STRATEGIC RESEARCH

TOP 10 MISTAKES CEOS AND CFOS MAKE

Arzu J. Cevik
Director, Thomson Reuters Strategic Research

Glenn S. Curtis
Director, Thomson Reuters Strategic Research

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For questions about this report, please contact Arzu J. Cevik at arzu.cevik@thomsonreuters.com or 646-822-6402

or Glenn S. Curtis at glenn.curtis@thomsonreuters.com or 646-822-2554

EXECUTIVE SUMMARY

- Not Understanding What Makes a Company Attractive
- Not Knowing How to Communicate With Hedge Funds & Activists
- Sending Mixed Messages When Dealing with Investors
- Focusing on the Wrong Shareholders
- Guidance
    - Manipulating
    - Not Providing
    - Providing but Setting Unrealistic Expectations
- Not Having the CEO Participate on the Earnings Call
- Not Knowing How to Respond To a Crisis
- Not Linking Compensation to Performance
- Not Forecasting Properly
- Taking Aggressive/Risky Bets with the Balance Sheet

OVERVIEW

CEOs and CFOs carry a lot of responsibilities in running a company no matter how large or small. However, many often overlook critical areas of execution. In the pages below, we outline 10 of the most common mistakes we believe CEOs and CFOs make. This information was gathered from client feedback, recent examples in the media and our own dealings with executives.

1. Not Understanding What Makes a Company Attractive

Some CFOs and CEOs have no idea or little idea of what truly makes their company attractive to the analyst community and/or to the average investor. Or, they do have an idea, but they fail to internalize it or to incorporate it within the company's message. This is a mistake.

In fact, it is of paramount importance that the CFO and CEO understand and internalize their company's most attractive features so that they can adequately communicate them with shareholders, and hopefully attract new shareholders.

What qualities might executives emphasize?

Of course, every company has different assets/qualities that the executive might want to detail or in some way make known. However, it is important to note that there are some constants, or characteristics, that tend to attract "fence-sitting" investors over others.

For example:

Backlog Numbers: Not all companies report a backlog figure, however, an increased backlog number or a high rate of incoming orders can be a sign of things to come. And so, if this number is quantifiable and available, consider communicating it.

Insider Activity: Many institutional and retail investors keep a close eye on such data. The logic: There is usually only one reason why executives pony up their money and buy stock and that's to reap a profit. Again, even small purchases have the potential to draw lots of eyeballs. In short, if asked, this is something that CFOs and CEOs should generally be happy to talk about (assuming the information is in the public domain).

Margin Growth: While generating good top and bottom line results is important, what is in between the lines is important as well. Very simply, if a company has shown solid sequential and/or year-over-year improvements in gross margins or operating margins, the CFO and CEO should consider talking about the improvements with the public. Again, margin trends are very important and should be communicated.

Raising the Earnings Bar: Companies that raise their quarterly or annual earnings forecast tend to garner a great deal of attention from the press and investors.

To be clear, it is important for a CEO/CFO to review and detail a new product so that investors understand it and the potential impact to its revenue stream. (Much like Steve Jobs did with the latest iPhone by Apple.) It's equally important to convey a vision for the future. After all, consumers and investors need to know where the company is headed. However, these executives must also not forget to detail certain metrics, particularly those mentioned above to the investment community (if they are indeed attractive) because it's these items that often may provide the best "bang for the buck" in terms of attracting new investors.

2. Not Knowing How to Communicate With Hedge Funds & Activists

Years ago, CFOs and CEOs had to deal with and field questions from aggressive "mom and pop"-type retail investors and other entities like mutual funds. But these days, CEOs and CFOs are often besieged with inquiries from aggressive hedge funds, and in some cases, private equity firms – some of which may have an activist bent. And worse yet, it's often hard to tell from communications with these players whether they intend to go long on, or short the company's stock.

The point is that some executives "wing" their communications with these types of entities. That is, they haven't learned how to deal with such firms. But that is another common mistake.

