

## US Securities and Exchange Commission Adopts Executive Compensation and Other Disclosure Changes

On December 16, 2009, the US Securities and Exchange Commission (the “SEC”) adopted rule changes set forth in Release Nos. 33-9089; 34-61175; IC-29092, titled “Proxy Disclosure Enhancements” (the “Adopting Release”), available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>. The new rules primarily address disclosures regarding executive compensation (including policies and practices regarding risk management), director qualifications and background, involvement in legal proceedings, governance structure, and compensation consultants, as well as requiring more timely reporting of shareholder meeting results. The new rules become effective February 28, 2010.

### Executive Compensation Disclosure

**Compensation Policies and Practices Relating to Risk Management.** A key element of the new rules is a requirement to discuss overall employee compensation policies and practices, if risks arising from them “are reasonably likely to have a material adverse effect” on the company. This requirement is not limited to executive officer compensation. In determining whether employee compensation policies and practices are reasonably likely to have a material adverse effect on the company, the Adopting Release makes clear that if a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered.

The narrative disclosure requirement for compensation policies and practices relating to risk management is contained in new Item 402(s) of Regulation S-K. As such, if they are required to be provided, the new disclosures will not be contained in the compensation

discussion and analysis section. Instead, they will appear elsewhere in the executive compensation discussion. Under the new rule, no disclosure need be provided if a company determines that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

The new rule recognizes that the circumstances requiring disclosure of compensation-related risks will vary. Item 402(s) specifically identifies, as non-exclusive examples of situations that may trigger disclosure, compensation policies and practices:

- At a business unit of the company that carries a significant portion of the company’s risk profile;
- At a business unit with compensation that is structured significantly differently than it is at other units within the company;
- At a business unit that is significantly more profitable than others within the company;
- At a business unit where the compensation expense is a significant percentage of the unit’s revenues; and
- That vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The Adopting Release notes that even in the situations listed above, there might be circumstances where it could be appropriate for a company to conclude that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

To the extent that the disclosure threshold is triggered, a company will be required to discuss its compensation policies and practices as they relate to risk management practices and risk-taking incentives. In particular, new Item 402(s) contains a non-exclusive list of issues that companies may need to address, which include:

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to, or affect, risk taking by those employees on behalf of the company, and the manner of their implementation;
- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;
- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short and long term, such as through policies requiring claw backs or imposing holding periods;
- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

The level of detail that a company will need to provide in discussing these issues depends on the relevant facts for that company. Also, these requirements will not apply to "smaller reporting companies" as defined in Rule 405 under the Securities Act of 1933 and Rule 12b-2 under the Securities Exchange Act of 1934.

**Summary Compensation Table/Director Compensation Table.** Under the new rules, both the Summary Compensation Table and the Director Compensation Table have been revised to require disclosure of stock and option awards based on the aggregate grant date fair value of awards, computed

in accordance with Financial Accounting Standards Board (FASB) ASC Topic 718, formerly FAS 123R (prior to the recent FASB financial standards codification), rather than the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with FASB ASC Topic 718.

The revised requirement reflects the SEC's belief that aggregate grant date fair value will provide investors with a better understanding of compensation decisions and that it will result in a more meaningful determination of which officers should be included in the summary compensation table because grant date fair value reflects data available at the time compensation decisions are being made. If a large new hire or retention grant results in the omission from the summary compensation table of another executive officer whose compensation would otherwise have been reported, the Adopting Release states that the company can consider including compensation disclosure for that otherwise-omitted executive officer as a supplement to the required disclosures.

With respect to performance-contingent vesting conditions, the grant date fair value for performance awards reported in the Summary Compensation Table, the Grant of Plan-Based Awards Table and the Director Compensation Table will be computed based upon the probable outcome. The relevant instruction that has been added to each of these tables clarifies that this amount should be calculated consistent with the estimate of aggregate compensation cost to be recognized over the service period, determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures. In addition, a footnote is required to be added to the Summary Compensation Table and to the Director Compensation Table disclosing the award's potential maximum value, assuming the highest level of performance conditions will be achieved if an amount less than the maximum amount was included in the table.

The revised rules also require disclosure of equity awards granted during the year, rather than awards granted for performance for a specific year. The Adopting Release notes that companies should continue to analyze in their compensation discussion and analysis "decisions to grant post-fiscal year end

equity awards where those decisions could affect a fair understanding of named executive officers' compensation for the last fiscal year, and consider including supplemental tabular disclosure" of such equity grants if that facilitates understanding of the compensation disclosure and analysis.

