

# COVID-19: Consolidated U.S. Investment Management Update – May 2020

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*May 5, 2020*

In this Update, we summarize and consolidate links to various Sidley alerts and other sources of information relating to the global COVID-19 pandemic and governmental and regulatory responses to it that are relevant for investment managers. Please feel free to contact a member of our Investment Funds group if you would like to discuss any of the topics covered in this Update.

**Last Updated: May 4, 2020**

In light of the evolving situation, we are reviewing and frequently updating information provided in this Update.

**1. Latest Rules and Guidance on the Paycheck Protection Program — Hedge Funds and Private Equity Firms Are Not Eligible** (*Issued April 24, 2020*)

On April 24, 2020, the U.S. Small Business Administration (SBA) and the U.S. Treasury Department issued a [new interim final rule](#) (Interim Rule) on the Paycheck Protection Program (PPP) that includes certain provisions of which funds and investment managers should be aware. In particular, the Interim Rule explicitly excludes “[h]edge funds and private equity firms” from receiving PPP loans. (See item 12 below.) The Interim Rule does not distinguish investment management entities from “[h]edge funds and private equity firms.” Given this ambiguity, it would be prudent for management entities to avoid seeking PPP loans.

Private fund managers that received PPP loans and determined that such loans should be repaid should review the safe harbor provided in Section III.5 of the Interim Rule, which provides that “[a]ny borrower that applied for a PPP loan prior to the issuance of this regulation and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the required certification [concerning need for PPP relief] in good faith.”

**2. SEC and PCAOB Officials Issue Statement on the Risks of Investing in Emerging Markets — Particularly China** (*Issued April 21, 2020*)

On April 21, 2020, a number of Public Company Accounting Oversight Board (PCAOB) and Securities and Exchange Commission (SEC) officials, including SEC Chairman Jay Clayton, released a [public statement](#) regarding investments in emerging markets, with a particular emphasis on China. The statement focused on the inconsistent quality standards for disclosure

and financial reporting in many emerging markets, the lack of legal recourse that investors may have against non-U.S. companies and non-U.S. persons in the event of harm and, in the case of China, the PCAOB's lack of access to inspect PCAOB-registered accounting firms in China. While the statement did not set forth any substantive policy changes, the SEC reinforced its view that investment advisers and funds should be mindful of the foregoing risks when investing in emerging markets.

In particular, the statement noted that as part of their fiduciary duty to their clients under the Investment Advisers Act of 1940, investment advisers that are recommending investments in emerging markets should consider whether there are limitations on the quality or availability of financial information with respect to these investments, possible limitations on investors' legal remedies and whether they have provided investors with adequate risk disclosure about the unique risks and uncertainties that companies with significant operations in emerging markets often face. The SEC cautioned against the use of boilerplate disclosures and noted that advisers should also consider the effect of market closures on their clients' investments and ability to gain access to their assets.

### **3. SEC FAQs Regarding Investment Advisers and Investment Companies in Response to COVID-19** *(Issued April 14, 2020)* (FAQs available [here](#))

The SEC's Division of Investment Management prepared a consolidated series of FAQs regarding investment companies and advisers that are being affected by COVID-19. FAQ topics relevant to investment advisers include

- a summary of previously provided Form ADV and Form PF relief (Question II.1) (see item 14 below)
- an assurance from the SEC's Office of Compliance Inspections and Examinations (OCIE) that "reliance on regulatory relief will not be a risk factor utilized in determining whether OCIE commences an examination" (Question II.2)
- Form ADV and custody rule guidance (Question II.3)

### **4. Compliance Program COVID Effects — 10 Areas for Thought and Consideration** *(Updated as of April 30, 2020)*

In an effort to focus attention and priorities while recognizing the elevated number of activities competing for the attention of compliance staff during this time, Sidley has prepared the following list of items investment managers may want to consider in maintaining and adapting their compliance programs.

