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LEGISLATIVE CORNER

The Jumpstart Our Business Startups (JOBS) Act—Some Interesting Tidbits

On March 22, 2012, the Senate passed its version of the Jumpstart Our Business Startups (JOBS) Act, which is a compilation of a number of bills addressing issues relating to raising capital and securities regulation, all in the name of creating jobs. On March 27, 2012, the House approved the Senate version, which had amended the crowdfunding provisions contained in the House's earlier version. President Obama is expected to sign the Act into law in the near future. Notably, the Act received strong bipartisan support and public support from President Obama.

When the Act becomes law, it will significantly erode the distinctions between public offerings (which generally have to be registered with the SEC) and private placements (which do not have to be registered with the SEC).

Briefly, and among other things, the Act will:

- Eliminate the prohibition on general solicitation for offerings of securities made pursuant to Rule 506 if the securities are sold only to accredited investors.
- Permit crowdfunding (raising small amounts of capital from many investors, often via the internet) without registration under state or federal securities laws.
- Create a new category of securities issuer—an "emerging growth company". Emerging growth companies would be granted limited relief from various accounting, auditing, governance and disclosure requirements for up to five years after their first sale of common equity pursuant to a registration statement under the Securities Act of 1933. Emerging growth companies would include companies with less than $1 billion in annual revenues and less than $700 million in publicly traded shares.
- Require the SEC to increase the offering limit under Regulation A to $50 million from $5 million and make pre-emption of state securities laws available for certain offerings under Regulation A.
- Require a company to register under the Securities Exchange Act of 1934 (the Exchange Act) when its securities are held of record by 2000 investors (or 500 non-accredited investors), rather than the current threshold of 500 record holders and exclude employees who received securities under an employee compensation plan and persons that purchased securities pursuant to the crowdfunding exemption from the count.

While the legislation is still in its infancy, much has already been written about the Act. Rather than provide a detailed summary of the Act, this article will highlight some of the interesting details of the Act.

- The Act would require issuers taking advantage of the crowdfunding exemption to file not less than annually with the SEC and provide to investors financial statements of the company as the SEC "shall, by rule, determine appropriate."

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- If your company went public after December 8, 2011, it can still qualify as an "emerging growth company." Section 101(d) of the Act provides that an issuer shall not be an emerging growth company if the first sale of common equity securities of such issuer pursuant to an effective registration statement under the Securities Act of 1933 occurred on or before December 8, 2011.

The SEC's opposition to, or "concern" over, the Act is no secret.[1] When the Act becomes law, will this opposition effectively lead the SEC to kill the Act through the rulemaking process? Most of the Act's Titles, and in particular Title III, Crowdfunding, direct the SEC to adopt rules. Typically, rules add detail and aid in the interpretation or implementation of the law. The SEC's opposition to the Act could find expression in delays in issuing required rules or in issuing rules that are consistent with the letter, but not the spirit of the Act. For example, the Act requires issuers to take reasonable steps to verify that purchasers of securities are accredited in order to use general solicitations in connection with securities offerings. The SEC could easily make the verification requirements so onerous that compliance would be too burdensome, expensive or simply not practical. ■

SEC NEWS

SEC Grants Global No-Action Relief for RSU Programs

The SEC's Division of Corporation Finance recently granted global no–action relief to non-public companies that maintain restricted stock unit (RSU) programs, thereby allowing such companies to issue RSUs to their employees, officers, directors and consultants without registering the RSUs under Section 12(g) of the Exchange Act. Although it does not break new ground (the SEC has issued similar no-action letters that applied to individual companies[2]), it provides clear guidance by which private companies can structure their RSU programs to avoid registration and reporting otherwise required under the Exchange Act if their RSUs are held by 500 or more persons.

Generally, Section 12(g) of the Exchange Act and Rule 12(g)(1) promulgated thereunder require every issuer with total assets of more than $10 million and a class of equity securities held of record by 500 or more persons to register that class of equity security under the Exchange Act. RSUs represent the right to receive stock in the future based upon the satisfaction of certain conditions (including continued employment, attainment of performance goals, a sale of the company or IPO, or a combination of the foregoing). RSUs are considered equity securities under the Exchange Act and, in the absence of no-action relief, an otherwise privately-held issuer would become subject to the registration and reporting requirements of the Exchange Act when it reached 500 or more holders of its RSUs.

