



# New Rules Regarding Communications With the Public by Brokers and Dealers Take Effect

## 1. Introduction

On May 9, 2003, the Securities and Exchange Commission (the "SEC") approved proposed amendments (the "Amendments") designed to modernize National Association of Securities Dealers, Inc. (the "NASD") Rules relating to communications with the public by NASD members.<sup>1</sup> The Adopted Rules took effect on November 3, 2003. The stated purpose of the Amendments is to modernize NASD Conduct Rule 2210 ("Rule 2210") regarding communications with the public.<sup>2</sup>

In general, Rule 2210 establishes two kinds of regulation regarding communications with the public. First, Rule 2210 establishes certain substantive regulations regarding communications with the public by NASD members. In addition to specific regulations regarding the content of advertising and other communications with the public, the NASD's existing regulations regarding communications with the public generally require (a) that all statements made in any such communication must be complete and accurate, (b) that no material fact should be omitted from any advertising, (c) that no exaggerated or unwarranted statements should be made in any advertising, and (d) that advertising should always be appropriate for its intended audience. Second, Rule 2210 creates a requirement that NASD members file (and in some circumstances receive approval regarding) specific advertisements or communications with the public.

The Amendments modify both of these kinds of regulation as found in Rule 2210 as it existed before the Amendments (the "Prior Rule").

The Adopted Rules differentiate between communications directed to institutional investors and communications directed to the public generally, and exclude the former from pre-use approval and filing regulation, as well as from some of the content standards. In addition to communications directed to institutional investors, the Amendments exclude from certain filing and content regulations (a) form letters and group electronic mail to certain persons, (b) independently prepared reprints of published articles, and (c) certain press releases by NASD members.

While many of the substantive changes found in the Amendments are described herein, this memorandum is summary in nature and does not fully describe or analyze the Amendments. For further information regarding the Amendments or regarding communications with the public generally, please feel free to call any of the Shearman & Sterling LLP attorneys listed on the last page of this client memorandum.

## 2. New regulation regarding communication with the public

### 2.1 Additions to the definition of "communication with the public"

Under the Prior Rule, the definition of "communication with the public" included, but was not limited to, (a) advertisements,<sup>3</sup> (b) sales literature,<sup>4</sup> and

<sup>1</sup> The SEC Order approving the Amendments was made in SEC Release 34-47820 (May 9, 2003), published in the Federal Register at 68 Fed. Reg. 96, pages 27116 *et seq.* (the "Adopting Release"). The NASD discusses the Adopting Release and sets forth the text of Rules 2210 and 2211 as adopted (together, the "Adopted Rules") in Notice to Members 03-38 (July 2003) (the "NASD NTM"). As of the date of this publication, the Adopting Release is available on-line at <[http://www.nasdr.com/pdf-text/rf00\\_12\\_app.pdf](http://www.nasdr.com/pdf-text/rf00_12_app.pdf)>, and the NASD NTM is available at <<http://www.nasdr.com/pdf-text/0338ntm.pdf>>.

<sup>2</sup> Citations in this document to specific sections of Rule 2210 are references to the Adopted Rules. Citations referencing the Prior Rule will be specifically noted.

<sup>3</sup> "Advertisement" is defined in the Adopted Rules to mean "Any material, other than an independently prepared reprint and institutional sales material, that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings)." See NASD Rule 2210(a)(1).

(c) correspondence.<sup>5</sup> The Amendments widen this definition to include (d) public appearances, (e) institutional sales material, and (f) independently prepared reprints.

### 2.1.1 Public Appearances

The Adopted Rules clarify the Prior Rule and specifically include public appearances as a form of communication with the public.<sup>6</sup> Public appearances are defined in the Adopted Rules to include “participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity.”<sup>7</sup> The NASD clarifies in the NASD NTM that participation in an electronic forum or “chat room” constitutes a public appearance for these purposes. It is important to note that there is some flexibility with respect to public appearances in the Adopted Rules, as public appearances are not subject to the content standards set out in Rule 2210(d)(2), which by its terms applies only to sales literature and advertisements.

