MAYER • BROWN

February 2010

Quarterly Review

Trustee Quarterly Pensions Review

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1. The courts tell trustees not to select against the PPF

In an important decision late last year (*Independent Trustee Services Ltd v Hope*), the High Court ruled that trustees should not use a power to buy-out members' benefits in order to improve their members' position at the expense of the Pension Protection Fund ("**PPF**"). It also indicated that, as a rule, trustees should not take decisions on the basis that the PPF will bear the burden if things go wrong.

The ruling concerned the Ilford Pension Scheme, which had a substantial deficit and an employer which was effectively insolvent. The scheme was likely soon to enter an assessment period which could lead to it falling into the PPF. If it did, members would receive a substantial proportion of their benefits from the PPF, but materially less than the benefits promised under the scheme rules.

To improve the members' position, the trustees asked the court if they could use a power in the scheme rules which appeared to let them spend a large part of the scheme's assets buying out some of the benefits before the PPF assessment period started. On the face of it, the PPF would still have had to pay members the same compensation even though most of the scheme's assets had been consumed in the buy-out, and members would have received the bought-out benefits on top of their PPF compensation. In other words, the buy-out would have left the members of this scheme better off, but at the expense of the PPF.

The court decided that the proposal went beyond the purposes for which the buy-out power was intended and that the trustees should not proceed with it. The court said that the motive behind the buy-out proposal might be to secure as much of members' benefits as possible, but that this was not the purpose of the proposal. Its purpose was to apply a disproportionately large and unfair share of assets in the buy-out. As the scheme's buy-out rule could not have been intended to allow that, using it for this purpose would be improper.

The court also held that prospective PPF compensation was not a relevant factor for the trustee to consider when exercising the buy-out power in this context, because it would be contrary to public policy and the legislative policy of the Pensions Act 2004. It followed that the scheme rules could not be amended to permit or oblige the trustee to take account of PPF compensation when exercising its buy-out powers.

As for whether the trustees could take the PPF's existence into account, there was no blanket answer. The court said it would depend on the context and the purpose of the power which the trustees sought to exercise, and how the trustees wished to take the PPF into account. This suggests that trustees could be accused of misusing their investment powers if they adopted a risky investment strategy on the basis that the PPF would bail them out if things went wrong.

2. The Pre-Budget Report: bad news for high earners

In his 2009 Pre-Budget Report in December, Alistair Darling fleshed out the Government's plans to tax high earners on the value of all their new pension saving after 5 April 2011.

He also announced a related and immediate change which extended the "anti-forestalling" rules originally announced in his 2009 Budget. From 9 December 2009, these rules could affect anyone with earnings of over £130,000 (previously £150,000) if there is a substantial change to the way their pension rights build up.

The position from 6 April 2011

From 6 April 2011, the Government intends to limit tax relief to 20% on all of a high earner's pension saving. It also means to introduce a new definition to identify the "high earners" to whom this limited tax relief will apply. Its proposed 2011 definition will apply to individuals whose pre-tax income (including pension contributions and charitable donations) in a tax year is £130,000 or more, but only if that income plus the value of their pension saving paid for by an employer in the year adds up to £150,000 or more.

The Government is consulting on how to value employer-sponsored pension saving for this purpose. In a DC arrangement, this will be simply the amount of the employer contributions to the scheme. But exactly how it will be valued in DB arrangements remains unclear. The Government has said that it wants the valuation to be fair as between DB and DC members, and as between members of different ages. All

indications are that this means the calculation will be anything but simple. At the very least, it will require schemes to calculate the exact amount of any high earning members' accrued pension at the start and at the end of the tax year. The scheme or the member will then have to apply a series of factors and offsets in order to place a capital value on any increase over the year.

In most cases, HMRC expects to claim the new tax charges due from the high earning individual himself or herself, through the self-assessment process.

