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The Senate Moves to Reform Mortgage Loan Origination and Underwriting Practices

The two and a half year old effort of Congress to revise the way in which residential mortgage loan originators are compensated and loans are underwritten is close to fruition as a result of a recently enacted amendment to the Senate's large, proposed financial reform bill, the Restoring American Financial Stability Act of 2010 (the "Financial Reform Bill").

Senator Jeff Merkley (D-OR) (along with Senator Amy Klobuchar (D-MN) and several other cosponsors¹) offered the amendment (the "M/K amendment"), reportedly to protect homeowners from the deceptive mortgages that "directly led to the Wall Street meltdown and resulted in millions of families losing their homes." While the causes of the financial markets meltdown and the foreclosure crisis are sources for continuing debate, the M/K amendment could, if the Financial Reform Bill is enacted, dramatically change the way in which retail and wholesale mortgage banking is conducted.

The new mortgage lending restrictions in the Financial Reform Bill in many respects parallel the companion provisions in the Wall Street Reform and Consumer Protection Act, H.R. 4173 (the "House Bill"), which the House of Representatives passed in December 2009 as part of its attempt at financial reform. The House Bill, however, also includes some of the most controversial elements of the Mortgage Reform and Anti-Predatory Lending Act, which the House of Representatives first passed in November 2007 and then again in May 2009, including requiring that a refinancing loan provide a "net tangible benefit," expanding the remedy of rescission for violations, imposing new forms of assignee liability, reducing the financial triggers under HOEPA for "high-cost" loans, and empowering state attorneys general to enforce the amendments to existing federal law.

Only time will tell whether the mortgage provisions in any final law will look like the House Bill, the Financial Reform Bill, or a combination of the two. The answer may well determine whether the heightened risk of making, financing and buying residential mortgage loans will impair the availability of consumer credit.

Prohibition on Steering Incentives

The M/K amendment would add a provision to Section 129 of the federal Truth in Lending Act ("TILA") prohibiting a loan originator from receiving from any person (and prohibiting any person from paying to a loan originator), directly or indirectly, any compensation that varies based on the loan's terms other than the loan amount. Similar to provisions in the House Bill and those found in the Federal Reserve Board's August 2009 Proposed Rule to amend Regulation Z implementing TILA ("Proposed Rule"),² the M/K amendment would prohibit loan originator compensation that is higher (or lower) depending upon, for example, whether the loan includes a prepayment fee, a fixed versus adjustable rate, a 15- versus a 30-year term, or qualifies as a Community Reinvestment Act loan. Thus, if the M/K

amendment were enacted, it appears a loan originator would be able to receive only a flat fee, or a fee that varies based upon the loan amount (or upon some criterion other than a loan term). As discussed in more detail below, because this is an amendment of Section 129 (which addresses high-cost loans, or “HOEPA” loans), violations of the M/K amendment would result in the availability of enhanced statutory damages for violations.

Earlier iterations of this effective ban on yield spread premiums (“YSPs”) were met by criticisms that the change would limit the ability of a borrower to finance all or a portion of the closing costs through a higher interest rate. Under the M/K amendment, a loan originator may only arrange for the consumer to finance his/her compensation and costs “through the rate” under constrained circumstances. Specifically, if the consumer chooses to finance the loan originator’s fee “through the rate,” the loan originator would be prohibited from receiving any other compensation, directly or indirectly, from the consumer or from any other person, and from receiving any other up-front payment of fees.

By using the phrase “finance through the rate,” the M/K amendment is setting its sights on YSPs, compensation a mortgage broker may receive in connection with a mortgage loan from the creditor (rather than the consumer), generally in exchange for delivering the creditor a mortgage loan with a relatively higher interest rate. While arguably this compensation from the creditor allows the consumer to choose to pay the mortgage broker’s compensation over time through his or her loan payments, rather than having to pay the broker on an up-front, out-of-pocket basis, YSPs have been criticized as at best opaque, and at worst unfair, to the consumer (although they are required to be disclosed on the HUD-1 settlement statement). Senators Merkley, Klobuchar, and others charge that YSPs are hidden tools used to steer borrowers into higher cost loans.

