-keeping, including relating to broker-dealer risk management controls (Exchange Act Rules 17a-3 and -4), and notification (Exchange Act Rule 17a-11) rules. The adopting release for these other changes is available at http://www.sec.gov/rules/final/2013/34-70072.pdf. In this memorandum, we discuss these other changes only insofar as they relate to risk management controls.

9. Exchange Act Rule 17a-13 requires a broker-dealer on a quarterly basis to count, examine and verify the securities it actually holds for customers and for itself, and compare that with the amounts of such securities it should be holding as indicated by its records.

10. Dodd-Frank gave the PCAOB oversight authority with regard to auditors of broker-dealers to the same extent it has carried out its authority with auditors of public companies.

11. Service organizations perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions.

12. Rule 2-01(c)(4)(i) of Regulation S-X provides that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides bookkeeping or other services relating to the accounting records or financial statements of the audit client, “unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.”

13. In a separate release on July 30, 2013, the SEC revised Exchange Act Rule 15c3-3 to also require these “carrying broker-dealers” to maintain a new segregated reserve account for account holders that are broker-dealers, which were previously not covered under the customer protection rule.

14. Internal control over compliance is defined as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.

(continued . . .)

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## ENDNOTES (CONTINUED)

15 A broker-dealer is not permitted to conclude that internal control over compliance was effective if there were one or more material weaknesses in internal control over compliance. A “material weakness” is defined as a deficiency, or a combination of deficiencies, in the broker-dealer's internal control over compliance such that there is a reasonable possibility that non-compliance with the net capital rule or special reserve account requirement will not be prevented or detected on a timely basis, or that non-compliance to a material extent with the other rules covered by the report will not be prevented or detected on a timely basis.

16 A broker-dealer that is also registered as an investment adviser under the Investment Advisers Act of 1940 may use the examination report covering the compliance report to satisfy its Advisers Act Rule 206(4)-2 internal control report requirements.

17 The statements reviewed include those relating to whether (1) the broker-dealer's internal control over compliance was effective during and as of the end of the most recent fiscal year; and (2) the broker-dealer was in compliance with the net capital rule and requirements for maintaining a special reserve account and whether such statement was based on information derived from the broker-dealer's books and records. The statements subject to the examination do not include a statement as to whether the broker-dealer has established and maintained a system of internal control over compliance or a description of instances of non-compliance with the net capital rule and requirements for maintaining a special reserve account under the customer protection rule.

18 In August 2012, the PCAOB issued a release in response to concerns about the nature and amount of inspection-related information audit firms of public companies provided to such companies’ audit committees, and provided guidance to enable audit committees to initiate meaningful discussion with audit firms about the inspection results. Our client memorandum on this release is available at [http://www.sullcrom.com/Audit-Committee-Oversight-of-Auditors/](http://www.sullcrom.com/Audit-Committee-Oversight-of-Auditors/). The PCAOB's August 2012 release should have additional relevance for broker-dealer audits upon the commencement of the PCAOB’s permanent inspection program of auditors.
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