But that could cause real problems in some cases: for example, where a final salary member with long service receives a big pay rise, the tax due on the increase in his or her pension could be more than the member has actually received. The Government therefore proposes to give individuals facing the highest charges (over £15,000?) the right to make their pension scheme pay the charge on their behalf; the scheme will then be allowed to reduce the member's pension (or money purchase pot) by an equivalent amount. Again, it is unclear how the Government intends DB schemes to apply the reduction. There may be no one-size-fits-all solution so we expect that legislation will let schemes choose any approach that the scheme actuary agrees is reasonable.

This new regime will place administrative burdens on any DB scheme which includes active members earning £130,000 or more. Some issues may need to be addressed well before April 2011, while others may not become issues until after the end of the 2011/2012 tax year:

- before April 2011, members earning between £130,000 and £150,000 will need advice on their likely benefit accrual in order to work out if they will count as high earners under the new definition;
- over the same period, members who *are* high earners may want accurate benefit information in order to decide whether to opt out before April 2011;
- trustees may need to decide how to implement and explain any offsets they will apply where members requires the scheme to meet their tax charge under the "scheme pays" option described earlier;
- where the "scheme pays" option actually applies, the scheme is likely to have to go through a process similar to that for implementing a pension sharing order on divorce (though the details depend on what choice schemes have and the approach they select); and
- schemes will have to provide, on a timely basis, at least the start-of-year and end-of-year benefit statements which members will need in order to complete their self-assessment forms; in practice these will need to be done with the same sort of care and precision that is applied to the calculation done when a member actually retires, on the basis that any inaccuracy could lead directly to a claim against the scheme, as it will cause a direct loss to either the member or HMRC.

We advise the trustees of any scheme that includes high earning active members to encourage their administrators not to wait for 2011 but to start preparing for the new regime soon after the final details are announced.

The extension to the "anti-forestalling" rules

The extended anti-forestalling rules now apply to anyone whose "relevant income" (again broadly their pre-tax income, including the member's pension contributions and donations), in the current tax year, or any of the last two tax years, is £130,000 or more. (For anti-forestalling purposes, "relevant income" does *not* include the value of pension savings paid for by the employer).

We discussed the anti-forestalling rules in more detail in the Summer 2009 edition of this Review. In broad terms, though, the rules impose a new tax (of up to 30% from April this year) on the value of high earners' new pension saving if there is a change to their established pattern of pension accrual or (in a DC scheme) contributions.

Where a scheme has members who earn £130,000 or more, trustees should therefore bear in mind that any material change could have unexpected and unwelcome tax implications for these members.

3. Scheme funding: taking account of post-valuation events

In a welcome move, the Pensions Regulator has recognised the unusual state of investment markets around March 2009.

It has said that, if a scheme had its effective valuation date around this period, then it may be reasonable to take some post-valuation improvements in asset values into account when negotiating the recovery plan and schedule of contributions. However, it has stressed that it would expect any variation to affect the length of the recovery plan rather than the amount of annual payments.

The Regulator's guidance can be found at:

http://www.thepensionsregulator.gov.uk/guidance/schemeFunding/technical/5360.aspx.

The Regulator also stressed that this guidance was issued strictly in response to the exceptional market conditions suffered around March 2009. It emphasises that the recovery plan should reflect what is reasonably affordable and that trustees must act in accordance with the best interests of scheme members. In future, this might involve taking account of a decline in the funding position to reflect a deterioration in asset values following extremely favourable market conditions around the effective valuation date. The implication is that employers who ask for accommodation now may have to accept in future that it goes both ways.

4. A Court ruling about benefit changes - the IMG case

SUMMARY

The High Court has ruled that amendments to convert the IMG Pension Plan from final salary to money purchase were partially ineffective. It also ruled that certain purported compromises by members were ineffective. [The case is formally called HR Trustee Limited v German.]