Thus, in a continuing attempt to delineate and prohibit what some allege is unfair mortgage broker compensation, the M/K amendment would create an all-or-nothing origination structure - either the borrower must pay the loan originator’s entire fee and costs up front, or the borrower must finance the

entire amount “through the rate,” with no choices in between. If the borrower wanted to pay a relatively higher rate to avoid paying the loan originator’s fee up front, the M/K amendment would prohibit the loan originator from receiving any other compensation (from the borrower or any other person), and charging the borrower additional up-front origination fees. The M/K amendment appears to provide a narrow exception to the outright prohibition of YSPs, suggesting that back-end compensation is permissible only when a higher rate is a substitute for, and not an addition to, the up-front origination costs (and no additional compensation is paid). This “exception” has people scratching their heads, as it permits loan originator compensation based on a higher rate, without justifying why YSPs are acceptable in certain circumstances. In effect, the M/K amendment provides less flexibility to structure loan pricing, and leaves borrowers with fewer options in financing their closing costs.

Nonetheless, the M/K amendment clarifies that it is not intended to restrict the consumer’s choice, at his or her option, to finance origination fees or costs “through principal,” so long as those fees or costs do not vary based on the terms of the loan (other than the loan amount), or based on the consumer’s decision about whether to finance the fees or costs. Of course, such an arrangement ultimately could harm a consumer because the principal would have to be repaid in full while a higher interest rate simply would evaporate when the loan is paid off. Thus, in the name of aiding the consumer, the amendment actually could increase the cost to the consumer. In addition, the amendment also clarifies that it is not intended to prohibit incentive payments to a loan originator based on the number of loans originated within a specified period of time. It further is not intended to limit or affect the amount of compensation the creditor receives on the loan in the secondary market (i.e., the “sale of a consummated loan to a subsequent purchaser”). Note, however, that the M/K amendment does not explicitly use the term “secondary market transaction,” nor does it discuss the treatment of “table funded” loans. None of these restrictions applies to bona fide third party settlement charges that neither the creditor nor the loan originator retains.

As we note below, the term “loan originator” would include retail loan officer employees of a creditor, and the restrictions would call into question the payment of overages and underages to loan officers. Similarly, the Federal Reserve Board’s Proposed Rule restricting loan originator compensation applies to a creditor’s employees, and would also include the creditor itself, if involved in a table-funding transaction. Unlike the M/K amendment, the compensation restrictions of the Proposed Rule would apply to certain purchasers in the secondary market. Another difference between the M/K amendment and the Proposed Rule concerns whether originator compensation should vary based on principal. The M/K amendment expressly allows such compensation, but the Federal Reserve Board expressed concern that such compensation creates incentives for the originator to steer consumers to a larger loan amount, and asked for comments whether prohibiting originator compensation on this basis would be unduly restrictive.

Broad Applicability to Consumer Mortgage Loans

Similar to the House Bill, the M/K amendment as it stands would appear to apply its loan originator compensation restructuring to every single consumer mortgage loan, including first- or subordinate-lien, open- or closed-end, forward or reverse loans, for purposes of purchase or refinancing, secured by the consumer’s principal residence or otherwise. (The provisions apply to mortgages that are “consumer credit transactions,” and thus would apparently not apply to commercial purpose or investment loans.) The original House Bill, H.R. 3915, on the other hand, would have limited these restrictions to loans that were not “qualified mortgages.”

Definition of “Loan Originator”

The compensation restrictions would apply to fees paid to or received by a “loan originator.” For this purpose, the M/K amendment defines “loan originator” as any person (presumably including an individual or an entity) that, for direct or indirect compensation or gain (or in the expectation of compensation or gain): (i) arranges for an extension, renewal, or continuation of such credit; (ii) takes an application for credit or assists a consumer in applying for such credit; or (iii) offers or negotiates terms of such credit. This would appear to include both independent mortgage brokers and retail loan

officers employed by a creditor. However, the term does not include a person performing purely administrative or clerical tasks on behalf of a loan originator; or a person performing solely real estate brokerage activities who is licensed or registered in accordance with applicable state law, and who does not receive compensation from a lender or loan originator (or agent of either).

House Bill 4173, the Wall Street Reform and Consumer Protection Act of 2009

As alluded to above, the House’s financial reform bill passed in December also includes a broad prohibition on steering incentives, prohibiting YSPs and any other direct and indirect compensation from any source that is based on loan terms (other than the amount of principal). Thus, both the House Bill and the M/K amendment would permit the financing of closing costs through an increase of the principal but not the interest rate, subject to certain exceptions. The House Bill also would similarly permit the financing of third party closing costs through the rate, but would also allow (for “qualified,” plain vanilla mortgages only³) an origination fee or cost to be financed through the rate so long as the originator does not receive any other compensation from the consumer, e.g., no loan origination or other fee.