### 2.1.2 Institutional Sales Material

For some broker-dealers, perhaps the most important innovation in the Adopted Rules is the definition of “institutional sales material” and the exclusion of that material from most of the substantive requirements of the Adopted Rules. “Institutional Sales Material” consists of any communication that is distributed or

made available only to institutional investors.<sup>8</sup> The definition of “institutional sales material” specifies, however, that communications may not be treated as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be made available to any person other than an institutional investor.

The Amendments eliminate the requirement that sales literature or other communications to institutional investors (that qualify as a “communication with the public” for purposes of Rule 2210) must be filed prior to use and approved by the NASD.

The Adopted Rules state that each member must establish written supervisory procedures providing for the internal review of sales material that is directed to institutional investors. While those written supervisory procedures need not provide for the review of all such material, the procedures do have to provide for education and training of associated persons with respect to the firm’s policies regarding such materials.<sup>9</sup>

As regards the content of institutional sales material, the Amendments revise the content standards to clarify those types of communication that are subject to each of the standards regarding communication with the public. Therefore, standards that apply only to “advertisements” or “sales literature” will not apply to institutional sales material.

It is noteworthy that institutional sales material is subject to a “spot-check” procedure: upon request, materials must be submitted to the NASD for review.<sup>10</sup>

### 2.1.3 Independently Prepared Reprints

The Prior Rule currently defines “sales literature” to include reprints or excerpts of any published article.

<sup>4</sup> The definition of “sales literature” in the Adopted Rules is substantially similar to the definition as it existed before the Amendments. Specifically, “sales literature” is defined as “Any written or electronic communication, other than an advertisement, independently prepared reprint, institutional sales material and correspondence, that is generally distributed or made generally available to customers or the public, including circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, reprints (that are not independently prepared reprints) or excerpts of any other advertisement, sales literature or published article, and press releases concerning a member’s products or services.” See NASD Rule 2210(a)(2).

<sup>5</sup> The definition of “Correspondence” in the Adopted Rules is as follows: “Correspondence” consists of any written letter or electronic mail message distributed by a member to: (A) one or more of its existing retail customers; and (B) fewer than 25 prospective retail customers within any 30 calendar-day period. See NASD Rule 2211(a)(1). The treatment of correspondence under the Adopted Rules is discussed below.

<sup>6</sup> The NASD NTM notes that, prior to the Amendments, Prior Rule 2210(d)(1)(C) provided that members who engage in public appearances must follow the content standards set forth in relevant NASD rules.

<sup>7</sup> See NASD Rule 2210(a)(5).

<sup>8</sup> “Institutional investor” for this purpose means any: (A) a bank, savings and loan, insurance company, registered investment company, registered investment adviser, or entity or natural person with total assets of at least \$50 million, regardless of whether that person has an account with a NASD member; (B) governmental entity or subdivision thereof; (C) employee benefit plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and has at least 100 participants, but does not include any participant of such a plan; (D) qualified plan, as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934, as amended, that has at least 100 participants, but does not include any participant of such a plan; (E) NASD member or registered associated person of such a member; and (F) person acting solely on behalf of any such institutional investor. For purposes of the Adopted Rules, the term “institutional investor” includes trust companies organized under state law that come within the definition of “bank” in Article I(b) of the NASD By-Laws.

<sup>9</sup> See NASD Rule 2211(b)(1).

<sup>10</sup> See NASD Rule 2211(c).

As adopted, the Amendments create a new form of communication with the public—an “independently prepared reprint.” Independently prepared reprints are defined as (a) “any reprint or excerpt of any article,” and (b) “any report concerning an investment company registered under the Investment Company Act of 1940,” with multiple provisos qualifying each of these broad definitions.<sup>11</sup>

Independently prepared reprints are subject to the content requirements of NASD Rule 2210(d) (described below), which sets out content requirements to which all communications with the public by NASD members are subject.<sup>12</sup> Further, independently prepared reprints are subject to the pre-approval and record-keeping requirements of the Adopted Rules.