THE COURT'S DECISIONS

The key decisions of the Court were:

- A restriction in the original scheme documentation (which had not been carried through to documentation as it stood in 1992) protecting the "value of benefits already secured by past contributions" meant that there remained a final salary underpin for benefits relating to service before the date of the amendment.
- Even though the amendments were expressed to take effect from 1 January 1992, they were not effective until the date the amending deed was actually signed, which didn't happen until 3 March 1992, so the final salary underpin applied in relation to service until that later date.
- The fact that members signed a form indicating that they wished to continue as members of the Plan on a money purchase basis after 1 January 1992 did not mean that the members had agreed by contract to the changes or were otherwise prevented from arguing now that they were entitled to a final salary underpin.

The Court decided that on the facts there was no binding contract as the parties hadn't established that there was an intention to create "contractual relations". This was because the conversion had been presented to the employees as a "fait accompli" i.e. there was no suggestion that the Plan's conversion was dependent on the agreement of the employees. The only choice they were given was whether to continue as a member or not. They were not given any real choice.

- Section 91 of the Pensions Act 1995, which prohibits surrenders of benefits, meant that certain compromise agreements waiving rights to final salary benefits were ineffective.

The result was that while benefits for service after the amending deed was executed (rather than after the intended date of 1 January 1992) were money purchase, there remained a final salary underpin for benefits relating to service before that date.

COMMENT

While certain aspects of the High Court's decision turn on the particular facts of the IMG case (such as the precise wording of the amendment power and the member communications issued), others are potentially of more general relevance.

The High Court has (again) emphasised that need for careful compliance with a pension scheme's amendment power. It is a useful reminder that Trustees need to consider carefully the scope of the amendment power and whether the current version includes all potential restrictions when making amendments.

Some commentators have expressed concern that the Court's decision rang the death knell for making changes to pension rights through the contract of employment. Since the 1986 case of *South West Trains Ltd v Wightman*, it has been accepted that this was a valid alternative to using a scheme's own amendment power, and indeed the only option when seeking to make amendments which may be prohibited by that amendment power.

On careful reading, however, the case does not actually contradict *South West Trains*. What it does do is emphasise that when employers seek to make changes to pension rights through the contract of employment, employees must be given all the information necessary for them to make a considered decision, including an explanation of what will happen if they do not agree. Passive or uninformed employee consent will not be enough, particularly where the change is one that cannot be made through the amendment power. In South West Trains there was undeniably a concluded contract; in the IMG case the finding was that there was not.

The decision in relation to compromise agreements is surprising. Section 67 of the Pensions Act 1995 expressly allows detrimental amendments to past service benefits with member consent so it would seem strange if section 91 nonetheless means that this cannot be done.

An appeal is due to be heard in June. We hope that some of these points will be clarified by the Court of Appeal.

In the meantime, trustees should exercise caution where employers are implementing pension changes via their employees' contract of employment. They need to ensure that they are comfortable that affected employees have in fact given their informed consent before administering their scheme on the revised basis or making amendments to reflect the changes.

5. An announcement about GMP equalisation

Since 1990, trustees have been required to ensure that they provide the same pension scheme benefits for men and women.

However, it has never been entirely clear whether contracted-out schemes must also "equalise" guaranteed minimum pensions (GMPs) earned since 1990, as GMPs effectively replace benefits which would have been provided (unequally) through the state pension system if the scheme had not contracted-out. It would also be very complex and costly for schemes, as there is no straightforward way to do this.

On 28 January 2010, Angela Eagle (Minister for Pensions and the Ageing Society) made a short announcement about the Government's view on GMP equalisation. She said that any schemes eligible for the Financial Assistance Scheme – broadly those where employers became insolvent before the PPF was set up – would be obliged to equalise their GMPs. This is because, in the Government's view, European law requires schemes to address inequalities in overall benefits resulting from compliance with GMP legislation and therefore that current UK law should be interpreted in this way. She also said that there is no requirement for a member to be able to point to a "comparator" of the opposite sex in order to bring a claim, removing one of the possible defences – and she said that UK law will be changed to reflect this.