The Summary Compensation Table for fiscal years ending on or after December 20, 2009, will need to present recomputed disclosure for each preceding fiscal year that is required to be included in the table. This means that the stock and option award columns for all years in the table will have to present the aggregate grant date fair values, and the total compensation column will have to be correspondingly recomputed. The amounts in the stock and option awards columns should be computed based on the individual award grant date fair values reported in the applicable year's Grants of Plan Based Awards Table, except for awards with performance conditions that need to be recomputed to present aggregate grant date fair value based on the probable outcome as of the grant date. If a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer for 2007, but not for 2008, the named executive officer's compensation for each of those three fiscal years must be reported. However, companies are not required to include different named executive officers for any preceding fiscal year based on recomputing total compensation for those years, or to amend prior years' SEC filings.

## Director and Nominee Disclosure

**Specific Qualifications.** The new rule requires additional information to be provided regarding directors and nominees for director. This information is in addition to that required by Item 407(c)(2)(v) of Regulation S-K regarding the specific minimum qualifications and specific qualities or skills used by the nominating committee. Specifically, for each director or person nominated or chosen to become a director, in light of the company's business and structure at the time of filing of the SEC report, the company must detail the specific experience, qualifications, attributes and skills that led to the conclusion that the person should serve as a director. The same disclosure, with respect to a proposed

nominee, would be required in the proxy materials of any proponent putting forward a nominee for director. The new disclosure of specific qualifications applies to both incumbent directors and new nominees, with the Adopting Release specifying that "[t]he final rule requires this disclosure to be made annually because the composition of the entire board is important information for voting decisions."

In addition, the new rule requires disclosure of public company and registered investment company directorships held by each director and nominee at any time during the past five years (as opposed to the existing requirement of disclosing only current directorships).

The new rule does not require disclosure of the specific experience, qualifications, attributes or skills that qualify a person to serve as a committee member. However, if a director or nominee is chosen because of a particular experience, qualification, attribute or skill related to committee service, such as audit committee membership, that would be disclosed as part of the reason why such an individual was chosen for the board service. Similarly, the new rule does not specify particular information that should be disclosed. However, particular skills, such as risk assessment or financial reporting expertise, would need to be mentioned if they constitute the particular experience, qualification, skill or attribute which led the company or proponent to conclude that the individual should serve as a director.

**Board Diversity.** Item 407(c) of Regulation S-K has been amended to require disclosure of whether and, if so, how a nominating committee or the board considers diversity in identifying nominees for director. If either the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, disclosure is required of how this policy is implemented, as well as how the nominating committee or the board assesses the effectiveness of its policy.

Diversity in this context is not defined in the rule. The Adopting Release expressly recognizes that "companies may define diversity in various ways, reflecting different perspectives" and that "some companies may conceptualize diversity expansively

to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin.”

## Involvement in Legal Proceedings

The time frame for disclosure of director, nominee and executive involvement in various legal proceedings has been increased from five to ten years. The list of legal proceedings for which disclosure is required has been expanded to include:

- Any federal or state judicial or administrative order, judgment, decree or finding not subsequently reversed, suspended or vacated, that results from involvement in mail or wire fraud or fraud in connection with any business entity;
- Any federal or state judicial or administrative order, judgment, decree or finding not subsequently reversed, suspended or vacated, based on violations of federal or state securities or commodities law or regulation, or any law or regulation respecting financial institutions or insurance companies; and
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or a self-regulatory organization.

An instruction has been added to Item 401(f) of Regulation S-K to make clear that disclosure is not required in response to either of the first two points above with respect to any settlement of civil proceedings among private litigants. Consistent with the existing disclosure requirements, no such proceedings need be disclosed if they are not material to an evaluation of the ability or integrity of a director, nominee or executive officer.

## Leadership Structure Disclosure and the Board’s Role in Risk Oversight

New Item 407(h) of Regulation S-K adds a disclosure provision requiring both a description of the board leadership structure and a statement as to why the company believes it is the appropriate structure for it given the specific characteristics or circumstances of the company. Companies will have to disclose whether and why they have chosen to combine or separate the

principal executive officer and board chair positions. If a company has combined the roles of principal executive officer and board chair, it will be required to disclose whether and why the company has a lead independent director and to discuss the specific role the lead independent director plays in the leadership of the company.

New Item 407(h) of Regulation S-K also requires a discussion of the extent of the board’s role in the risk oversight of the company, such as how the board administers its oversight function (e.g., through the whole board, a separate risk committee or the audit committee) and the effect that this risk oversight has on the board’s leadership structure. For example, this disclosure might address whether individuals who supervise the day-to-day risk management responsibilities report directly to the full board or a board committee or how the board or committee otherwise receives information from the company’s risk management employees.

