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Regulation Best Interest: The Next Big Thing for Broker-Dealer Cross-Border Private Wealth

In April 2018, the U.S. Securities and Exchange Commission ("SEC") released Regulation Best Interest, or Reg BI, a proposed rule that will require broker-dealers to operate in the best interest of their customers. Under Reg BI, broker-dealers must disclose key details of the client-broker relationship; exercise diligence and care when making recommendations to clients; and enforce policies to disclose and mitigate, or eliminate, potential conflicts. However, the proposed regulation, which is back before the SEC for consideration after passing its August 2018 comment period, may create more disruption than it resolves.

This White Paper examines Reg BI and the new and significant challenges it will present to the cross-border private wealth industry.
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OVERVIEW

The broker-dealer cross-border private wealth industry is no stranger to recent challenges, and on the horizon looms another—the U.S. Securities and Exchange Commission’s (“SEC”) proposed Regulation Best Interest (“Reg BI”). As a required offshoot of the Dodd-Frank Act and an anticipated follow-up to the Department of Labor’s (“DOL”) failed fiduciary rule, Reg BI has passed its August 2018 comment period and is back before the SEC for consideration.

Although its final form is yet to be known, many believe that some level of “best interest” regulation is a certainty. However, Reg BI may create more disruption to the cross-border private wealth management business than it resolves. Reg BI—which requires disclosure and mitigation, or elimination, of many potential conflicts—is premised heavily on an economics-driven model that fails to take into account many of the issues underlying cross-border investment, such as geographic diversity, dollarization of assets, heightened need for privacy and security, use of complex structures for tax and succession planning, and similar highly personalized customer interests.

Additionally, it may disproportionately affect products traditionally used by international customers, such as structured products and offshore mutual funds, and disproportionately affect brokers specializing in cross-border who change employment more frequently than their U.S. domestic counterparts.

Further, because Reg BI creates a duty to act to a defined standard, the proposed rule fails to recognize the difficulty of completing those duties in foreign countries with customers whose frame of reference is predominantly local, not in English, and who have complicated product and holding structure needs.

THE PROPOSED REGULATION

Reg BI is intended to establish a higher standard of affirmative conduct, including disclosure and care obligations for broker-dealers and their associated persons (for ease of reference sometimes collectively referred to herein as “broker-dealers”) when making recommendations to retail customers (i.e., a person who uses the recommendation primarily for personal, family, or household purposes). While proponents cite to the lack of an imposed fiduciary duty, some commentators argue that there seems to be little functional distinction left. In summary, Reg BI requires broker-dealers to act in the best interest of retail customers when recommending securities transactions. Reg BI specifies that in order to satisfy the best interest obligation, broker-dealers must:

1. Prior to, or at the time of making the recommendation, disclose to the customer, in writing, material facts relating to the scope and terms of the relationship, including all material conflicts of interest related to the recommended transaction.
2. Exercise reasonable diligence, care, skill, and prudence to: (i) understand the potential risks and rewards of the transaction and have a reasonable basis to believe that the transaction could be in the best interests of at least some
retail customers; and (ii) have a reasonable basis to believe that: (a) the recommended transaction is in the best interest of the particular customer, based on both the customer’s investment profile (e.g., the customer’s age, other investments, financial situation and needs, tax status, investment objectives, experience and time horizon, liquidity needs, and risk tolerance) and the relevant risks and rewards; and (b) any series of recommended transactions is not excessive and is in the customer’s best interest (when viewed together) under the customer’s investment profile.

3. Establish, maintain, and enforce written policies and procedures that, with respect to recommendations to retail customers, are reasonably designed to: (i) identify and disclose or eliminate all associated material conflicts; and (ii) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from associated financial incentives.

Reg BI also requires that certain books and records be maintained, including: (i) a record of all information given to and received from retail customers and (ii) the identity of each natural person at the broker-dealer who is responsible for the retail account.