Documentation of changes to compliance controls or departures from policies can occur during times of market stress or the declaration of contingencies under business continuity procedures. Most investment advisers are operating under those conditions or more severe constraints given the events of the past several weeks. The leaders of the adviser's compliance functions should consider reminding staff of the firm's explicit compliance policies and code of ethics, business continuity policy, cyber-IT policy, valuation and other policies. Existing policies should be

followed, but where current circumstances dictate another approach, exceptions and deviations and the rationale for such exceptions and deviations should be promptly identified and documented.

#### 1) Cybersecurity/IT/Business Continuity

- *Phishing Attacks* — Consider reminding staff of the need to be vigilant and thinking about whether there are new and/or different cybersecurity risks. This bears repeating.
- *Communication Tools (approval and risks)*
  - Are staff using only approved software and applications?
  - Do they know the proper way to request approval for new applications or tools?
  - Is texting a permitted mode of communication? If so, does the firm have a specific policy on texting for business communications? Is the policy being followed? Should it be revisited or revised under current circumstances?
- *Record Retention*
  - Consider file sharing, collaboration, local saving of electronic records, printing sensitive documents, manual signatures, notarization requirements.
  - Are staff thinking about how they save, store and maintain documents that are part of your firm's books and records?

#### 2) Trading/Investment Program

- *Investment Restrictions and Limitations*
  - Have market movements affected any existing limitations or restriction? Have risk metrics been exceeded?
  - Is the firm considering opportunities presented by the current market environment? Is there style drift? Is there appropriate disclosure given the risk, concentration etc.?
  - Are there liquidity issues within client portfolios? Are there existing controls to address liquidity constraints?
- *Principal/Agency Transactions* — Consider reminding your staff about the limitations, restrictions and requirements and inherent conflicts for these types of transactions and any prohibitions, if applicable.

- *Cash/Settlement/Custody*
  - Have remote work arrangements affected cash movement controls, custody controls, settlement procedures?
  - If new procedures are being used, have they been documented; are they temporary?
- *Risk Disclosure* — Consider whether the risk disclosure is accurate and adequate (e.g., if the fund invests in emerging markets). (See item 2 above.)

### 3) Material Nonpublic Information (MNPI)

- Consider how the current market environment may present new opportunities or concerns for MNPI.
- Are portfolio management staff having off-cycle discussions with company insiders and investor relations teams?
- Are portfolio holdings (or portfolio companies) critical vendors or suppliers in public company supply chains?
- Are funds contemplating share purchases to support portfolio companies?

### 4) Code of Ethics

- *Personal Trading* — Consider the firm's personal trading restrictions.
  - Should additional testing be run to confirm adherence to trading policies?
  - Have staff requested exemptions from personal trading prohibitions?
  - Are staff mindful of household requirements for reporting and preclearance?
- *Outside Business Activities* — Consider reminding staff of reporting and preclearance requirements for outside business activities.
  - Have staff taken on new roles, or have responsibilities for existing activities changed?
  - Are staff volunteering assistance in ways that should be picked up as outside business activities?
- *Trustee Appointments* — Consider reminding staff of their obligations to report and preclear appointment as a trustee (the firm's personal trading policies could also be implicated).

- Are clients, friends or close family members addressing estate planning questions prompted by COVID concerns?
- Are staff being asked to serve as trustees for any new arrangements?

#### 5) Promotional Activities/Marketing

- Consider whether new services or new materials refocused for the current market are being discussed or prepared.
- Are existing vetting procedures being followed?
- Are there new or changed risks present in the service or strategy being offered? (See item 2 above.)
- Is the firm's policy on media contacts and appearances being followed?

#### 6) Conflicts

- *Transactions With Portfolio Companies* — Are transactions being proposed with portfolio companies?
- *Vendor/Service Provider Conflicts* — Consider changes that vendors/service providers are implementing in response to alternative work arrangements.
  - Are new services being performed for clients or the manager?
  - Are the vendors fees expensed to clients?
- *Soft Dollar Assessment* — Consider whether any mixed-use allocations should be reassessed based on alternative uses initiated in response to alternative work arrangements

#### 7) New/Unusual Expenses and Reimbursements

- Consider reminding staff about expense and reimbursement policies.
- Are accounting and finance staff observing new or unusual expenses related to responding to COVID and remote work arrangements?
- Are any new categories of expenses being passed to clients or funds?