## 2.2 Treatment of correspondence

Under the Adopted Rules, “Correspondence” is defined to mean any written letter or electronic mail message distributed by a member to: (a) one or more

of its existing retail customers<sup>13</sup>; and (b) fewer than 25 prospective retail customers<sup>14</sup> within any 30 calendar-day period. The Adopted Rules specifically subject correspondence to the general content requirements found in Rule 2210(d)(1), and to the requirements of NASD Rule 3010(d) relating to correspondence by NASD members. In addition, all correspondence<sup>15</sup> must:

- prominently disclose the name of the member, and may also include a fictional name by which the member is commonly recognized or which is required by any state or jurisdiction;<sup>16</sup>
- reflect any relationship between the member and any nonmember or individual who is also named; and
- if it includes other names, reflect which products or services are being offered by the member.

Finally, NASD members may not use investment company rankings in any correspondence, unless those rankings are based on (a) a category or subcategory created and published by a Ranking Entity<sup>17</sup> or (b) a category or subcategory created by an investment company or an investment company affiliate but based on the performance measurements of a Ranking Entity.

<sup>11</sup> With respect to any article reprint or excerpt of any article, the following criteria must be met: (i) the publisher of the article may not be an affiliate of the member using the reprint or any underwriter or issuer of a security mentioned in the reprint or excerpt and that the member is promoting; (ii) neither the member using the reprint or excerpt nor any underwriter or issuer of a security mentioned in the reprint or excerpt may have commissioned the reprinted or excerpted article; and (iii) the member using the reprint or excerpt must not have materially altered its contents except as necessary to make the reprint or excerpt consistent with applicable regulatory standards or to correct factual errors. With respect to any report concerning a registered investment company the following criteria must be met: (i) the report must be prepared by an entity that is independent of the investment company, its affiliates, and the member using the report (the “research firm”); (ii) the report’s contents must not have been materially altered by the member using the report except as necessary to make the report consistent with applicable regulatory standards or to correct factual errors; (iii) the research firm must prepare and distribute reports based on similar research with respect to a substantial number of investment companies; (iv) the research firm must update and distribute reports based on its research of the investment company with reasonable regularity in the normal course of the research firm’s business; (v) neither the investment company, its affiliates nor the member using the research report may have commissioned the research used by the research firm in preparing the report; and (vi) if a customized report was prepared at the request of the investment company, its affiliate or a member, then the report must include only information that the research firm has already compiled and published in another report, and may not omit information in that report necessary to make the customized report fair and balanced.

<sup>12</sup> The SEC clarifies in the Adopting Release that NASD content rules regarding predictions and projections found in NASD Rule 2210(d)(1)(D) would not apply to statements found in an independently prepared reprint inasmuch as that document represented its author’s opinion regarding the subject for which it is being distributed. See the Adopting Release at 27118.

<sup>13</sup> For these purposes, “Existing Retail Customer” means any person for whom the member or a clearing broker or dealer on behalf of the member carries an account, or who has an account with any registered investment company for which the member serves as principal underwriter, and who is not an institutional investor. See NASD Rule 2211(a)(4).

<sup>14</sup> For these purposes, “Prospective Retail Customer” means any person who has not opened such an account and is not an institutional investor. See NASD Rule 2211(a)(4).

<sup>15</sup> For purposes of this provision, correspondence includes a NASD member’s business cards and letterhead.

<sup>16</sup> While regulations regarding use of a member’s name in communications with the public have been simplified in the Adopted Rules, the NASD NTM states that the NASD does not intend to modify the substance of the standards regarding use of a member’s name found in Prior Rule 2210(f) with respect to use of a member’s name in any communication with the public. See NASD NTM at page 389.