Keep in mind that it is up to the CFO and CEO to communicate the company's message in such a way that hedge funds and other investors want to come aboard and to purchase the stock, and not act in an activist capacity. It's also up to these individuals to properly communicate the opportunities the company has so that "hedgies" don't even want to consider shorting the shares.

How specifically should CEOs and CFOs deal with hedge funds?

There's nothing set in stone. However, it does often make sense to communicate with these entities because without direct contact they may form their opinions by conversing with third parties, or by listening to and/or creating rumors.

The same goes for conference and/or earnings calls. Keeping hedge fund managers off a call might reduce the chance that the executive will be asked a tough question. However, banning such individuals/firms can again cause them to obtain their information from third parties that may be wrong or be simply biased.

CEOs and CFOs also must understand that if a known short or activist hedge fund approaches, that they may want to respond (if applicable) with things that have the potential to turn off such investors. For example, when it comes to activist funds, they may want to play up the high amount of insider ownership, the existence of a poison pill, a staggered board or other factors that could potentially stymie a takeover attempt.

Regarding communications with short players, talking up the opportunities the company has going forward on the earnings front or other catalysts may be a great way to diminish their interest.

Put another way, when it comes to activists or potential shorts, the old adage "keep your friends close and your enemies closer" often applies. In other words, engaging and conversing with activists will enable the potential target to get a better feel for the activist's beliefs and potential strategies. This in turn may enable them to combat an attempt to for example, seek board seats or to garner the support of other shareholders.

Of course, this doesn't mean that CEOs and/or CFOs should necessarily be beholden to these types of investors. To the contrary, it often pays to have the Investor Relations Officer or another company spokesperson first conduct some research on these investors and/or to feel them out to see where their interests lie. This can allow the CEO/CFO to be prepared and understand the investor's behavior and whether they'll be friendly or adversarial.

Again, knowing how to deal with hedge funds is extremely important and unfortunately, it seems that many CFOs and CEOs are not prepared.

One final point on this matter - in order to effectively communicate with hedge funds and/or activists, it is vital that executives understand what types of companies (sector-wise) are being targeted, and what their typical demands are. The Strategic Research team monitors this information on a quarterly basis. For reference, over the last several years Consumer Discretionary companies have been either a top target or among the top targets for activists. In terms of demands, activists have aggressively sought board seats although in the past, they have asked for changes in executive compensation and for deal activity such as spin-offs to unlock asset value and buybacks.

3. Sending Mixed Messages When Dealing with Investors

Communication with the Street is essential and keeping the message consistent, when speaking with both the sell-side and the buy-side, can make or break your reputation.

Many CFOs will tailor what they say depending on who they're meeting with, which can lead to problems. This is especially true during one-on-one meetings. If a CFO is meeting with an investor at a hedge fund, who may be more aggressive than an investor at a mutual fund, the way he interacts with the investor may be different. He may be more defensive, act arrogant, get angry and refuse to answer questions. (Most executives do not act this way when addressing a large crowd – for example, during an analyst day conference).

CFOs should be cognizant that many buy-side investors (at competing firms) will speak to each other and compare notes. If you're painting a rosy picture with one investor and less so with another, you're not being consistent and your reputation may be at stake. Losing credibility with investors may lead to losing important shareholders and create potential volatility in your stock. Below, we list effective strategies CEOs and CFOs can use when dealing with investors.

10 Key Strategies to Keep in Mind When Dealing with Investors:

1. Prepare and review the key issues with your management team. What issues are likely to be asked by investors?

2. Play devil's advocate; ask yourself the difficult questions and prepare effective answers.

3. Comply with Reg FD. It's important to meet with your compliance group and review the answers you've prepared. Do they violate Reg FD?

4. Role play – research, prepare and practice how best to answer questions either in front of a mirror or have your team videotape your comments. Sometimes inflection and physical mannerisms are a "tell" for investors looking for any insight/edge.