Under Reg BI, broker-dealers would be required to act in an undefined, but highly prescribed, “best interest” of their retail customers. The context of the mandatory best interest determination centers almost exclusively on prohibiting the broker-dealer from placing its financial interest ahead of the client’s and disclosing any information which may lead a customer to believe that the broker is not consciously or unconsciously “disinterested.”

Reg BI is triggered by (i) a recommendation; (ii) to a retail securities customer; (iii) on a securities transaction or strategy. While “recommendation” remains defined by FINRA, “retail customer” is defined in Reg BI without regard to corporate or individual form or wealth. Instead, a retail customer is defined by the purpose of the trade as one who “… uses the recommendation primarily for personal, family, or household purposes.”

The definition of “customer” does not require an account relationship, rather merely that one receives a recommendation.

At its core, Reg BI creates a standard of conduct at the time the recommendation is made that does not place the interest of the broker-dealer ahead of the interest of the retail customer. Reg BI prescribes satisfying this obligation by way of a three-dimensional, four-part obligation. The proposal designates specific duties to the broker-dealer institutionally and the recommending individual broker at the product level. Reg BI calls for the institutional broker-dealer to disclose, in plain-English writing, all material conflicts of interest associated with the recommendation. Under Reg BI, the standard for assessing materiality is based on whether the conflict carries the expectation that it “might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.” Accompanying SEC proposals command the provision of a Client Relationship Summary (“CRS”) designed to address certain specific institutional conflicts of interest, such as the difference between advisory and brokerage accounts.

The second of the four-part steps imposes a duty of care upon the maker of the recommendation, usually the individual broker, and prescribes the exercise of reasonable diligence, care, skill, and “prudence.” The recommendation must have a reasonable basis based on the customer’s investment profile which is expansively redefined to include tax status and any other information the customer may disclose to the broker.

The propriety of the recommendation also is to be considered in the context of frequency and number of trades and must not be excessive as a series of recommendations, even if appropriate when viewed in isolation.

Reg BI would require the establishment, maintenance, and enforcement of policies and procedures designed to identify, disclose, or eliminate material conflicts of interest associated with the recommendation, and identify and disclose, and mitigate, or eliminate, material conflicts of interest related to the financial incentives of the broker-dealer. The isolation of financial incentives as a class of conflicts requiring mitigation or elimination is one of Reg BI’s most pronounced departures from current requirements and is perhaps the most difficult conflict-of-interest obligation to implement. It establishes a burden on brokers arguably greater than that of investment advisers.

Lastly, Reg BI’s record-keeping provision described above is not to be minimized in its application to cross-border customers. Given the complex purposes for which foreign customers invest, the availability of personal information mandated to be held by brokerages may well increase the targeting of brokerages under Reg BI for nonfinancial discovery, such as divorces and commercial disputes.
THE DISCLOSURE OBLIGATION

The disclosure obligation requires the broker-dealer to disclose to the retail customer, in writing, all material conflicts of interest associated with the recommendation, along with material facts, such as the capacity in which the broker is acting, fees and charges, and the type and scope of services being provided by the broker and any other facts that the broker-dealer determines are material.

THE DUTY OF CARE

Many have called Reg BI a “suitability plus” standard. While closely related to the FINRA suitability requirements, it neither mimics nor replaces suitability. Instead, Reg BI would require an analysis and cascading compliance program to consider a customer’s perceived best interest, not just threshold suitability. While the FINRA requirements of reasonable basis suitability and customer-specific suitability remain intact, the undertaking of those would, under Reg BI, be subject to a specific standard of reasonable diligence, due care, skill, and prudence. This objective standard would require a more diligent approach to a customer’s investment objectives than before and relevant extraneous considerations that cannot be waived contractually or disclosed away. It also would effectively require a broader array of investment alternatives to be considered, where available.

Suggested diligence and disclosure includes the cost to the customer, as well as the level of remuneration to the broker. However, a lower cost product does not immunize a broker from the methodology. Liquidity, volatility, and extraneous risk all must factor into the mix. In the end, an articulated and demonstrable reason for a recommendation should be constructed.