The SEC granted the no-action relief provided that the following conditions are met:

- the RSUs must be granted pursuant to a written compensatory equity incentive plan of the company (or its parent, majority-owned subsidiary or parent's majority-owned subsidiary) and the recipient must not have paid any consideration for the RSUs or for the shares issuable under the RSUs;
- holders of the RSUs must not, by virtue of such holdings, own common stock or have any voting, dividend, liquidation or other rights of stockholders, or otherwise be reflected as stockholders in the company's records until the shares are issued upon settlement of the RSUs;
- the RSUs may be held only by employees, officers, directors and other persons described in Securities Act Rule 701(c), including certain consultants, and their permitted transferees, as described below;
- pursuant to terms contained in writing (whether in the equity incentive plan, RSU award, other agreement between the holders and the company or the company's bylaws or certificate of incorporation), the RSUs may not be transferred other than (i) to family members, as defined in Securities Act Rule 701(c)(3), by gift or domestic relations order or to an executor or guardian upon the holder's death or disability, (ii) to the company or (iii) in connection with a change of control or other acquisition transaction involving the company, if after such transaction the RSUs will not be outstanding and the company will not be relying on the SEC's no-action letter;
- such written terms must also provide that the RSUs and the shares issuable thereunder are restricted as to any pledge, hypothecation, or other transfer, including any short position, any "put equivalent position" (as defined in Exchange Act Rule 16a-1(h)), or any "call equivalent position" (as defined in Exchange Act Rule 16a-1(b)) by the RSU holder prior to settlement of the RSUs, except in the circumstances permitted in the preceding bullet, until the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act or is no longer relying on the SEC's no-action letter;
- permitted transferees of the RSUs may not transfer the RSUs under any circumstances except upon the death of the permitted transferee, which restriction must be in writing as described above and acknowledged in writing by the permitted transferee; and
- the company must agree in writing (in the plan, a written agreement with the RSU holder or other written agreement enforceable against the company), to provide the holder with the information specified in Exchange Act Rule 12h-1(f)(vi) (generally, information about risks of the investment and financial statements) until such time as it becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act or is no longer relying on the SEC's no-action letter.

The SEC cautioned that any different facts or conditions might result in a different conclusion. We recommend that a private company with a RSU program tailor such program to fit within the conditions imposed by this no-action letter to avoid Exchange Act registration and reporting requirements that would otherwise result if the number of its RSU holders reaches 500. Such issuers should also keep in mind that if the settlement of the RSUs in the future (due to the satisfaction of time, performance or other conditions in the RSU) causes them to have 500 or more holders of record, then issuers cannot rely on this no-action letter and will be required to register and report under Section 12(g) of the Exchange Act. ■

SEC and CFTC Jointly Issue Proposed Rules and Guidelines Addressing Identity Theft

The Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010 (Dodd Frank) added the SEC and the Commodity Futures Trading Commission (CFTC and together with the SEC, the Commissions) to the list of federal agencies required to jointly prescribe and enforce identity theft red flags rules and guidelines and card issuer rules. On February 28, 2012, the Commissions released the proposed rules and guidelines addressing identity theft, which according to the Commissions, are substantially similar to those adopted by other agencies in 2007.[3] The Commissions noted that most of the entities over which they have jurisdiction are likely to already be in compliance with the final rules and guidelines adopted by the other agencies.

Proposed Rules and Guidelines—Identity Theft Program. The proposed rules and guidelines would require financial institutions and creditors[4] to develop and implement a written identity theft program designed to detect, prevent and mitigate indentify theft in connection with certain existing accounts or the opening of new accounts.

Financial Institutions and Creditors and Covered Accounts. The CFTC's proposed rules would apply to futures commission merchants, retail foreign exchange dealers, commodity trading advisors, commodity pool operators, introducing brokers, swap dealers and major swap participants. The SEC's proposed rules would apply to a broker, dealer, any entity that is registered or required to be registered under the Exchange Act, an investment company and an investment advisor.

A covered account, as proposed by the Commissions, would include accounts that a financial institution or creditor offers or maintains:

- Primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; or
- For which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation or litigation risks.

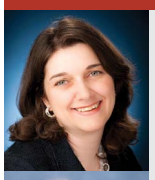
Identity Theft Program. The financial institutions and creditors would be required to develop a written identity theft program that includes reasonable policies and procedures to identify red flags, detect the red flags, respond appropriately to any red flags that are detected and ensure that the program is updated periodically to reflect changes in risks to customers and to the safety and soundness of the financial institution or creditor from identity theft. The Commissions point out that there are no mandatory red flags, but rather the financial institutions and creditors have flexibility in determining which red flags are relevant to their businesses and the covered accounts managed over time. That being said, the Commissions, in the proposed rule, provide guidelines for developing the program. The Commissions noted five categories of red flags that must be considered for the program. These include:

- Alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services;
- Presentation of suspicious documents, such as documents that appear to have been altered or forged;
- Presentation of suspicious personal identifying information, such as a suspicious address change;
- Unusual use of, or other suspicious activity related to, a covered account; and
- Notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution or creditor.