#### 8) Corporate and Fund Governance

- Have supervisory functions have changed or shifted?
- Are committees still meeting as planned? Are they being held more or less frequently?

- Are new governance structures emerging?

#### 9) Communications With Investors

- Are more questions being addressed by email or written communications?
- Who is addressing investor communications; is anyone new to that role or function?
- Are staff aware of investor compliant monitoring and reporting obligations under the firm's compliance procedures?

#### 10) Oversight of Third-Party Services

- Are staff who typically perform oversight able to do so?
- Do they continue to have the capacity connectivity, data or reports necessary to do so?
- Consider whether any specific function that depends heavily on the execution of third parties has been compromised, degraded or negatively affected (i.e., anti-money-laundering support, brokerage and trading support, valuation reports, market data and portfolio risk reporting or analytics).

### **5. Navigating Trading Agreements in Volatile Markets: Tips for NAV Waivers and Counterparty Risk Management** *(Update published April 15, 2020) (Update available [here](#))*

Amid recent market volatility, we have seen a growing number of inquiries from clients concerned about (1) breaching default triggers in trading agreements that are tied to a decline in a fund's net asset value (NAV) over a designated period of time and/or (2) measures they can take to mitigate their risks in the event of an insolvency at one of their financial institution counterparties. The linked Update provides some recommended action items for funds experiencing concerns about one (or both) of these issues.

### **6. Over-the-Counter Derivatives: Questions Managers Should Ask in Light of COVID-19 Disruptions** *(Updated as of April 14, 2020)*

In assessing existing trade documentation, investment managers may want to consider the following questions:

- Does COVID-19 or any declaration of a state of emergency stemming from COVID-19 trigger a *force majeure* event under the 2002 International Swaps and Derivatives Association (ISDA) Master Agreement?
- Can a *force majeure* event trigger an acceleration and thus a breakage payment becoming due under the 2002 ISDA Master Agreement?

- What constitutes a trading disruption and/or what actions would constitute market disruptions that would affect the valuation and settlement terms of an over-the-counter (OTC) derivative transaction?
- If markets are closed or trading is disrupted on a day on which a trading contract terminates, expires or settles, how will that contract be valued and/or settled?
- If an exchange floor is closed, would that constitute a market disruption under any ISDA-published definitions (e.g., the 2002 Equity Definitions, the 2005 Commodity Definitions, the 2006 ISDA Definitions, the 1998 FX and Currency Option Definitions)?
- What institution(s) determines when trading markets will be suspended and for how long can markets be suspended?
- What regulatory relief has the U.S. Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) issued in light of the impact of COVID-19 on business operations? (See item 15 below.)
- What relief have U.S. and global regulators provided in connection with upcoming compliance deadlines relating to initial margin requirements for uncleared derivatives? (See item 7 below.)

**7. Over-the-Counter Derivatives: Final Implementation Phases of Initial Margin for Uncleared Derivatives Set for Deferral** (*Update published April 3, 2020*) (*Update available [here](#)*)

On April 3, 2020, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced that they have agreed to a one-year extension of the deadlines for completing the final two implementation phases of initial margin requirements for uncleared derivatives in light of the significant challenges posed by the COVID-19 pandemic. If adopted by global regulators, this extension would push out the Phase 5 compliance date to September 1, 2021, and the Phase 6 compliance date to September 1, 2022.

**8. OCIE Announces Plans to Assess Compliance With Reg BI and Form CRS as Scheduled** (*Update published April 8, 2020*) (*Update available [here](#)*)

On April 7, 2020, OCIE released two risk alerts regarding Regulation Best Interest (Reg BI) and Form CRS, a disclosure form broker-dealers and investment advisers must provide to retail clients about the nature of their relationship with such clients. This follows SEC Chairman Clayton's announcement that the SEC will not extend the June 30, 2020, compliance date for Reg BI and Form CRS (discussed [here](#)).