5. When meeting with investors, try to maintain your tone and composure. Many investors complain that CFOs become arrogant or abusive when faced with difficult questions.

6. If pressed to answer a question which you don't have the answer to or if answered, would reveal material non-public information, work with your compliance department to craft an appropriate response before the meeting and provide the answer without losing your cool.

7. Don't be arrogant. Many executives become defensive and/or arrogant when dealing with difficult investors. For example, if an investor is concerned about your quarterly results and you're aware of what the results will be but you haven't disclosed this information publicly, it would be easy to act arrogantly. Not only would you be violating Reg FD by disclosing this information (easily rectified by issuing a press release immediately) but you'd lose your composure and gain a reputation for being a "hot-head."

8. Don't give mixed messages to investors. Saying different things to different investors will only serve to help create confusion, ruin your reputation and could potentially lead to that investor selling his shares or choosing not to invest in your firm.

9. Quality of management team is a key factor for many investors (especially value investors) when making a decision to buy or sell shares. Maintain your integrity and stay true to your prepared commentary.

10. Don't lose sight of your focus. At the end of the day, hopefully you enjoy being CFO. Don't forget that joy and optimism when dealing with investors because it can be infectious.

4. Focusing on Your Top Institutional Investors More Than Other Investors

Many executives choose to focus on the investors that own the majority of their shares, primarily the top largest investors.

But focusing on the next tier of investors can be essential to building a solid investor base. In some sectors, investors in the top 10 to 20 tend not to sell their shares as often as other investors (top 20 to 40 shareholders) and usually have timely access to management. Not spending enough time with the second tier of investors may create volatility in your stock. They don't always have timely access to management (if at all) which can be frustrating.

This is also true of investors that don't yet own shares. Periods of market volatility represent buying opportunities for many investors, especially value investors, who typically have low turnover relative to other investors.

A value investor we spoke with on this topic lamented, "If we don't own the stock – then it's definitely harder to get the company to call me back. Sometimes, it takes more than five days – which is very frustrating. But it happens – they don't know who we are sometimes."

Strategies to consider:

1) Identify your current shareholder base.

2) Compare and contrast your investor base to your peers.

3) Prioritize and keep handy a target list of investors by their investment style.

4) Be proactive – try to communicate with current investors especially during periods of market volatility and uncertainty.

5) Stay up-to-date on current market sentiment and investor concerns.

The same methodology can be applied to retail investors and institutional investors outside the U.S.

CONSIDERATIONS

How do you deal with investors?

Are you arrogant?

Are you quick to lose your temper?

Do you send the same message to investors or do you say different things to different people?

5. Guidance

- *Manipulating Guidance*

Some companies that choose to provide guidance, either on an annual basis with quarterly updates, or on a quarterly basis may be manipulating investors and analysts.

They do so by leaving room for upside potential and/or by adjusting guidance for one-time gains.

Most media outlets are only concerned with reporting two metrics – did the company meet or beat estimates? And did they raise their guidance/outlook?

Companies know that what gets reported can impact the stock either on the upside or the downside.

But if companies did not provide guidance, they wouldn't have investors focused on the short-term and whether or not they met expectations for one quarter. Warren Buffet is not a fan of guidance and it's easy to see why. It's estimated that only 20% of companies beat their own guidance.

If companies have guided investors and analysts to a lower number knowing that they will beat guidance, then some may question the company's tactics. If a CFO is adjusting because he wants his company's stock price to increase (perhaps to potentially sell some shares/cash in options that have vested), then it may become an integrity and a quality of management issue.

If a CFO repeatedly guides the Street in this way, then some may begin to question what is said and raise their estimates thereby diminishing any upside potential in your stock. Additionally, investors (especially value investors (and other long-term shareholders) who seek to invest in companies that have strong management teams and where integrity isn't an issue) may sell their shares and/or decide not to invest.