Her statement, when considered in light of the PPF's recent announcement on the subject (covered in our last Quarterly Review), indicates that trustees are increasingly being pushed towards equalising the GMPs in their schemes. But the concern remains that trustees who attempt to equalise GMPs by amending their scheme's rules could end up doing this in one way, and then incurring further unexpected costs if, as now seems likely, the Government later legislates on the subject and requires a different approach to be taken.

6. New draft guidance on internal controls

GOVERNANCE UPDATE

The Pensions Regulator is increasing its focus on scheme governance. This quarter the Regulator published its fourth annual pension scheme governance survey, announced its campaign to improve governance and administration, and it initiated the campaign with a consultation on internal controls. We take a look at the survey, the campaign, and the consultation.

THE SURVEY

The Regulator identified and surveyed "key indicators of good governance" and specific "governance activities". It noted the areas where trustees are making progress and the persistent "gaps".

Key indicators of good governance

The Regulator identified the following as key indicators of good governance: whether the board engaged in self-assessment; its attention to trustee knowledge and understanding ("**TKU**"); the frequency of meetings; the use of committees; good record keeping; the ability to recruit and retain trustees.

Governance activities

The Regulator surveyed the following trustee board "behaviours": monitoring the covenant; dealing with inducement exercises; taking decisions; managing conflicts; instructing advisers and service providers; managing administration; putting in place internal controls; handling member communications; and managing investment fund choice.

Persistent gaps

The Regulator concluded that trustee boards' behaviours in most of the areas had not changed significantly since last year's survey, but it identified persistent gaps in these areas:

- Training: large schemes perform well, small schemes do not.
- Internal controls: less than 50% of schemes are very confident that theirs are appropriate.
- Record-keeping: few schemes are aware of the Regulator's guidance on this issue.
- Investment: poor trustee understanding of how the scheme's assets are invested.
- Employer covenant: poor trustee understanding of how to assess the covenant.

THE CAMPAIGN TO IMPROVE GOVERNANCE AND ADMINISTRATION

The governance campaign is the Regulator's response to the persistent problem areas. The Regulator announced that it will take the following steps to close the gaps:

- Publish a revised TKU code and scope guidance and update the Trustee toolkit.
- Provide updated guidance on internal controls.
- Consult on new proposals for record-keeping.
- Update its guidance on winding-up pension schemes.

THE CONSULTATION ON INTERNAL CONTROLS GUIDANCE

The Regulator's proposed internal controls guidance is substantially different from the current guidance. It shows trustees not only how to use the now familiar internal controls methodology, but it shows trustees how to use the guidance the Regulator has issued on a variety of topics. Helpfully, it specifically identifies key risks and suggests relevant controls. More significantly, it tells trustees what "behaviours" it expects to see in all of the significant areas of scheme governance.

While the Regulator developed the guidance specifically to help trustees of smaller schemes, it gives trustees of larger schemes a useful benchmark against which to test and review their internal controls. The consultation period ends on 1 March 2010. We expect the guidance to become final this year.

We strongly encourage trustees to review their scheme's internal controls for compliance with the guidance. Even if the guidance is not adopted as a whole, it gives trustees a very useful insight into the Regulator's expectations. Putting in place internal controls is also a good way to make the TKU requirements meaningful and to learn about your scheme.

We are designing an on-line self-assessment questionnaire (based on the latest scope guidance) and have developed our own compliance-based internal controls workshop (based on this proposed guidance). Please let us know if you are interested in learning more about them.

7. Amendment powers that require HMRC consent

Some schemes historically had a restriction on their amendment power which prohibited amendments without HMRC's express consent. In practice these have been ignored since A Day (6 April 2006), when obtaining HMRC consent to rule amendments ceased to be a statutory requirement, and HMRC stopped providing formal consents: there was no practical alternative to ignoring restrictions like that, and it seemed reasonable anyway to assume that, if HMRC could not reject a rule amendment, then it had implicitly consented to it.