In developing the program, the Commissions propose that a financial institution or creditor should incorporate relevant red flags from such sources as (i) incidents of identity theft that the financial institution or creditor has experienced, (ii) methods of identity theft risk and (iii) applicable regulatory guidance. The Commissions include a list of risk factors that must be considered in identifying red flags such as the types of accounts offered or maintained, the methods provided to open accounts, the methods provided to access the accounts and previous experiences with identity theft.

The proposed guidelines require the financial institution or creditor to report to its board of directors, an appropriate committee of the board, or a designated senior management employee, at least annually, on compliance by the financial institution or creditor with the proposed rules.

Comments on the proposed rule are due on or before May 7, 2012. ■



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Director Independence Is Under GRId 2.0 Microscope

Several years ago, Institutional Shareholder Services Inc. (ISS) launched Governance Risk Indicators (GRId), which serve as a measure of governance-related risk. GRId answers questions about a company's corporate governance practices using publicly available information, scores these answers based on best practices, and determines an overall governance concern level for the company. On March 6, 2012, ISS updated its Governance Risk Indicators 2.0: Technical Document.

Generally, GRId evaluates companies' governance practices in four categories: Audit, Board, Shareholder Rights and Compensation. In each category, GRId 2.0 has added new questions or split up existing questions to hone in on a few specific issues. For example, the following questions added to, or updated in, the Board category focused on board composition and director independence:

- What is the classification of the Chairman of the Board?
- Are the roles of Chairman and CEO separated?
- Has the company identified a lead/senior independent director?
- What percentage of the board is related to executives or majority shareholders of the company?
- What percentage of the board are former executives of the company?

Generally, under the GRId 2.0 scoring approach, the absence of a majority of independent directors serving on the board raises significant governance concerns. This approach may be mostly relevant for public companies whose securities are quoted on the Over the Counter Bulletin Board because, subject to certain limited exceptions, public companies whose securities are listed on a national securities exchange must have a board comprised of a majority of independent directors to comply with the continued listing requirements of the exchange.

ISS classifies the Chairman of the board as an executive, an affiliated non-executive, independent or a former CEO. ISS supports the push for separating the roles of Chairman of the Board and CEO of the company and believes that a combined Chair/CEO raises a moderate level of governance concern, where a non-independent chair (for example, former CEO or other affiliated outsider) raises a smaller degree of concern. However, the presence of a lead independent director may mitigate governance concerns raised by a non-independent Chair or combined CEO/Chair position.

Unfortunately, this granular analysis of a company's governance practices and the company's desire to appease its institutional holders following ISS guidelines may lead to board composition that is driven by ISS corporate governance scores rather than business needs of the company. ■

PCAOB Proposes Related Parties Auditing Standard and Amendments Regarding Significant Unusual Transactions and Executive Compensation

The Public Company Accounting Oversight Board (PCAOB) has proposed a new auditing standard, *Related Parties,* and amendments to existing standards to address "significant unusual transactions," as well as a company's financial relationships and transactions with its executive officers (for example, executive compensation, perquisites and any other transactions). The PCAOB said that it developed the proposed standard and amendments in light of the magnitude and number of financial frauds involving public companies that arose out of these areas.

Related Parties. Under the proposed Related Parties standard, the auditor will be required, among other things, to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.

The proposed standard provides that the auditor should inquire of the audit committee or its chair regarding:

- the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- whether any member of the audit committee has particular concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Further, the auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor also should communicate other significant matters, including:

- the identification of related parties, relationships or transactions with related parties that were previously not disclosed by management to the auditor;
- the identification of significant related party transactions (i) that were not authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted; and
- the identification of significant related party transactions that appear to the auditor to lack a business purpose.

The proposed standard provides that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

Significant Unusual Transactions. The PCAOB is also proposing amendments to existing standards to strengthen the auditor's evaluation of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size or nature, referred to as "significant unusual transactions."