THE CONFLICT-OF-INTEREST OBLIGATION

In perhaps its most innovative and complicated assertion of affirmative duty, the SEC has tackled the multiple conflicts inherent in a multifaceted industry and separated them into silos defined by the existence of financial incentives. Importantly, the conflicts inherent in broker-dealer compensation, such as acting as principal, selling proprietary products, or receiving trailers post-sale, are not prohibited, per se. However, the disclosure must be the result of policies and systems that reliably identify, eliminate, or mitigate those material conflicts. Additionally, if material conflicts of interest arise from financial incentives tied to the recommendation, disclosure alone is insufficient. Those conflicts must be subject to disclosure and mitigation or elimination.

Under Reg BI, a material conflict of interest would exist if “a reasonable person would expect [it] might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested” and if it brings the compensation of the broker-dealer and the individual broker to the forefront of the analysis.\(^6\)

In proposing Reg BI, the SEC identified a wide range of practices that it believes “preliminarily” would constitute material conflicts arising from financial incentives, such as sales contests and sales-based recognition awards. The SEC requested comment on the scope of the conflicts to be impacted. Depending on the result of its deliberations, many products, including mutual funds of multiple classes, structured products, and non-U.S. mirror funds, may be subjected to much deeper diligence, disclosure, and potentially mitigation or elimination as to varying modes of compensation. Similarly, the presence of revenue and asset benchmarks in employment contracts may require much greater disclosure, if not mitigation and elimination.

IMPACT ON THE CROSS-BORDER PRIVATE WEALTH INDUSTRY

While the broker-dealer cross-border private wealth industry is subject to the same standards and regulations attached to all SEC and FINRA registered broker-dealers and their associated persons, its uniqueness in the application of Reg BI lies in certain key differences from the U.S. domestic practice, among them:

- Foreign investment into U.S. accounts is often driven by many non-economic factors, including dollarization for currency risk, family security risk, geographic diversification, and international tax considerations.
- Due to international tax considerations, among other things, many international clients invest through offshore
holding vehicles, such as PICs, trusts, foundations, or other vehicles, adding complicated tax analysis to any “best interest” standard.

• Non-U.S. investors necessarily operate often within a frame of reference more attuned to their home country experiences and in languages other than English.

• Brokers who service cross-border clients must often travel to service their clients in countries that may restrict, either legally or prudentially, the provision of financial documents and system access while traveling.

• Non-U.S. investors gravitate toward more complex products and structures that often implicate more complex compensation and remuneration components.

• Because of time, technology, and geography, many non-U.S. investors grant their representatives brokerage discretion, creating further overlap between the boundaries of brokerage and advisory.

• International financial representatives exhibit more mobility than domestic representatives and their financial compensation may be more exposed to benchmark-laden transition packages which may now require fulsome disclosure.

ECONOMICS ALONE ARE INSUFFICIENT

Reg BI places an emphasis on the economics of a recommendation, and the SEC commentary and a proposed form called the Client Relationship Summary (“Form CRS”) strongly urge an economic analysis. The basis for the recommendation must be gleaned from the customer’s investment profile. The SEC’s interpretation of the care obligation “would make the costs of the security or strategy … more important factors.” Other factors listed by the SEC to be considered include “investment objectives, … liquidity, … volatility and likely performance.” In the same vein, potentially mandatory mitigation or elimination of conflicts focus on broker-dealer compensation and remuneration—both inherently economic considerations.

The reality of international investors often strays from primarily economic factors. Additional topics important to cross-border investors often center on firm capital, cybersecurity, privacy concerns and processes, and a firm’s risk and compliance programs. Many non-U.S. investors are keenly concerned about home country security and the reach of international information exchange treaties. Further, the need for U.S. dollarization of assets and geographic diversity do not easily fit into the SEC’s prescribed primary factors for the satisfaction of Reg BI’s obligations.