However, the House Bill includes some ambiguous provisions that the M/K amendment does not. The House Bill would direct regulators to prescribe regulations that would, for example, prohibit steering a consumer to a mortgage loan with predatory characteristics or away from a mortgage loan that is not a “qualified” mortgage; prohibit promoting disparities among consumers of equal creditworthiness but of different race, ethnicity, gender, or age; and prohibit discouraging consumers from seeking less expensive loans from other originators.⁴ The House Bill would appear to apply these vague provisions only to closed-end, dwelling-secured mortgage loans.

Importantly, the House Bill also includes a loan originator duty of care, requiring the loan originator to be qualified and licensed or registered as required; to diligently work on behalf of any consumer seeking or inquiring about a residential mortgage loan; to present the consumer with a range of residential mortgage loan products for which the

consumer likely qualifies and that are “appropriate”; and to disclose to each consumer the comparative costs and benefits of each residential mortgage loan product that the loan originator offered, discussed, or referred to, and the nature of the originator’s relationship and cost to the consumer. The bill contains a presumption that a loan is appropriate for a consumer if the mortgage originator determines in good faith, based on existing information (without undergoing a full underwriting process) that the consumer has a reasonable ability to repay and, in the case of a refinancing of an existing residential mortgage loan, receives a net tangible benefit, and the loan does not have predatory characteristics or effects (such as equity stripping, excessive fees, and abusive terms).

The House Bill states, however, that the duty of care provision does not require the loan originator to present any specific loan product offered by a creditor that does not accept referrals or applications from the originator; nor does it require a creditor to offer products it does not otherwise offer to the general public. Further, the provision asserts that it must not be construed as creating an agency or fiduciary relationship between the originator and the consumer, so long as the originator does not hold himself or herself out as such.

A similarly subjective originator duty of care can also be found in the Federal Reserve Board’s Proposed Rule. The Board is considering a rule that seeks to prohibit loan originators from steering consumers to loans because the originator will receive additional compensation, when that loan may not be “in the consumer’s best interest.” A safe harbor would be created, and there would be no violation, provided the following conditions are met. The loan originator must obtain loan options from a significant number of creditors with which the originator regularly does business. For each type of transaction in which the consumer expressed an interest, the originator must present and permit the consumer to choose from at least three loans that include: the loan with the lowest interest rate, the loan with the second lowest interest rate, and the loan with the lowest total dollar amount for origination points or fees and discount points. Finally, the loan originator must have a good faith belief that these are loans for which the consumer likely qualifies. Not only is this standard for “the

consumer’s best interest” subjective, but the safe harbor, as it stands, would require a creditor’s loan originators to offer products of its competitors.

Ability to Repay and Income Verification

Similar to the House Bill, the M/K amendment would add another provision to Section 129 of TILA, prohibiting creditors from making any mortgage loan unless the creditor determines that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms, plus all applicable taxes, insurance, and assessments. The creditor’s determination must be based on verified and documented information, considering the consumer’s current income and “expected income” the consumer is “reasonably assured of receiving.” While the determination is to be made at the time the loan is consummated, it is not clear how in an uncertain economy a creditor could predict expected income in the future with any degree of reasonable assurance; should a lender, for example, deny credit to an applicant who works in an industry with repeated layoffs? The creditor also must consider the consumer’s employment status and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan.

On the other side of the equation, the creditor must consider the consumer’s current obligations and the debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations. If the creditor knows, or has reason to know, that more than one loan to be secured by the same real property or dwelling will be made to the same consumer, the creditor must determine that the consumer has a reasonable ability to repay the combined payments of all loans on the same real property or dwelling according to the terms of those loans, plus all applicable taxes, insurance, and assessments. The creditor also must consider the consumer’s credit history.

The M/K amendment to TILA would accompany that ability-to-repay requirement with an obligation to verify the consumer’s income or assets upon which the creditor will rely in determining repayment ability. The creditor must verify the amounts of that income or assets, including

expected income or assets, by reviewing the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records, or other reasonably reliable third party documents. Specifically, the amendment demands that in any consideration of income history, the creditor must verify that income by using either IRS transcripts of tax returns, or a method that quickly and effectively verifies income documentation by a third party subject to rules prescribed by the Federal Reserve Board.

The M/K amendment would allow a creditor to consider the seasonality and irregularity of documented income, including income from a small business, in the underwriting of and scheduling of payments for credit in an extension of credit secured by residential real estate or a dwelling. However, these strict documentation and verification requirements will still be very difficult for any consumer with irregular income (e.g., tips) to meet. Lenders may be very cautious about providing any documentation flexibility – the legal risks of making a loan based on other than W-2s and tax returns may simply not be worth it. As even salaried employees with full income documentation are currently finding it hard to qualify for mortgage loans, these additional verification requirements could certainly serve to restrict credit and increase loan approval times.