To test compliance with the rules governing Form CRS, OCIE will

- confirm that the firm has filed Form CRS with the SEC and posted Form CRS on its website

- evaluate whether the firm timely delivered Form CRS to existing and new retail customers
- assess whether the firm's Form CRS is formatted in accordance with the instructions (e.g., it includes particular wording where required, it uses text features where required and it is written in plain English)
- review the firm's written policies and procedures, recordkeeping processes and delivery processes and dates in light of the obligations imposed by Form CRS

**9. Summary of COVID-19 Relief Programs of the CARES Act** (*Update published April 2, 2020*) (*Update available [here](#)*)

On March 27, 2020, the U.S. government enacted the Coronavirus Aid, Relief and Economic Security Act (CARES Act). The economic stimulus package in the CARES Act provides three sets of benefits for some businesses, nonprofits and individuals:

- programs administered by the Small Business Administration (SBA) under Title I of the CARES Act provide expanded eligibility and payroll support for small businesses (generally those with fewer than 500 employees)
- lending programs administered by the Federal Reserve System (Fed) under Title IV of the CARES Act are intended to ensure the stabilization and continued functioning of the short- and medium-term corporate debt markets
- tax relief provisions are intended to provide taxpayers with access to cash as quickly as possible

**10. Registered Funds: SEC Provides Certain Conditional, Temporary Regulatory Relief for Registered Funds Due to COVID-19** (*Update published March 30, 2020*) (*Update available [here](#)*)

The SEC has issued exemptive orders providing certain conditional, temporary relief relating to the impact of COVID-19, including relief relating to in-person meeting requirements under the Investment Company Act of 1940, as amended (1940 Act); relief relating to Form N-CEN and Form N-PORT filings; relief from certain 1940 Act requirements with respect to transmission of annual and semiannual reports to investors; and permission for registered funds to borrow from affiliated persons and for affiliated persons to make collateralized loans to a registered fund. The SEC's order provided regulatory flexibility for registered funds to obtain short-term funding by deviating from fundamental policies and by engaging in interfund lending outside the scope of existing interfund lending orders and in situations where the fund was not able to rely on an existing interfund lending order.

*Money Market Funds*

On March 18, 2020, the Fed established the Money Market Mutual Fund Liquidity Facility (MMLF) to assist funds in meeting demands for redemptions, to enhance overall market functioning and to provide credit to the broader economy. Eligible borrowers under the MMLF include all U.S. depository institutions, U.S. bank holding companies and U.S. branches and



agencies of foreign banks. On March 19, 2020, the Board of Governors of the Fed (Board of Governors), the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued an interim final rule to allow banking organizations to neutralize the effects of purchasing assets through the MMLF on risk-based and leveraged capital ratios. No new credit extensions to eligible borrowers will be made after September 30, 2020, unless the Board of Governors extends the MMLF.

#### *Rule 17a-9 No-Action Letter*

In a letter addressed to the Investment Company Institute dated March 19, 2020 (the [Letter](#)), the staff of the Division of Investment Management explained that they will not recommend enforcement action to the SEC against any money market fund or any affiliated person of such fund (or any affiliated person of such person) that is subject to Sections 23A and 23B of the Federal Reserve Act and that purchases a security from a fund (each, an Affiliated Purchaser), under Section 17(a) of the 1940 Act or Rule 17a-9 thereunder, if an Affiliated Purchaser purchases securities from a fund subject to certain conditions.

#### **11. COVID-19: Common U.S. Tax Considerations During an Economic Downturn** *(Update published March 30, 2020) (Update available [here](#))*

Amidst the uncertainty in global capital markets introduced by the COVID-19 pandemic, Sidley tax attorneys have prepared a summary of common U.S. tax considerations facing both creditors and debtors as they plan around the evolving economic environment. This summary includes a discussion of common tax questions relating to debt restructurings and modifications, net operating losses and bankruptcy and insolvency. For a summary of tax-related changes implemented by the CARES Act, see item 13 below.