A BROKER-DEALER’S DUTIES AS TO A CLIENT’S HOLDING STRUCTURES REMAIN UNCLEAR

Unlike U.S. domestic clients, many cross-border clients hold their investments in offshore private investment companies, offshore trusts, or similar structures. The reasons include the punitive treatment of nonresident clients for U.S. estate tax purposes, the lack of effective trust structures in many civil law jurisdictions, and the planning flexibility that those structures provide for post-death administration.

The prescribed framework of the client’s best interest expressly includes the client’s tax status as a factor for consideration in any recommendation. In its raising of the standard to something beyond suitability, and casting it as an affirmative duty, the existence of the standard at a specific point in time at recommendation is very much akin to that owed by a fiduciary investment adviser. Reg BI may mandate a degree of tax awareness as a predicate to a recommendation that is both daunting and unwieldy. Moreover, it remains to be seen whether Reg BI will be interpreted to require the broker-dealer to ferret out the foreign country tax status of the customer to a detailed degree, as Reg BI would command a broker-dealer to “consider whether it has sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the retail customer’s best interest” and a “broker-dealer that makes a recommendation to a retail customer for whom it lacks sufficient information … would not meet its obligations under the proposed rule.”

Complicating this duty further, Reg BI extends the definition of retail customer beyond Section 913(a) of the Dodd-Frank Act and potentially includes corporate forms and structures as long as the intent of the recommendation is for the benefit of personal, family, or household reasons. Even assuming the purpose of a transaction can be succinctly pegged by including corporate structures, Reg BI potentially mandates a new level of tax awareness of foreign holding companies, controlled foreign corporations, and their effective control.

The potential requirement of adequate tax knowledge is further complicated by the inclusion of professionally managed offshore companies and U.S. registered, investment adviser-led
accounts under the “retail” label. Despite the Dodd-Frank Act’s admonition in Sec 913(a) that a “retail customer” be limited to natural persons, Reg BI, as written, would appear to include Registered Investment Advisers (“RIAs”) if acting on behalf of a retail customer, partnerships, corporations, and trusts—even if professionally staffed and with more than $50 million in assets. The corporate tax exposure in both the home country and the U.S. would add a tax knowledge burden to the broker-dealer. A significant possibility also exists that many broker-dealers may no longer support RIA accounts, as those broker–dealers who are currently set up to support only institutional clients may not be able to adequately support the Reg BI obligations.

WHEN DOES TOO MUCH INFORMATION CONFUSE?

By definition, cross-border clients reside outside of the U.S. and, naturally, bring to the brokerage relationship a different frame of reference as to what they expect from financial services. The complexity of the disclosure needed to meet Reg BI has led many to comment that the proposed rule could result in excessive disclosure that would overwhelm investors.

More than just the amount of disclosure, the disclosure of interwoven U.S. financial system intricacies (e.g., unlike in many countries, that mutual funds are continuously offered initial shares) may create additional confusion for many who are naturally grounded in the different capital market systems of their home countries. Additionally, the “plain English” requirement may be difficult to satisfy when disclosing to non-English-fluent clients. Even assuming the plain English standard is not a call for “English-only” but rather clarity and simplicity, the reality is that the adequacy of the form and manner of foreign language disclosure must now become an even greater regulatory concern. Additionally, the “in writing” requirement adds significant operating costs to a traditionally verbal business, as various documents are deemed necessary. The adequacy of disclosure will be measured over a timeline of onboarding, regular and periodic updates, and at the recommendation or point of sale, which may require an ongoing flow of translated document disclosure.

REG BI MAY CONFLICT WITH LOCAL COUNTRY RULES

The requirement to provide needed disclosure accompanying the recommendation in real time, and potentially at the point of sale, presents foreign country regulatory conflicts unique to the cross-border business. Reg BI is indisputably triggered at the time of the recommendation. Only the broad firm-level disclosure contemplated by Form CRS may be made prior to the time of recommendation.