We finally have formal confirmation that restrictions of that sort can be ignored – at least until 5 April 2011.

Regulations published last December say that, between A- Day and 5 April 2011, restrictions on amendment powers that require HMRC consent to any amendment (however that restriction is worded) have had no effect. (The Finance Act 2004 allows HMRC to modify scheme rules in connection with the A-Day legislation only for the five years after A-Day).

This leads to the issue of whether restrictions of this type can actually be removed from a scheme's amendment power. Whatever the strict legal answer to that question may be, help is at hand. The Government aims to issue related regulations later this year, which will let trustees remove restrictions like that from their amendment powers by resolution. We anticipate that many trustees will want to use this new power, in order to avoid any suggestion that the old restriction will come back to life in April next year when the December 2009 Regulations cease to operate. We will return to this issue when the promised new regulations appear.

8. Some deadlines this spring: the PPF levy and retirement before 55

Trustees should remember two deadlines which are rapidly approaching. One relates to the PPF levy for 2010/11. The other affects members who want to draw their pensions before age 55.

The PPF levy deadline

If schemes want the PPF to take account of their contingent assets (parent company guarantees, security over employer property and so on) in setting their 2010/11 levy, the scheme must submit a contingent asset certificate to the PPF (including any documents required in paper form) no later than **5pm on 31 March 2010**.

New contingent assets

Any trustees hoping to put a new contingent asset in place before that date should speak as soon as possible to their usual Mayer Brown contact to discuss the process. The time required depends on the asset to be granted (for example, securities over land and guarantees given by an overseas guarantor tend to take longer to set up because of the need to involve other parties). We may be able to suggest an alternative approach and can put forward a timetable to implementation.

Re-certifying existing contingent assets

Even if a contingent asset has been recognised by the PPF for previous levy years, it must still be "re-certified" to the PPF this year (via "Exchange", the PPF's online registration service) by **5pm on 31 March 2010.** Failure to do this will mean that the asset will not be taken into account for the levy year 2010/11.

If there are no changes to the existing arrangement, then the re-certification process normally just requires trustees to confirm this by submitting a partially pre-populated certificate which is available online. However, there is an important exception to this for any securities (charges, mortgages etc) that involve real estate, if the most recent valuation that was supplied to the PPF is more than 15 months before the date of the new contingent asset certificate: in this case, a new valuation, or at least an up-to-date confirmation of the old one, will also need to be submitted as part of the re-certification process.

If you are making changes to the existing arrangement this will need to be done by deed and a certified copy will need to be submitted to the PPF in paper form before the deadline, along with any supporting documentation.

Check your sponsoring employer's failure score

For the purpose of calculating the 2010/11 levy, the PPF will use the Dun & Bradstreet (D&B) failure score assigned to an employer as at 31 March 2009. If you wish to influence these scores for the next levy year, again the deadline for providing information to D&B is **5pm on 31 March 2010.**

For more information about contingent assets please see our client alert "Managing your PPF Levy" or speak to your usual contact in the pensions team.

The deadline for retiring before age 55

Pension scheme members should by now be aware of the change to normal minimum pension age, which will affect those drawing benefits after 5 April this year.

After that date, the earliest time that most scheme members will be able to draw their pension (without incurring tax penalties) is their 55th birthday. The exceptions are members retiring early on ill-health grounds and those with a "protected pension age" of below 55, typically their 50th birthday. Members with a protected pension age will continue to have the right to draw their pension from that age even after 5 April 2010.

Generally a member will have a protected pension age only if the scheme rules (as they stood on both 10 December 2003 and 5 April 2006) gave the member a right to draw his or her pension from an age below 55 without needing anyone else's consent, and he or she was already a member on 5 April 2006.

HMRC has published guidance in relation to members who will reach their normal minimum pension age on or around 6 April 2010. HMRC Pension Schemes Newsletter 38 clarifies certain matters relating to the timing of payment of pension commencement lump sums and pensions around that date.