## Compensation Consultant Disclosure

The new rule requires disclosure, under certain circumstances, of fees paid to compensation consultants and their affiliates if they played a role in determining or recommending executive or director compensation and also provided additional services to the company.

If the board or the compensation committee engages its own consultant to provide advice or recommendations on the amount or the form of executive or director compensation, and the consultant, or its affiliates, provided more than \$120,000 of additional services to the company or its affiliates during the company’s last fiscal year, the company must disclose the aggregate fees paid for the executive or director compensation services and the aggregate fees paid for the additional services. The disclosure would also have to state whether the decision to engage the compensation consultant or its affiliates for non-executive compensation consulting services was made or recommended by management, and whether the board or compensation committee approved the non-executive compensation consulting services.

If neither the board nor the compensation committee engaged its own executive or director compensation

consultant, but management did, and that consultant, or its affiliates, provided more than \$120,000 of additional services during the company's last fiscal year, the aggregate fees paid for executive and director compensation services and the aggregate fees paid for the additional services need to be separately disclosed.

No fee disclosure is required with respect to consultants that work with management if the board or compensation committee uses its own, separate consultant. In addition, the new rule does not treat services involving only broad-based non-discriminatory plans or the provision of information (e.g., surveys that are not customized for the company, or that are customized based on parameters that are not developed by the consultant) as consulting services with respect to the amount or form of executive and director compensation. Therefore, the new disclosure requirement is not triggered because of these excepted services unless the compensation consultant provides advice or recommendations in connection with the information provided in the survey.

There is no requirement to disclose the nature and extent of additional services that the compensation consultant or its affiliates provide to the company or its affiliates. The Adopting Release notes, however, that "companies may, at their discretion, include a description of any additional non-executive compensation consulting services provided by the compensation consultant and its affiliates where such information would facilitate investor understanding of the existence or nature of any potential conflict of interest."

## Reporting of Voting Results

Currently, the voting results of a shareholder meeting are reported in the Quarterly Report on Form 10-Q, or in the Annual Report on Form 10-K, for the period covering the date on which the shareholder meeting occurred, which may be filed months after the meeting. Under the new rule, voting results will now have to be reported on new Item 5.07 of Current Report on Form 8-K, filed within four business days after the end of the meeting on which the vote was held. If the voting results are not definitively determined at the end of the meeting, companies must disclose the preliminary voting results on Form 8-K within four business days

after the preliminary voting results are determined, and they must file an amended Form 8-K within four business days after the final voting results are certified.

## Transition Rules

On December 22, 2009, the SEC posted several Compliance and Disclosure Interpretations, available at <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>, clarifying the effective date of the new rules. These interpretations specify as follows:

- If a company's fiscal year ends *on or after* December 20, 2009, its Form 10-K and proxy statement must comply with the new rules if filed *on or after* February 28, 2010.
- Any preliminary proxy statement for a company with a fiscal year ending *on or after* December 20, 2009, must be in compliance with the new proxy disclosure requirements, even if filed *before* February 28, 2010, if the company expects to file its definitive proxy statement *on or after* February 28, 2010.
- If a company with a fiscal year ending *on or after* December 20, 2009, files its Form 10-K before February 28, 2010, and its proxy statement *on or after* February 28, 2010, the proxy statement must be in compliance with the new disclosure requirements.
- If a company's fiscal year ends *before* December 20, 2009, its Form 10-K for 2009 and related proxy statement are not required to be in compliance with the new proxy disclosure requirements, even if filed *on or after* February 28, 2010.
- Companies that are not required to comply with the new rules for their 2009 Form 10-K and related proxy statement may comply on a voluntary and discretionary basis. However, a company may voluntarily comply with the Summary Compensation Table and Director Compensation Table amendments *only* if it also complies with all other Regulation S-K amendments adopted in the Adopting Release that apply to the form filed. A company may provide any of the other new disclosures without having to comply with all of the new requirements.

- If a company's 2009 fiscal year end is *before* December 20, 2009, it will not be required to comply with the Regulation S-K amendments until the filing of its Form 10-K for fiscal year 2010. Any Securities Act or Exchange Act registration statements for such a company filed before the 2010 Form 10-K is required to be filed would not be subject to the Regulation S-K amendments.
- A new registrant that files its first registration statement (i.e., for an initial public offering or a first registration on Form 10) *on or after* December 20, 2009, would be required to comply with the new rules for such registration statement in order for it to be declared effective *on or after* February 28, 2010.
- If a shareholder meeting takes place *on or after* February 28, 2010, the voting results must be reported on new Item 5.07 of Form 8-K. If a shareholder meeting takes place *before* February 28, 2010, no Form 8-K is required to report voting results.