Some companies also raise guidance for one-time beneficial items that are non-operational in nature. This would not be viewed as a best practice because the gain was not a result of operations and can cause confusion among analysts and skew a company's mean on First Call. Guidance should be revised upward due to operational reasons such as increased revenues, better economic climate, etc.

It also sends a red flag to analysts about quality of management and experience. Furthermore, it sets a company up for potential downside, such as what if your company has a one-time charge? Would you adjust guidance downward?

If a company has a tendency to revise guidance each quarter (perhaps based on visibility), then a pattern is set and may indirectly lead to short-term interest and volatility in your stock. A company may be attracting investors that are not going to own the stock for the long-term. This is especially true for small cap companies that may not have as much liquidity as larger cap companies.

From a P/E perspective, it wouldn't make much of a difference to attracting an investor if a company has a small market cap and it adjusted guidance upward for a one-time gain. However, it would make a difference for a company with a much larger market cap, such as Google, where every uptick in guidance could attract an investor (it should be noted that Google has a practice of not providing guidance although it will occasionally provide color on items such as revenue pace).

If a company chooses to provide guidance, it's better to be fair and consistent and abide by best-in-class practices. Typically, larger cap, more well-known companies in your peer group may have practices that other smaller cap companies can try to emulate. At the end of the day, manipulating earnings guidance may lead investors to question the quality of the management team.

- *Not Providing Guidance*

Some CEOs and CFOs prefer not to provide quarterly guidance to Wall Street. Why? Some think that the volatility that sometimes occurs as investors speculate whether the company will meet or beat expectations might be avoided. Still others may think that preparing and communicating quarterly guidance is a waste of time.

To be clear, there may be some truth to those reasons in some circumstances. However, where CEOs and CFOs sometimes go wrong is that they may not fully understand or appreciate how halting guidance may adversely impact the company.

For example, if a company forgoes guidance, some retail or institutional investors that prefer handholding may bail out of the stock. In addition, absent guidance, the rumor mill may heat up and the volatility that management was trying to avoid may actually be worse. Not to mention that when a company meets or exceeds guidance, it often provides senior executives with some "Street cred."

CEOs and CFOs should also understand that if a company's peers continue to release quarterly guidance, that investors may decide to invest in that competitor because of visibility. And even if they don't, they may use the guidance provided by the competitor and apply it to the company – right or wrong.

- *Providing Guidance But Setting Unrealistic Expectations*

Be careful what you promise. Many executives over-promise and under-deliver especially on the earnings front, which can be costly not just to shareholders but to CEOs themselves. Missing earnings can lead to losing your job.

Recently, several CEOs have lost their jobs because they've missed earnings expectations. For example, both the CEO and Chairman of Alcatel-Lucent announced they were both stepping down after pressure due to six consecutive losses at the tech giant and declining market capitalization (which was halved after the earnings miss). Other CEOs who have been ousted include the CEO of Advanced Micro Devices (who stepped down after missing expectations for seven consecutive quarters) and the CEO of Washington Mutual, which also suffered losses.

Although they won't admit it, many executives often manage expectations by either providing low guidance in order to beat the Street, hoping for an uptick in their stock price, or they become too aggressive and underestimate the amount of time required to fix issues or do not accurately anticipate the impact of economic issues (currently, fuel & consumer spending).

How to avoid this problem? Some would say stop providing quarterly guidance. In the past, some companies that have missed quarterly expectations have stopped providing quarterly guidance altogether. One in particular, Gillette (now a part of Procter & Gamble), stopped the practice after Warren Buffett (who was a board member at the time) advised against it. Mr. Buffett believes that providing quarterly guidance encourages investors to focus on the short-term and not the long-term.

Those in favor of quarterly guidance believe it's necessary and provides accountability. As one sell-side analyst commented, "I want to know if the CEO can deliver on results and it's something that should be measured quarterly."

For many, it's a catch-22 situation – you're damned if you do and damned if you don't. If a company decides to be conservative and provide guidance that may be lower than expectations, then they may set off a panic among analysts and investors which could result in weakness in the stock and potentially to the stocks in your peers group.