#### **12. Small Business Eligibility for Economic Stimulus** *(Update published March 30, 2020) (Update available [here](#))*

Title I of the CARES Act contains provisions designed to assist qualified small businesses, including loans, loan forgiveness and subsidies. Businesses that employ no more than the greater of (i) 500 employees or (ii) the size standard for the specific industry are eligible for SBA loans, with exceptions made for franchises and the hospitality and restaurant industries (§ 1102).

Loans are tied to payroll costs and are limited to \$10 million. Rates are capped at 4 percent, with payment presumptively deferred for a period of between six months and one year (§ 1102). Certain of these loans may be entitled to loan forgiveness but may be reduced if an employer has decreased the salary or number of its employees (§ 1106). Additionally, businesses with certain SBA loans that were not issued under § 1102 of the CARES Act (i.e., certain non-PPP SBA loans) may be entitled to subsidies related to the payment of principal, interest and associated fees owed under the loans for a period of six months (§ 1112).

#### **13. Tax Relief Provided by the Coronavirus Aid, Relief, and Economic Security Act** *(Update published March 26, 2020) (Update available [here](#))*

The CARES Act includes various tax provisions, most of which are intended to provide taxpayers with access to cash as quickly as possible.

These tax provisions include

- rebates of up to \$1,200 for individuals and \$2,400 for taxpayers filing jointly, with an additional \$500 for each qualified child
- charitable deductions, including an increase on the limitation on deductions for charitable contributions by individuals and corporations
- employee retention credits for each calendar quarter for “eligible employers,” equal to 50 percent of “qualified wages” paid to employees during such quarter
- deferred payment of employer payroll taxes
- modifications to net operating loss rules under the Tax Cut and Jobs Act (2017 Tax Act)
- modifications to limitations on business losses for noncorporate taxpayers under the 2017 Tax Act
- modification of corporate alternative minimum tax credits
- modifications of limits on the amount of business interest that taxpayers can deduct to allow taxpayers to deduct more of their business interest expense in 2019 and 2020
- correction of the “retail glitch” in the 2017 Tax Act

**14. Form ADV and Form PF Conditional Relief** (*Update published March 26, 2020*) (*Update available [here](#)*)

On March 25, 2020, the SEC issued an [order](#) superseding and extending its previous targeted relief with respect to Form ADV filing and delivery and Form PF filing obligations. The order sets forth the procedures for claiming an extension for Form ADV and Form PF filings that fall due between March 13 and June 30, 2020. An adviser relying on the relief must make the required filing or delivery “as soon as practicable, but not later than 45 days after the original due date.”

**15. CFTC and NFA Provide Pandemic-Related Relief to Commodity Pool Operators and Commodity Trading Advisors** (*Update published March 25, 2020*) (*Update available [here](#)*)

On March 20, 2020, the CFTC issued a no-action letter ([CFTC Letter](#)) extending the deadlines for CFTC-registered commodity pool operators (CPOs) to (i) file Form CPO-PQR, (ii) file and deliver pool annual reports and (iii) distribute periodic account statements. NFA followed suit and delivered a [notice to its members](#) providing the relief for both CPOs and commodity trading advisors. The CFTC Letter notably does not require any notice to be filed, though it is expected that CPOs relying on the relief maintain a supervisory system reasonably designed to supervise the activities of personnel while acting from alternative or remote locations during the COVID-19 pandemic. A link to a regularly updated summary of COVID-19-related actions taken by the CFTC and NFA can be found at the end of the Update.

**16. Capital Injections in Challenging Times: How Do Private Equity Funds Manage Downside Risk and Stay Ahead in the Capital Structure?** *(Update published March 23, 2020) (Update available [here](#))*

Leveraging decades of experience in the private equity, growth, structured equity and restructuring markets, we have put together a checklist applicable to all private equity investors in times of financial uncertainty. This checklist covers the main instruments that a private equity investor would use to establish a strong position in the capital structure (including preferred equity, convertible loans and warrants) and the tools an investor would use to maintain its position and preserve its upside (including antidilution, minimum returns, exit demand rights, put and redemption rights).