The cross-border representative often travels outside the U.S. to meet with clients and is seldom permitted, by both local law and risk prudence, to access firm systems from abroad or to produce written materials while abroad. Importantly, the fact that the proposal is not triggered by an actual order—which more often than not is uniformly prohibited in a foreign country—but by the recommendation of either a security or a strategy, complicates the current cross-border “doing business in” guidance. Today, in order not to trigger “doing business in” laws of many countries, the transaction (e.g., order) is not placed by the traveling broker. The provision of a recommendation or ancillary brokerage advice is merely prelude, and the order is usually reserved for U.S. action. Under Reg BI, that ancillary and prelude activity—including the systems designed to monitor its compliance—may now trigger regulatory obligations to be satisfied in country and drive supervisory systems to redesign.

Also, under many non-U.S. securities laws and specifically those that require customer initiation of the relationship, the mandate to provide extensive documentation prior to the formation of a client relationship may create difficult “proof of non-solicitation” issues. By requiring that recommendations given to prospects be subject to Reg BI, the ability of firms to craft terms of a relationship compliant with local law before prospects receive voluminous documentation, and to secure customer consent to them, may be lost. Even irrespective of the awkward timing for prospects, Reg BI will require a level of disclosure for clients that will dramatically increase onboarding costs, and even more so if the prospect never engages the firm or places the trade. With this awkward initiation of regulatory obligations pre-relationship, blurred lines of invited relationships as a prerequisite to interaction and increased pre-account costs may well drive broker-dealers out of certain markets and limit investor choice.

Additionally, technology transfer laws including data protection laws and cybersecurity considerations often limit the access of traveling brokers to their firm’s systems while abroad (e.g., Brazil’s new data protection law which imposes
local requirements on data collected or stored in Brazil. Many firms only permit data input upon return to the U.S. Moreover, traveling with sensitive client data is often restricted on a prudential basis, as broker and client security demand discretion and the minimization of in-country data to the extent possible. Under Reg BI, a conversation inadvertently triggering a recommendation may potentially create a documentary and tailored disclosure obligation which may not be able to be met technologically or prudentially while the representative is traveling.

Additionally, the “at the time of recommendation” standard may often be, in actuality, a point-of-sale trigger. Real time, point-of-sale recommendations present significant costs and practical considerations, including preserving the currency of the information and the costs of effectively delivering it. Also, point-of-sale requirements create difficult compliance and supervision challenges, in addition to the challenges of providing the information in a moving market in a manner that is consistent and documentable, as well as developing easily retrievable disclosures, so as not to paralyze or slow the trade execution process. All the foregoing are aggravated by delivery in a foreign country without access to systems.

THE COMPLEXITY OF FAVORED PRODUCT DISPROPORTIONATELY DISADVANTAGES INTERNATIONAL CLIENTS

Cross-border clients are traditionally well-versed in foreign exchange markets and the movements of business extending beyond home-country borders. Accordingly, it is not surprising that many on the higher end of the wealth spectrum are comfortable with structured products with added complexity. On the lower end of the wealth spectrum, many tend not to pick specific equities, given the local inability to follow in real time, but to invest in mutual funds or exchange-traded funds to provide them with a range of professional management and diversification not found in their local public capital markets.

Depending on the resolution of the determination of which practices constitute financial incentives, both investments may require extensive and complicated disclosures which will create disproportionate costs and impact to the international client base. Under Reg BI, fees and charges will need fulsome written conflict disclosure given their importance to investors. Due to the complexity of mutual fund offerings (e.g., share classes, loads, and contingent and deferred sales charges), these products are mentioned frequently in the SEC commentary:

We preliminarily believe that a material conflict of interest that generally should be disclosed would include … proprietary products, products of affiliates … [and] … one share class versus another… of a mutual fund.13

In addition to their inherent complexity, many of these investments are issued under Reg S and not currently subject to specified U.S. disclosure standards. Nonetheless, under Reg BI, U.S. licensed brokers may find themselves required to disclose in writing intricate complexities of deferred compensation, trailers, cross-marketing fees, and other common compensation conventions against a backdrop of less than U.S. standard disclosure and offering documents by the funds. Moreover, the duty to mitigate or eliminate—and not just disclose—material conflicts of interest arising from financial incentives may well create a flurry of activity in the offshore fund world, as many of the compensation mechanisms may now require re-evaluation.