Or a company may instill a lack of credibility with the Street if they have a habit of "low-balling" estimates and then beating expectations. Sell-side analysts will adjust their estimates accordingly, thereby eliminating any potential upside to your stock.

Unless regulations change, ultimately, providing quarterly guidance -- including how much detail and whether or not there's a cushion - is a decision each CEO and CFO has to make but his or her job may depend on it. But given how challenging the current environment is, providing guidance may be a losing game and encourages "short-termism".

6. Not Having the CEO Participate on the Earnings Call

It's surprising but some CEOs choose not to participate on their company's earnings conference call with investors. We would argue that this is not a best practice. In fact, in an IR Practices study we conducted last year (of more than 560 companies globally), an overwhelming majority of companies reported their CEO participates on earnings calls. We would argue that not having the CEO participate on an earnings call sends a negative message to the Street and may be viewed as suspicious.

When everything a company says is analyzed and reviewed in detail, this could be cause for alarm. Why wouldn't the CEO participate? He has a vested interest in the company, earnings calls happen only four times a year so travel conflicts should not be an issue and he should be available to answer any calls the CFO may not be able to handle.

Communication is key and investors want to reassure that they've made a sound investment decision, particularly in this tough economic environment.

7. Not Knowing How to Respond To a Crisis

CEOs and CFOs are busy people. On some days, they may find themselves getting bogged down in the minutia of budgeting. Meanwhile, on other days they may find themselves dealing with problems among their subordinates or dealing with the wording of a particular contract.

To be clear, there's nothing wrong with this. However, where some of these executives go wrong is that they spend too much time focusing on offense and not enough on defense. That is, they fail to have plans in place to deal with a crisis situation. And a result they leave their company and by extension their shareholders exposed.

What type of situations do CEOs and CFOs need to be prepared for?

Anything from a terrorist attack, to a situation where it becomes impossible for workers to access their offices, but really anything that could disrupt the daily operations of the business.

How should the CEO or CFO go about preparing such a plan?

Obviously, that often depends upon the situation – meaning what company/industry specific risks the company might face. However, there are some constants.

For example, the company might spend some time pondering what could potentially go wrong. In addition a rapid response type team might be established so that if and when a crisis does occur, the team has the potential to respond in a timely manner. But even beyond thinking about the possibilities and having the manpower, it is important that CEOs and CFOs understand the importance and the power of technology such as webcasts and podcasts as a response tool.

Why consider webcasts and/or podcasts?

Very simply, because they are generally inexpensive to produce, can be compiled quickly and have the ability to reach tons of people. Of course, utilizing the company's website and building out its investor relations tab is often important too – and such direction must come from the top.

In addition, some companies might want to build out a library or file of "canned-type" responses so that when a certain event transpires, a quick response is possible. Obviously, certain details can be left out and filled in after the event takes place. But again, the idea is to have a framework in place so that the company is ready to deal with adversity. And again, at the risk of sounding like a broken record, such direction can only come from those at the helm of the ship.

8. Not Linking Compensation to Performance

According to Forbes magazine, in 2007, the CEOs of the 500 biggest U.S. companies averaged $15.2 million in total annual compensation and the top eight CEOs on the Forbes list each pocketed over $100 million. Perhaps not surprisingly, many investors think executive pay is excessive.

In fact, it seems that calls for a reduction in CEO pay have only become louder and more frequent in this down market as stock prices decline while executive pay seems to increase. However, there is sentiment on the Street that much of the controversy could be eliminated if public companies paid chief executives based on long-term performance.

Executive pay has been a major issue for some activist shareholders. The American Federation of State, County & Municipal Employees (ASCME) has been one of the most vocal lobbyists against excessive executive pay and an advocate of independent directors to corporate boards.