<sup>17</sup> The term “Ranking Entity” is defined in IM-2210-3(a) to refer to any entity (a) that provides the public with general information regarding investment companies, (b) is independent of the investment company producing the correspondence, and (c) whose services are not procured by the investment company producing the correspondence (or its affiliates) to assign a ranking to such investment company. The use of rankings in investment company advertisements and sales literature is regulated by NASD IM-2110-3.

### 3. Continued filing requirement for communications with the public

#### 3.1 General filing requirement and information to be provided

The Adopted Rules continue to require that communications with the public continue to be filed with the NASD under various circumstances. Regardless of the specific filing requirement, the Adopted Rules set forth that each filing must provide the actual or anticipated date of first use of the item being filed. If the item being filed constitutes an advertisement or an item of sales literature for purposes of the Adopted Rules, then the filing of that item must include the name and title of the registered principal who approved the advertisement or sales literature, and the date on which such approval was given.<sup>18</sup>

#### 3.2 Requirement to file certain material within 10 business days of first use

The Adopted Rules provide that, within 10 business days of first use, the following advertisements and sales literature must be filed with the NASD:

- Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts, continuously offered closed-end funds, and unit investment trusts) not specifically regulated by Rule 2210(c)(3).<sup>19</sup> The filing of any advertisement or sales literature that includes or incorporates a performance ranking or performance comparison of the investment company with other investment companies must include a copy of the ranking or comparison used in the advertisement or sales literature.
- Advertisements and sales literature concerning public direct participation programs.<sup>20</sup>
- Advertisements concerning government securities.

<sup>18</sup> See Rule 2210(c)(1).

<sup>19</sup> Rule 2210(c)(3) regulates sales literature containing bond fund volatility ratings.

<sup>20</sup> Direct participation programs are defined, and the distribution of direct participation programs is regulated, by NASD Rule 2810.

#### 3.3 Requirement to file certain material within 10 business days prior to first use and to receive NASD approval prior to first use

The Adopted Rules provide that, within 10 business days prior to first use, the following communications must be filed with the NASD and may not be published or circulated by the NASD member until any changes specified by the NASD have been made:

- Advertisements and sales literature with respect to registered investment companies that include or incorporate performance rankings or comparisons of the performance of the investment company with other investment companies, unless the ranking or comparison category is generally published. The Adopted Rules specifically state that if the ranking or comparison is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, then such advertisements or sales literature must be filed.<sup>21</sup>
- Advertisements concerning collateralized mortgage obligations.<sup>22</sup>
- Advertisements concerning security futures.

#### 3.4 New filing standards relating to specific material

##### 3.4.1 Form Letters and Group Electronic Mail

Under the Prior Rule, any form letter or electronic mail message sent to more than one person may constitute “sales literature” and will thus be subject to the content and filing requirements of the Prior Rule. Under the Amendments, form letters or electronic mail messages may meet the definition of “correspondence” described above and therefore be subject to the more flexible requirements of that rule.

Under the Adopted Rules, correspondence need not be approved by a registered principal of the broker-dealer prior to use, but as noted above is specifically subjected to the general content requirements of the Adopted Rules, and to the requirements of NASD Rule 3010(d) relating to correspondence by NASD members. As well, each NASD member’s correspondence is subject to the “spot-check” procedure described above.

<sup>21</sup> Such filings must include a copy of the data on which the ranking or comparison is based.

<sup>22</sup> Communications regarding Collateralized Mortgage Obligations are regulated by NASD IM-2110-8.

### 3.4.2 Press Releases Made Available Only to the Media

Under the Prior Rule, press releases can constitute “sales literature” and thus be subject to the filing, approval and content standards of the Prior Rule. While the Amendments specifically include press releases in the definition of “sales literature,” thereby subjecting press releases to both the general content standards found in the Adopted Rules as well as the content standards applicable to advertising and sales literature, the Adopted Rules create an exclusion from the filing requirement for “press releases that are made available only to members of the media.” Press releases are, however, subject to the “spot check” procedure described above.