Presumptions of Compliance

As guidance, particularly for loans with adjustable rates or payment schedules, the M/K amendment would offer a "safe harbor" of sorts. A creditor would be presumed to have complied with the ability-to-repay and verification requirements if the creditor verifies the consumer's ability to repay (as described above), and determines the consumer's ability to repay using: (i) the maximum rate permitted under the loan during the first 5 years following consummation; and (ii) a payment schedule that fully amortizes the loan, taking into account current obligations and all applicable taxes, insurance, and assessments. The M/K amendment would not, however, offer any acceptable debt-to-income ratios or other presumptions in connection with ensuring that a creditor complies with the requirement to determine a consumer's ability to repay.

The "presumption of compliance" is significantly diluted by other provisions which affirmatively state there is no presumption. For example, there would be no presumption of compliance in the case of a loan for which the regular periodic payments for the loan may result in an increase of the principal balance or allow the consumer to defer repayment of principal (regardless of whether the consumer actually exercises that option during the life of the loan). A presumption of compliance also would not be available if the terms of the mortgage loan result in a balloon payment.

The M/K amendment also provides there is no presumption of compliance as to the ability to repay if a loan has total points and fees that exceed 3 percent of the total loan amount, using the same definition of "total points and fees" that HOEPA now uses (which would exclude back-end broker compensation unless revision to HOEPA in the House Bill prevails in any final law). Rather than creating a presumption of compliance for loans meeting stringent standards of the Federal Housing Administration ("FHA") or Department of Veterans Affairs ("VA"), the M/K amendment would only allow the exclusion from this points and fees calculation for premiums for mortgage guarantee insurance provided by a state or federal government agency to the extent the premiums exceed 1 percent of the total loan amount. Thus, like the Federal Reserve Board's ability-to-repay regulations⁵ and the House Bill's (described briefly below), the applicability of the M/K amendment's ability-to-repay requirement effectively depends upon the cost of the loan (among other factors). Since loans with points and fees over 3 percent will not enjoy any presumption of compliance (even if the loan is an FHA/VA loan, and the consumer can afford the maximum rate permitted under the loan during the first 5 years and a payment schedule that fully amortizes the loan), those loans would enjoy no safe harbor of compliance. The same would be true of balloon loans, negative amortization loans, and interest-only loans. In each of these instances lenders would be required to make the ability-to-repay determination and verification.

The Federal Reserve Board would have discretionary authority to revise, add to or subtract from the presumption criteria and exceptions for compliance, upon certain findings.

Broad Applicability to Consumer Mortgage Loans

As with the loan originator restrictions, the M/K amendment would impose its ability-to-repay and verification requirements broadly to nearly every “loan secured by real property or a dwelling,” although presumably it would apply only to those loans made to consumers (and TILA generally applies only to credit extended for personal, family, or household purposes). As it currently stands, it would appear to apply broadly to first- or subordinate-lien, open- or closed-end loans, for purposes of purchase or refinancing, secured by the consumer’s principal residence or otherwise. Unlike the loan originator compensation restriction, however, the ability-to-repay and verification requirements would not apply to bridge loans or reverse mortgage loans.

House Bill 4173, the Wall Street Reform and Consumer Protection Act of 2009

The House Bill contains similar ability-to-repay and verification requirements, although it appears the House’s requirements would apply only to certain closed-end, dwelling-secured mortgage loans. As mentioned above, the House Bill relies upon the concept of a “qualified” mortgage, and in connection with its ability-to-repay requirement, it would at least allow a presumption that those qualified mortgages meet the requirement. The House Bill would, however, allow consumers to rebut that presumption (against both creditors and assignees).

The House Bill also would impose other limitations and requirements that are not (yet) included in the M/K amendment or in the remainder of the Senate Financial Reform Bill. For example, the House Bill includes a net tangible benefit requirement in connection with refinancings. As another example, the House Bill would include significant restrictions on prepayment penalties, prohibiting them for non-qualified mortgages, and limit those penalties beyond 3 years on a declining 3-2-1 scale for qualified mortgages (however, if a creditor imposes a 3 percent penalty, the loan would become a high-cost loan under the bill).