The government may be getting involved in executive compensation. A bill about “say on executive pay” passed the House of Representatives earlier this year (it would allow shareholders to vote on executive pay) and House Financial Services Committee Chairman Barney Frank, who blames the recent trouble with financial companies on CEOs who were incentivized to take big risks in exchange for multi-million dollar payouts, is encouraging lawmakers to pass legislation limiting how much executives can earn. The CEO of AIG was promised a $22 million exit package after the government took over the troubled insurance giant.

But what metrics should be used to determine performance. Is it the number of hours the executive works in a day or the stock price? Or is it some other intangible?

The answer isn’t so simple, and it seems that many firms have developed their own calculations. Some set goals based on a number of metrics from cash flow, to stock price, to other company specific data points.

A December 2006 report conducted by Thomson Reuters on the subject of executive compensation practices reveals that investors prefer three specific metrics. They are: Total return to shareholders, Return on Equity, and Return on Invested Capital.

And when it comes to stock option compensation, the accompanying survey in that same report reveals that investors prefer performance contingent options.

The point is that in order to make investors happy and perhaps garner respect, CEOs should consider working with the board to make certain that compensation is based upon similar metrics subject to company specific needs and preferences.

9. Not Forecasting Properly

Predicting macroeconomic trends is not an easy task. In fact, as many economists and analysts would likely attest, it can be very time consuming and mentally strenuous. However, that doesn’t mean that CFOs and CEOs should not try to make and communicate such predictions.

Why are they so important?

Macroeconomic forecasting may help CEOs and CFOs get a better feel for how the industry/sector in which they operate will perform. It may also allow them to make more accurate company specific forecasts. (For example, an auto manufacturer may be better able to compute anticipated demand or earnings knowing the current interest rate environment and the cost of fuel, among other data points.)

Of course communicating what a company’s forward looking forecasts are predicated upon seems to make sense as well.

Why?

Allowing investors to understand the various moving parts that can potentially impact the company will give them some appreciation for just how hard making an earnings forecast can be.

What types of metrics or data points might CFOs/CEOs want to look at?

That obviously depends upon personal preferences and the business in which the company operates. For example, a clothing company might want to look at and communicate predictions for the price of cotton. Meanwhile, a major retailer might want to keep a close eye on and communicate its forecasts for oil, or even healthcare prices.

Again, the point is to let investors know the many factors that can influence the company's performance over time.

10. Taking Aggressive Risks with the Balance Sheet

As evidenced in the financial sector recently, taking risky bets can lead to the demise of a firm. For some companies, having too much debt and not enough cash to meet its operating needs can lead to its downfall. Sometimes, the dividend is at risk of being cut or eliminated altogether. Unfortunately for many companies with sub-prime exposure, the risk didn't pay off (Lehman filed for bankruptcy, AIG needed emergency funding and Merrill was sold to Bank of America).

Given how challenging it is for many companies to operate in this uncertain environment, taking risks with the balance sheet is a common mistake CEOs and CFOs make. For some, it's exposure to credit-related issues; for others, it's taking risky bets in the currency markets. In recent failures, the heavy debt levels were a major concern as were exposure to credit default swaps.

In this environment, cash is king. How does your balance sheet compare? Does your company have enough cash to pay down its debt? What are the interest rates on your commercial paper? Have you taken risky bets? What's your company's exposure to sub-prime?

To be clear, this is not to say that publicly traded companies should avoid taking on debt or engaging in derivative transactions. However, exposing one's firm to inordinate risk or aggressive risk during difficult macroeconomic times is still an all too common mistake.

Moreover, it's important that CEOs and CFOs be prepared to address debt loads and cash balances if major shareholders begin to question the company's liquidity in earnest. Remember, although it should go without saying, the common shareholder is the ultimate boss. Furthermore, institutions with sizable positions can have a dramatic impact on the value of the company (by unloading their position) if they are unimpressed with the company's liquidity situation.

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Contact us at:
thomsonreuters.com
tfcorporate@thomson.com
North America: 866.915.9891
Europe: +44.207.369.7199
Asia: +852.2533.5564

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