THE MORE FREQUENT USE OF DISCRETION CREATES FURTHER CONFUSION

Not surprisingly given the time zone and geographic and technological hurdles to effective real-time communication, foreign clients often grant limited discretionary powers to their brokers. This time/price discretion may create disproportionate confusion in the cross-border markets. The granting of discretion necessitated by the inefficiencies of international communication is commonplace and has traditionally not raised an advisory relationship, as it is viewed as “solely incidental to the broker-dealer’s business.” In the SEC commentary, the Commission revives old concerns that engaging in “too much” discretionary activity may trigger the staff to consider the broker-dealer to be providing advisory services and not just “solely incidental” brokerage advice. The Commission in Reg BI calls for a reconsideration of the scope of the broker-dealer exclusion of the Advisers Act “in light of Regulation Best Interest and the proposed Client Relationship Summary.”

Adding to the confusion is the inherent tension in the dual-registrant setting where Reg BI would not apply when acting in an advisory role, but would apply when providing ancillary brokerage advice. Although proponents may argue that the
SEC has not changed the determinative tests for broker versus adviser, in the context of frequent international time/price discretion, knowing which conduct standard to apply could become a more daunting challenge.

BROKER COMPENSATION

With the industry consolidation and de-risking initiatives that have impacted the cross-border space, many cross-border international brokers are switching firms and moving their book much more so than U.S. domestic brokers unaffected by those factors. With those moves come financial packages often laden with incentives both on the asset and revenue side. The SEC has preliminarily identified certain specific compensation practices as presenting material conflicts of interest arising from financial incentives. Under Reg BI, those financial packages, to the extent they create financial incentives, will almost certainly need to be disclosed and potentially reworked to include “neutral factors” as a base for compensation.

Some industry commentators argue that recruitment bonuses should be viewed differently than sales contests because recruitment bonuses tied to assets under management, total production, or revenue growth are not tied to specific securities recommendations. However, it remains to be seen how those practices are treated under the final version of Reg BI (e.g., whether those financial incentive conflicts are subject not just to disclosure but also to mitigation and/or elimination).

The SEC acknowledges that financial incentives for the broker will inevitably exist, but says that those interests cannot predominate the recommendation. In short, the SEC believes that a violation of Reg BI would occur if any recommendation was predominantly motivated by a broker’s self-interest, including self-enrichment, self-dealing, or self-promotion, among other things.

As additional guidance, the SEC provides certain practices that should be considered as mitigants in satisfaction of the “mitigation/elimination” obligation, including implementing “supervisory procedures to monitor recommendations that are near compensation thresholds; [or] near thresholds for firm recognition.” The SEC continues that certain conflicts may be difficult to mitigate and “may be more appropriately avoided,” including “bonuses that are based on ... accumulation of assets under management.”

CONCLUSION

The resiliency of the broker-dealer cross-border business has been proven time and again. The global allure of participating in the U.S. capital markets is simply too strong to create disinterest. Yet, Reg BI will present new and significant challenges to those firms active in this industry segment.

This White Paper is an expanded version of an article that appeared in the November 2018 edition of Citywire Americas magazine.

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ENDNOTES

1  Reg BI, subsection (b)(1)(B).
2  Reg BI, subsection (a).
4  Reg BI, subsection (b)(2).
5  SEC, at p. 150.
6  Id., at p. 169.
7  Id., at p. 150.
8  Id., at p. 10.
9  Id., at p. 145.
10 Id., at p. 118.
11 Id., at p. 119.
12 Id.
13 Id., at p. 112.
14 Id., at p. 169.
15 Id., at pp. 50 and 58.
16 Id., at p. 182.
17 Id., at p. 183.