Section 129 of TILA

As we noted above, the M/K amendment described above would be added to Section 129 of TILA. This placement of the new provisions is important, since provisions falling under Section 129 (which otherwise addresses HOEPA loans) bring regulations issued pursuant to that authority under the purview of TILA’s enhanced statutory damages. Persons who violate Section 129’s restrictions on loan terms, lending practices, and advertising are subject to civil liability to a consumer not just for actual damages, “regular” statutory damages, and court costs, but also for “special” or enhanced statutory damages equal to the sum of all finance charges and fees paid by the consumer (unless the consumer demonstrates that the failure to comply is not material). Historically, those “enhanced” statutory damages were available only in connection with HOEPA loans. However, congressional (and regulatory) attempts to pack Section 129 of TILA with every new requirement or prohibition in connection with all consumer mortgage loans are likely to frighten most mortgage lenders (and confuse the statute printers further – in last year’s fervor to add more provisions to Section 129, Congress inadvertently passed a second Section 129, which the printers were forced to renumber as Section 129a).

Conclusion

Senator Merkley promises that the M/K amendment will ensure that “never again will hidden steering payments put millions of homeowners on the fast track to foreclosure,” and Senator Klobuchar promises that the amendment’s safeguards will protect consumers from “complex and deceitful lending practices [that] were at the heart of the financial crisis.” While it appears clear that tighter restrictions on loan originator compensation and underwriting standards are on their way, it is unclear whether those restrictions will solve the nation’s financial crisis and foreclosure problems or will impose steep obstacles to consumers obtaining and affording mortgage loan credit. If, however, any finally enacted law contains the broader provisions of the House Bill, the phrase “never again” may describe the willingness of some to participate in the residential mortgage industry.

¹ The amendment was also cosponsored by Senators Chuck Schumer (D-NY), Olympia Snowe (R-ME), Scott Brown (R-MA), Mark Begich (D-AK), Barbara Boxer (D-CA), Chris Dodd (D-CT), Carl Levin (D-MI), Al Franken (D-MN), and John Kerry (D-MA).

² The Proposed Rule was published in the *Federal Register* on Aug. 26, 2009. 74 Fed. Reg. 43,232.

³ The House Bill would define the term “qualified mortgage” to mean any residential mortgage loan: (i) that does not allow a consumer to defer repayment of principal or interest, or is not otherwise deemed a “non-traditional mortgage” under guidance, advisories, or regulations prescribed by the Federal Banking Agencies; (ii) that does not provide for a repayment schedule that results in negative amortization at any time; (iii) for which the terms are fully amortizing and which does not result in a balloon payment, where a “balloon payment” is a scheduled payment that is more than twice as large as the average of earlier scheduled payments; (iv) which has an annual percentage rate that does not exceed the average prime offer rate for a comparable transaction, as of the date the interest rate is set: (I) by 1.5 or more percentage points, in the case of a first lien residential mortgage loan having an original principal obligation amount that is equal to or less than the Freddie Mac conforming loan amount for a residence of the applicable size, as of the date the interest rate is set; (II) by 2.5 or more percentage points, in the case of a first lien residential mortgage loan having an original principal obligation amount that is more than the Freddie Mac conforming loan amount for a residence of the applicable size, as of the date the interest rate is set; and (III) by 3.5 or more percentage points, in the case of a subordinate lien residential mortgage loan; (v) for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented; (vi) in the case of a fixed rate loan, for which the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments; (vii) in the case of an adjustable rate loan, for which the underwriting is based on the maximum rate permitted under the loan during the first seven years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments; (viii) that does not cause the consumer’s total monthly debts, including amounts under the loan, to exceed a percentage established by regulation of the consumer’s monthly gross income or such other maximum percentage of such income as may be prescribed by regulation, and such rules shall also take into consideration the consumer’s income available to pay regular expenses after payment of all installment and revolving debt; (ix) for which the total points and fees payable in connection with the loan do not exceed 2 percent of the total loan amount; and (x) for which the term of the loan does not exceed 30 years, except as such term may be extended by regulation.

⁴ These provisions were imported from the earlier H.R. 3915 and H.R. 1728 passed by the House in November 2007 and May 2009, respectively.

⁵ The Board’s regulations impose an ability-to-repay requirement on “higher-priced mortgage loans” and HOEPA loans, which obviously are loans categorized by their

relatively higher APR or points and fees. See 12 C.F.R. §§ 226.32, 226.34, 226.35. See K&L Gates Client Alert “Satisficing Subprime: New HOEPA Rules Might Just Be Good Enough,” by Kristie D. Kully and Laurence E. Platt (Aug. 2008), available at <http://www.klgates.com/newsstand/Detail.aspx?publication=4809>.

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