See also HMRC's guidance issued in January which includes a glossary of terms and some questions and answers, which is available on their website: http://www.hmrc.gov.uk/pensionschemes/min-pen-age.pdf

9. A tax simplification deadline next year

As we have mentioned elsewhere in this Review, the Finance Act 2004 gave HMRC a power to modify scheme rules for a five-year transitional period until 6 April 2011.

The most important modifications made under this power were the ones contained in the Registered Pension Schemes (Modification of the Rules of Existing Schemes) Regulations 2006. These override schemes' rules so that, unless and until the scheme is amended to disapply the Regulations, certain provisions are automatically included in scheme rules until 5 April 2011. The most important of these provisions are:

- where the scheme's rules restrict a benefit or transfer payment to an amount which does not prejudice Revenue approval, that restriction will continue to be read as limiting the payment to the same extent as if the pre-6 April 2006 tax regime still applied;
- the trustees are not obliged to make an unauthorised payment (even if the scheme rules would otherwise require it to do so);
- the earnings cap continues to apply; and
- the trustees are entitled to recover a lifetime allowance charge from a member's benefits.

The Pensions Act helpfully gives trustees a specific power to amend their schemes by resolution in order to achieve the same effect as the Regulations (but without the 2011 time limit). Most schemes took advantage of these powers, to incorporate all of those overriding provisions into their own scheme rules (but on the basis that they would not automatically stop operating in 2011). This allowed them to retain any pre-A Day Inland Revenue limits for as long as they want to keep them, but also let them disapply any limits that they did not want.

However, schemes which have not yet started that process (by incorporating those overriding provisions into their own rules) now only have a year or so to make the amendments allowed by the Pensions Act, if they want the pre-A Day limits still to apply. If they do not, they may find that members whose benefits were restricted by Inland Revenue limits get a windfall, certainly at the expense of the employer but possibly also at the expense of the security of other members' benefits.

10. Government proposals to allow electronic disclosure

The Government has published a response to its consultation last year about possible changes to trustees' duties to give information to scheme members. Taking into account the concerns expressed by the industry (including this firm), the Government has dropped its original proposal to include a broadly-drafted over-arching disclosure principle in addition to the specific disclosure duties set out in current legislation.

Trustees will generally welcome the Government's change of direction here. The over-arching disclosure principle the Government had originally suggested was at best unclear, and might have imposed substantially higher duties on trustees than currently exist – which was the opposite of what the Government said it was trying to achieve.

For similar reasons the Government has also withdrawn its earlier proposals to replace specific timescales for disclosure with an over-arching principle.

The Government does however propose to implement its original and helpful proposal to let schemes provide information to members electronically, for example through a website or by email, rather than in paper form. The Regulations would still let individual members elect to have information provided in paper form if they so wish.

Legislation allowing electronic disclosure is likely to come into force on 1 October 2010.

11. The latest news on personal accounts

The Government issued eleven sets of regulations in January about employers' obligation to enrol workers automatically into "qualifying schemes" – either a scheme of their own or the new personal accounts scheme set up under legislation (now known as the "NEST") starting in April 2012.

Under the final regulations, smaller employers will wait longer before they are first obliged to comply with the automatic-enrolment requirements. A specific "staging date" from which the requirements will apply will be allocated to each employer, depending on its size. The range of possible staging dates extends from 1 October 2012 (for the largest employers with 120,000 or more employees) to 1 September 2016 for the smallest employers.

This is coupled with an extended transitional period for qualifying DC schemes. The minimum rate of contributions required will increase in stages, reaching the full 8% total on 1 October 2017 (comprising 3% employer contributions, 4% employee contributions and 1% in tax relief). Employers who provide qualifying defined benefit schemes and certain hybrid schemes will be able to defer the automatic-enrolment requirements for four years until October 2016.

Trustees and employers will wish to work together to check that their existing schemes meet the conditions for counting as qualifying schemes before their staging dates.

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February 2010