### 3.4.3 Television and Video Advertisements

Existing NASD policy mandates that, if television or video advertisements are required to be filed, NASD members file a draft or “story-board” version of any television or video advertisement with the NASD prior to use, as well as filing a final version after the first use of the advertisement.<sup>23</sup> The Adopted Rules codify this requirement, stating that if a member has filed a draft version of a television or video advertisement pursuant to a filing requirement, then the member must also file the final filmed version within 10 business days of first use or broadcast.<sup>24</sup>

## 4. Record-keeping requirements

The Adopted Rules set forth record-keeping requirements with respect to advertising and other communications.<sup>25</sup> With respect to communications with institutional investors falling under new Rule 2211, NASD members must maintain all such material, including the name of the person who prepared each piece of institutional sales material, for a period of three years. With respect to advertisements, sales literature, and independently prepared reprints, NASD members must make a record containing such communications with the public and must retain that record for a period of three years from the date of use of that material. The record must include the name of the registered representative that approved each such communication with the public, as well as the date that such approval was given.

<sup>23</sup> The existing NASD policy is described by the SEC in the Adopting Release. See the Adopting Release at 27119.

<sup>24</sup> See NASD Rule 2210(c)(6).

<sup>25</sup> For further information regarding the record-keeping requirements of U.S.-registered broker-dealers under SEC Rules 17a-3 and 17a-4, please see “SEC Amendments to Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Take Effect,” available at [http://www.shearman.com/documents/CM\\_04\\_05\\_03.pdf](http://www.shearman.com/documents/CM_04_05_03.pdf).

NASD members must also retain information regarding the source of any table, chart, graph or other illustration used in any communication with the public<sup>26</sup>; NASD members need not retain the underlying data found in any such illustration when creating the required records.<sup>27</sup>

## 5. Specific standards regarding communications with the public

### 5.1 Standards applicable to all communications with the public

As with the Prior Rule, under the Adopted Rules, certain content standards apply to all communication with the public. Specifically, pursuant to Rule 2210(d)(1), all communication with the public (including institutional sales material) must adhere to the following five content standards:

- All member communications with the public must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
- No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. Similarly, no member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.
- Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor’s understanding of the communication.<sup>28</sup>
- Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or pro-

<sup>26</sup> See NASD Rule 2211(b).

<sup>27</sup> See the Adopting Release at 27119.

<sup>28</sup> The Adopting Release specifically warns that footnotes in “especially small type,” or that claims made in communication with the public that are balanced only by footnotes may not satisfy this standard. See the Adopting Release at 27119.

ject the performance of an investment or investment strategy.

- If any testimonial in a communication with the public concerns a technical aspect of investing, then the person making the testimonial must have the knowledge and experience to form a valid opinion with respect to the applicable subject.

While the content rules found in NASD Rule 2210 have changed somewhat under the Amendments, it continues to be good practice to ensure (a) that all statements made in any such communication must be complete and accurate, (b) that no material fact should be omitted from any advertising, (c) that no exaggerated or unwarranted statements should be made in any advertising, and (d) that advertising should always be appropriate for its intended audience.

## 5.2 New Interpretive Material IM-2210-1

The Amendments move several of the specific regulations relating to the content of communications with the public currently found in Prior Rule 2210 to new IM-2210-1. Current IM-2210-1 relating to collateralized mortgage obligations is revised and renumbered as IM-2210-8. Under IM-2210-1, it is clarified that NASD members' principal responsibility is to ensure that communications with the public are not misleading. While several of the specific standards in the Prior Rule have been rewritten for clarity, and while several of such standards have been eliminated altogether,<sup>29</sup> all such communications remain subject to the general standards and to the standards of IM-2210-1.