### Proxy Solicitation Process

The new rules do not include any of the proposed amendments relating to the proxy solicitation process and issues that have arisen with respect to proxy solicitation. These may be considered by the SEC at a later date.

### Proxy Access

On another proxy-related matter, the SEC has re-opened the comment period on its shareholder access proposal to permit comment on the additional data and analyses that have been included in the public comment file, including data and related analysis by the SEC staff. Such comments are due January 19, 2010. See Release Nos. 33-9086; 34-61161; IC-29069, available at <http://www.sec.gov/rules/proposed/2009/33-9086.pdf>. The SEC is expected to consider its proxy access proposal in early 2010, but any final rule on proxy access is not expected to apply to the 2010 proxy season. For more detail about the scope of the SEC's proxy access proposal, see our Securities Update dated July 6, 2009, titled "US SEC Proxy Access Proposal," available at <http://www.mayerbrown.com/securities/article.asp?id=7197&nid=10707>.

### Practical Considerations

Because the new rules will be effective for the 2010 proxy season, it is very important that public companies begin their preparations for implementation as soon as possible. In that regard, companies should consider the following issues:

- Revise or supplement director and officer questionnaires to request information about public company directorships held during the past five years (as opposed to just current directorships), and to request information about various legal or regulatory proceedings involving the director, nominee or officer for the past 10 years (as opposed to five years), including information relating to the expanded list of proceedings added by the new rules.
- Determine whether there are any risks relating to compensation policies and practices for employees in general that are reasonably likely to have a material adverse effect on the company. Also, consider the relationship between compensation and the management of risk. These new disclosures will likely be the subject of a significant amount of internal discussion and scrutiny and, as a result, will take a considerable amount of time to finalize. Companies should also be thinking about how they are going to gather this information and who are the appropriate internal parties that need to be involved in this process, as it may not overlap completely with the people who historically have been involved in the preparation of the proxy statement. Because it could take time to thoughtfully address this new disclosure requirement, it would be wise to prepare preliminary disclosure responsive to these concepts as soon as possible so that it can be reviewed by management and the compensation committee.
- Prepare for circulation within the company, also as soon as possible, a draft of the new discussion on the leadership structure and the board's involvement in the oversight of risk, as well as disclosure about the specific qualifications, experience and attributes of each director and nominee. Senior management and the board will likely want to review the board leadership and qualification disclosure carefully.

- Consider how best to articulate and implement the response to the new board diversity disclosure requirement. The requirement does not define what diversity means in the context of board diversity. Instead, it will permit companies to take into account various attributes that contribute to diversity in different ways. Because the diversity disclosure requirement was not part of the SEC's initial proposal on proxy disclosure enhancements, company counsel should consider specifically calling this new rule to the attention of the nominating committee in advance of its next scheduled meeting.
- Notify the persons gathering the information for the compensation tables to report stock and option awards based on aggregate grant date fair value and inform them that prior year information, and the resulting totals, need to be recalculated. Companies should be aware that the new stock and option valuation requirements may result in different individuals being the named executive officers for the purpose of compensation disclosure than would have been the case under the prior rules.
- Companies that make equity awards following the fiscal year end should consider whether, and how best, to include that information in the proxy statement to the extent it is intended as compensation for 2009. In addition to disclosure in the compensation discussion and analysis, consider whether it would be appropriate to include supplemental tables to disclose such equity awards.
- Gather information about all relationships the company has with its compensation consultants and their affiliates. For many large companies, the services may be provided to, and paid for by, separate units within the organization, perhaps in different countries. Companies may want to ask their board compensation consultants for an organizational chart and/or a list of all of their affiliates that perform services for them. To the extent that contracts with consultants prohibit disclosure of fees and services, those contracts may need to be amended to provide a carve-out when such disclosure is required by law. Companies may also want to implement procedures on a going-forward basis to track the fees provided to compensation consultants and their affiliates.
- Companies should add to their disclosure controls and procedures and their annual meeting checklists the requirement to report voting results on a Form 8-K within four business days following their annual meeting.
- Consider whether any corporate governance changes are advisable. For example, the new director qualification and diversity disclosure requirements may generate discussion at the nominating committee or full board level as to the appropriate composition of the board and whether a specific qualification or diversity policy should be adopted. In response to the disclosure requirements regarding the relationship between compensation and risk, compensation committees should focus closely on how the company's compensation policies and practices impact risk and consider whether any risk assessment procedures should be implemented.

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*If you have any questions regarding the SEC's disclosure changes, please contact the author of this Securities Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group.*

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