The proposed amendments would, among other things,

- require the auditor to perform specific procedures to identify significant unusual transactions, as well as to obtain an understanding of the business purpose (or the lack thereof) of identified significant unusual transactions;

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EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

PCAOB Proposes Related Parties Auditing Standard and Amendments Regarding Significant Unusual Transactions and Executive Compensation (continued from page 4)

- enhance the auditor's evaluation of the business purpose of significant unusual transactions; and
- require the auditor to evaluate whether significant unusual transactions have been appropriately accounted for and adequately disclosed.

Financial Relationships and Transactions. The third area addressed by the proposal would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (such as executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, among other tasks:

- reading employment and compensation contracts; and
- reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

The proposed amendments would also require the auditor to consider inquiring of the chair of the compensation committee and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers.

The release states that these proposed audit procedures are not intended to question the policies and procedures of the company, but rather to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers, including unrecognized compensation, illegal acts, or other matters (e.g., self-dealing or other conflicts of interest). However, at least one commentator has suggested that the proposals might lead to the auditors "second guessing" the compensation committee's business judgment in the executive compensation area.[5]

The proposal is open for public comment through May 15, 2012. The PCAOB anticipates that the proposed standard and amendments will be effective for fiscal years beginning on and after December 15, 2012. ■

SEC COMMENT LETTER TRENDS

Don't Forget About Board Diversity

Item 407(c) of Regulation S-K requires a registrant to disclose whether its nominating committee or board considers diversity in identifying nominees for director, and if the nominating committee or board has a policy on diversity, to describe how the policy is implemented, as well as the manner in which effectiveness of the policy is assessed.[6] In recent comment letters, the SEC has focused on this subsection of Item 407 addressing diversity, requesting certain registrants to revise their disclosures to fully describe the role diversity plays in the process for identifying and evaluating nominees for director. The SEC's focus on board diversity through the comment letter process should serve as a reminder of not only the disclosure obligations with respect to board diversity, but the real-world value a diverse board can bring to a public company. ■

INVESTMENT ADVISER REGULATION

CFTC Issues Final Rule Amending Certain Registration Requirements Affecting Registered Investment Companies

On February 9, 2012, the CFTC issued a final rule, amending Part 4 of the CFTC's regulations involving registration and compliance obligations for commodity pool operators (CPOs) and commodity trading advisors (CTAs).[7] The new rule reflects the CFTC's response to the Dodd-Frank Act and the failure of MF Global, Inc., and targets a "loophole" exempting registered investment companies (RICs) from CFTC registration.[8] The new rule:

- Rescinds the exemption from registration provided in section 4.13(a)(4);
- Modifies the criteria for claiming relief under section 4.5;
- Removes relief from the certification requirement for annual reports provided to operators of certain pools offered only to qualified eligible persons under section 4.7 (b)(3); and
- Adopts amendments that include new risk disclosure requirements for CPOs and CTAs regarding swap transactions.[9]

The rule targets an investment strategy that allowed RICs to market and sell investments in commodity futures.[10] Under the previous regulatory scheme, RICs could invest in commodities without having to register with the CFTC by forming controlled foreign corporations in reliance on IRS private letter rulings. In order to do so, a RIC created a controlled foreign corporation, a wholly-owned subsidiary of the RIC, which would then invest in commodities. The result was that both the RIC and the controlled foreign corporation were excluded from registration with the CFTC under sections 4.5 and 4.13(a)(4), respectively.

The new rule rescinds section 4.13(a)(4) and amends section 4.5. Previously, section 4.13(a)(4) exempted a CPO from registration with the CFTC where interests in the pool (i) were exempt from registration under the Securities Act of 1933, and (ii) were marketed only to qualified eligible persons and accredited investors.[11] An entity previously relying on section 4.13(a)(4) for exemption from registration must now register with the CFTC unless it qualifies for a different exemption available under section 4.13(a).

Additionally, the new rule amends section 4.5. Previously, RICs were excluded from the definition of commodity pool operators by virtue of their registration under the Investment Company Act of 1940. Under new section 4.5(c)(2)(iii), to remain exempt, a RIC must only invest in commodity futures, commodity options contracts, or swaps for *bona fide* hedging purposes. Additionally, a RIC's positions in commodity futures, commodity option contracts, or certain swaps cannot exceed a five percent *de minimis* threshold.[12] Otherwise, the RIC will have to register with the CFTC.

The new rule is effective on April 24, 2012, except for the amendments to section 4.27, which will become effective on July 2, 2012. Compliance with section 4.27 will be required by September

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CFTC Issues Final Rule Amending Certain Registration Requirements Affecting Registered Investment Companies (continued from page 5)

15, 2012, for a CPO having at least $5 billion in assets under management, and by December 14, 2012, for all other registered CPOs and all CTAs.