In addition to the general standard that communication with the public must not be misleading, IM-2210-1 requires that:

- NASD members must ensure that statements are not misleading within the context in which they are made.
- NASD member communications should be consistent with the risks of fluctuating prices and the uncertain dividends, rates of return and yield inherent to investments.
- NASD members must consider the nature of the audience to which the communication will be directed.

<sup>29</sup> For example, the Prior Rule regarding references to self-conferred degrees or designations, offers of free service, claims for research facilities, hedge clauses, recruiting advertising, and periodic investment plans have been deleted; such communications are subject to the general standards applicable to all communications with the public as well as to the standards applicable pursuant to IM-2210-1.

- Communications must be clear, and not overly complex or technical.
- Income or investment returns cannot be characterized as tax-free or exempt from income tax if the nature of the investment is such that tax liability is postponed or deferred.
- In advertisements and sales literature, references to tax-free or tax-exempt income must indicate which income taxes apply, or which do not, unless income arising from the investment is free from all applicable taxes.

## 5.3 Use of recommendations

The Adopted Rules clarify certain aspects of the Prior Rule, and of other recent NASD rules, relating to the use of recommendations in communications with the public. In particular, the use of recommendations in communications with the public has been modified to ensure consistency with NASD Rule 2711, relating to research reports.<sup>30</sup> Specifically, IM-2210-1 will require that recommendations meet the following criteria:

- NASD members must have a reasonable basis for any recommendation contained in any advertisements or sales literature.
- NASD members must disclose whether: (i) at the time the advertisement or sales literature was published, the member was making a market in the securities being recommended (or in the underlying security, if applicable); (ii) the member or associated persons will sell the recommended security to or buy the recommended security from customers on a principal basis; (iii) the member and/or its officers or partners have a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal; (iv) the member was manager or co-manager of a public offering of any securities of the recommended issuer within the past 12 months.
- NASD members must provide, or offer to furnish upon request, available investment information supporting the recommendation.
- Recommendations on behalf of corporate equities must provide the price at the time the recommendation is made.

<sup>30</sup> For more information regarding NASD Rule 2711 relating to research reports, please see "SEC Approves Changes to NASD and NYSE Rules Relating to Research Analyst Conflicts of Interest," currently available at <[http://www.shearman.com/documents/SD\\_08\\_03.pdf](http://www.shearman.com/documents/SD_08_03.pdf)>.

- NASD members may use material referring to past recommendations if that material sets forth all recommendations as to the same type, kind, grade or classification of securities made by a member within the last year (longer periods of years may be covered if they are consecutive and include the most recent year).<sup>31</sup>
- No list of recommendations,<sup>32</sup> nor any material offering such list, may imply comparable future

<sup>31</sup> See NASD IM-2210-1(6)(C). Under that section, material provided in accordance with this requirement must also (i) name each security recommended, (ii) give the date and nature of each recommendation (e.g., whether to buy or sell), (iii) provide the price at the time of the recommendation, the price at which, or the price range within which, the recommendation was to be acted upon, and (iv) indicate the general market conditions during the period covered.

<sup>32</sup> Material that does not make any specific recommendation but which offers to furnish a list of all recommendations made by a member within the past year or over longer periods of consecutive years, including the most recent year, is also permitted to be used as communications with the public, provided that the list provided contains all the information specified in IM-2210-1(6)(C).

performance. The NASD states that reference to the results of a previous specific recommendation, including such a reference in a follow-up research report or market letter, is prohibited if the intent or the effect is to show the success of a past recommendation, unless all of the foregoing requirements with respect to past recommendations are met.

## 6. Conclusion

While the Adopted Rules create significant efficiencies with respect to certain communications with the public, the Adopted Rules continue the NASD's substantial and complex regulation of this area. NASD members are still required to be knowledgeable about and adhere to content standards as well as to filing and approval standards in respect of advertisements and other communications with the public. For more information regarding these issues, please feel free to contact any of the Shearman & Sterling LLP attorneys listed below.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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