**17. Market Turmoil May Cause Fund Managers to Breach Commodity Pool Operator Exemption Thresholds** *(Update published March 20, 2020) (Update available [here](#))*

Operators of investment funds that trade commodity interests are required to register with the CFTC as CPOs and become members of NFA unless they are able to rely on an exemption or exclusion. Among the most common exemptions and exclusions are CFTC Regulation 4.5(a)(1) (applicable to managers of publicly offered registered investment companies and business development companies, among others) and CFTC Regulation 4.13(a)(3) (applicable to managers of privately offered hedge funds), both of which place strict limits on commodity interest trading. The current market turmoil caused in large part by the global COVID-19 pandemic has led to increased margin rates, increased options premiums, increased use of derivatives in general and declines in fund net asset values. Each of these effects may cause investment funds operating under these rules to breach the applicable trading limits, thereby triggering a CPO registration requirement and compliance with CFTC regulations applicable to CPOs, absent relief from the CFTC and/or NFA. Fund managers relying on Regulations 4.5(a)(1) or 4.13(a)(3) should carefully monitor their portfolios to ensure they continue to adhere to the trading limits.

**18. Trading Halts and Suspensions for Securities and Derivatives** *(Update published March 18, 2020) (Update available [here](#))*

Given the significant volatility in the financial markets, we provide a summary of existing trading halts and suspensions and the authority of U.S. regulators to potentially institute broader trading halts and suspensions. This includes (1) marketwide circuit breakers and individual stock circuit breakers under the Limit-Up Limit-Down Plan ([LULD Plan](#)) and (2) trading suspension authority of the SEC, the CFTC, exchanges and the Financial Industry Regulatory Authority (FINRA).

*Marketwide Circuit Breakers*

As evidenced by recent market events, trading in U.S. equities may be halted temporarily pursuant to the national market system (NMS) Plan to Address Extraordinary Market Volatility, also known as the LULD Plan. There are no corresponding marketwide circuit breakers for derivatives, although at least some designated contract markets (DCMs) cease trading upon the triggering of the LULD Plan and have certain price limit controls.

### *Futures Circuit Breakers*

Different futures contracts have different price limits and rules governing what occurs when triggered (e.g., some markets temporarily halt trading, while others may stop trading for the entire day). Price limits are determined daily and can have multiple levels (e.g., certain equity index futures have a three-level expansion on the downside of 7 percent, 13 percent and 20 percent, and a 5 percent limit up and down in overnight trading).

### *Trading Suspensions*

The SEC and CFTC, as well as the self-regulatory organizations that they regulate, have certain authority to halt or suspend trading. The SEC has authority to suspend trading pursuant to Section 12(k) of the Securities Exchange Act of 1934, as amended (Exchange Act), including implementation of 10-day suspensions, 90-day suspensions and emergency orders. Pursuant to Exchange Act Rule 12d2-1, a securities exchange is also authorized to suspend trading in any listed security in accordance with its rules, provided the exchange promptly notifies the SEC of the effective date and reasons for suspension. FINRA also has broad authority under its rules to suspend OTC trading in any NMS stock whenever the primary listing exchange halts trading or in response to certain “extraordinary market activity.”

The CFTC has broad authority to direct a registered entity (e.g., a DCM), when the CFTC has reason to believe that an emergency exists, to take action it believes is “necessary to maintain or restore orderly trading in or liquidation of futures contracts” pursuant to an “emergency.” DCMs have broad authority to halt trading in contracts in the interest of fair and orderly markets. Pursuant to CFTC regulations, DCMs are required to have controls in place that pause or halt trading to address market disruptions and emergencies.

### **19. Pandemic-Related Relief Announced by U.S. Commodity Futures Trading Commission and National Futures Association** *(Update published March 19, 2020) (Update available [here](#))*

On March 17, 2020, Chairman Heath Tarbert of the CFTC released a video statement identifying the CFTC’s actions to address the COVID-19 pandemic and providing five key objectives: (i) monitoring derivatives markets and their participants; (ii) using the CFTC’s regulatory framework to promote orderly and liquid markets; (iii) responding swiftly to changing conditions with practical, targeted relief; (iv) communicating consistently and transparently with all stakeholders; and (v) maintaining the CFTC’s commitment to advancing strategic policy goals.

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