Compliance with section 4.5 for registration purposes only will be required by the later of December 31, 2012, or 60 days after the effective date of the final rulemaking further defining the term "swap." Entities required to register due to the amendments to section 4.5 will be subject to the CFTC's record-keeping, reporting, and disclosure requirements within 60 days following the effectiveness of the final rule implementing the CFTC's proposed harmonization effort with the SEC.

CPOs claiming exemption under section 4.13(a)(4) will be required to comply with the rescission of Section 4.13(a)(4) by December 31, 2012; however, compliance will be required for all other CPOs by April 24, 2012.

Compliance with all other amendments, not otherwise specified above, will be required by December 31, 2012.[13]

Are Future Exemptions to Private Fund Adviser Registration Forthcoming?

Daniel Gallagher, the newest SEC commissioner, gave the keynote address at the Investment Adviser Association Investment Adviser Compliance Conference on March 8, 2012. During his address, Commissioner Gallagher spoke about, among other things, the SEC's role in implementing Dodd Frank. Gallagher pointed out that "[e]xcept in rare circumstances, the [SEC] may always use its exemptive authority to mitigate the unintended consequences of rulemaking. . . Indeed, in its role as an expert regulator, the [SEC] has an obligation to read any specific statutory provision in harmony with its overarching mission to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation." While Gallagher did note that it was not the SEC's job to undercut Congress' intent, he also expressed his belief that in the case of private fund adviser registration "there will be cases, moving forward, when an individual adviser or a particular class of advisers ought to be granted some measure of relief from the full panoply of requirements that come with registration under the Advisers Act. Robert Plaze, deputy director of the SEC's Division of Investment Management, spoke later at the conference and explained that advisers should not anticipate broad exemptive relief at this point. Whether the SEC will utilize its exemptive authority to grant relief to private fund advisers remains to be seen. ■

1. *See, e.g.,* Investor Protection is Needed for True Capital Formation (March 16, 2012), *available at* http://www.sec.gov/news/speech/2012/spch031612laa.htm.
2. *See, eg., Facebook, Inc.,* (October 14, 2008), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2008/facebook101408-12gh.htm; *Twitter, Inc.* (September 13, 2011) *available at* http://sec.gov/divisions/corpfin/cf-noaction/2011/twitter091311-12gh.htm.
3. In 2007, the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Trade Commission issued joint final rules and guidelines regarding the detection, prevention and mitigation of identity theft for entities that are subject to their respective enforcement authority pursuant to the Fair Credit Reporting Act of 1970, as amended by the Fair and Accurate Credit Transactions Act of 2003.
4. The terms "financial institution" and "creditor" have the same meanings they do under the FCRA.
5. Seelig, Steve, "PCAOB Proposal Could Bring Added Auditor Involvement in Executive Compensation Decisions," (March 1, 2012), *available at* http://www.towerswatson.com/blog/executive-pay-matters/6523.
6. *See* 17 CFR §229.407.
7. CFTC Press Release PR6176-12, "CFTC Issues Final Rule Amending Registration and Compliance Obligations for Commodity Pool Operators and Commodity Trading Advisors," (February 9, 2012), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6176-12.
8. *See, e.g.* Commissioner O'Malia, Scott D. "Statement of Concurrence, Commodity Operators and Commodity Trading Advisors: Amendments to Compliance Obligations," (February 2, 2012), *available at* http://knowledgemosaic.com/gateway/CFTC/Speech/omaliastatement020212.htm.
9. *See* CFTC Press Release, *supra* note 7.
10. *See* O'Malia, *supra* note 8.
11. Commodity Futures Law Reporter, Regulation, § 4.13(a)(3).
12. *See* "Commodity Pool Operators and Commodity Trading Advisors: Amendment Obligations," Federal Register, Vol. 77, No. 37 (February 24, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-02-24/pdf/2012-3390.pdf (The five percent threshold is calculated as not exceeding five percent of the liquidation value of the qualifying entity's portfolio. Swaps not within the ambit of Rules 1.3(z)(1) and 151.5 are included in the calculation for the five percent threshold. Also note that the calculation of five percent of the liquidation value of the portfolio is after taking into account unrealized profits and unrealized losses on any such contracts it has entered into. Furthermore, in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defend in Rule 190.01(x) may be excluded in computing such five percent.)
13. Id.

QUESTIONS: If you have a question regarding the issues raised in this newsletter, you may obtain additional guidance from the authors and other members of our Public Companies Group.

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