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December 17, 2013

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Financial Institutions Regulation Group Client Alert:

Still Global: The Final Volcker Rule and its Impact on Foreign Banks

On December 10, 2013, five federal financial services regulatory agencies ("Agencies") promulgated the final rule ("Final Rule")[1] implementing Section 619 of the Dodd-Frank Act,[2] commonly known as the "Volcker Rule." The Final Rule is a broad and exceedingly complex set of interlocking provisions that are applicable to a large number of banking entities. It is most accurately described as two related, but largely separable, rules: one bans proprietary trading and one strictly limits investments in "covered funds," both subject to detailed exemptions. The Final Rule applies to any bank holding company and any company that is treated as a bank holding company for purposes of U.S. banking law, as well as all of their affiliates and subsidiaries, whether inside or outside the United States. It also imposes heavy compliance and reporting obligations on covered banking entities.

Because the Final Rule is so complex, we plan to analyze its impact through a series of Client Alerts over the coming weeks, each addressing a smaller set of specific issues. In this first installment, we begin to address the impact of the provisions that apply to non-U.S. banking entities and to cross-border financial transactions. Any non-U.S. banking entity that operates a branch or agency office in the U.S., or that controls a U.S. subsidiary bank, and the parent of each such entity ("foreign banking organization" or "FBO"), is subject to the Final Rule's restrictions. In broad terms, these prohibit the banking entity from purchasing or selling certain types of securities, derivatives, and futures transactions for its trading account unless it can demonstrate that such purchase or sale is undertaken pursuant to one of the enumerated exemptions, such as for market-making, underwriting or risk-mitigating hedging. Accordingly, all banking entities in the U.S. will need to establish detailed compliance systems in order to allow their trading desks to continue to engage in the various types of short-term trading permitted by the Final Rule. The Final Rule also

[1] Federal Reserve, OCC, FDIC, CFTC, SEC "Proprietary Trading and Certain Interests in and Relationships with Covered Funds" (December 10, 2013) (Final Rule).
[2] "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," 76 Fed. Reg. 68,846 (Nov. 7, 2011).

severely limits an FBO's ability to invest in, or sponsor, covered funds, unless the FBO can also demonstrate that such relationship is within an exemption.

In comments to the Agencies on the proposed rules implementing the Volcker Rule issued in October 2011 (the "Proposed Rule"), FBOs noted that it would be confusing and counter-productive, and not consistent with comity, to impose the detailed compliance regime required by the rule on the activities of foreign banks outside the U.S. As detailed further below, however, while the Agencies adopted many of the comments submitted by FBOs on the Proposed Rule, the Final Rule still creates significant compliance burdens for such organizations outside the United States. Furthermore, there remain a number of interpretive uncertainties with respect to the extra-territorial reach of the Final Rule, some of which can likely only be addressed in the context of ongoing discussions with the Agencies overseeing the implementation of the Final Rule.

1. Trading Outside the U.S. (§_.6)(e))

The Proposed Rule offered a narrow exception from the ban on proprietary trading for FBOs to trade "solely outside of the United States" (commonly known as "SOTUS"). Given the complicated compliance regime that attends most of the other exemptions from the proprietary trading ban, the SOTUS exemption was the only means under the Proposed Rule by which FBOs could avoid creating conflicts between the detailed compliance obligations of the Proposed Rule and the regulatory requirements of their home (and other host) countries. Many FBOs and industry groups commented to the Agencies about the problems with the SOTUS exemption as proposed, including that it focused too heavily on territorial concerns of who sat where while ignoring where the risk from a trade actually resided. In addition, the Proposed Rule discouraged the use of U.S. market infrastructure for the payment, settlement and clearing of financial transactions, limiting the ability of FBOs to use these risk-reducing options for non-U.S. transactions.

The Final Rule solves some of the issues raised by the Proposed Rule but imposes additional hurdles for FBOs seeking to rely on the exemption (which we refer to here as "Trading Outside the United States," or "TOTUS"). TOTUS works as follows: an FBO can trade as principal outside of the U.S. without having to show that the trade falls into another compliance-laden exemption (such as market-making or risk-mitigating hedging) if:

(i) the personnel of the banking entity (or its affiliates) that arrange, negotiate, execute or decide to undertake the trade are not located in the U.S.,

(ii) the banking entity making the decision to trade is not located in the U.S. or organized under U.S. law,

(iii) the trade is not booked as principal by any branch, affiliate or subsidiary of an FBO located in the U.S. or organized under U.S. law,

(iv) no financing of the trade is provided, directly or indirectly, by any branch, affiliate or subsidiary of an FBO located in the U.S. or organized under U.S. law, and

(v) the trade is not conducted with or through any U.S. entity, which includes any entity (including a branch of a foreign bank) that is located or organized in the U.S., or is controlled by or acting on behalf of another U.S. entity, except:

(A) the non-U.S. operations of a U.S. entity may be a counterparty so long as no personnel involved in the arrangement, negotiation or execution of the trade are located in the U.S.,

(B) FBOs may use an unaffiliated market intermediary located in the U.S. as principal followed by the prompt clearing and settlement of such trade through a clearing agency or derivatives clearing organization; and

(C) FBOs may use an unaffiliated market intermediary located in the U.S. as agent to effect an anonymous trade on an exchange or similar platform followed by the prompt clearing and settlement of such a trade through a clearing agency or derivatives clearing organization.

As compared with the requirements of the Proposed Rule, TOTUS now permits FBOs to use U.S. market infrastructure to execute, settle and clear trades. It also permits FBOs to trade with the non-U.S. operations (including branches and subsidiaries) of U.S. banks (and other entities), so long as no person within the U.S. is involved in the trade. This change goes a long way to simplify the trading environment for FBOs outside the United States, as under the Proposed Rule, an FBO could not use SOTUS to trade with a U.S. bank in any form anywhere in the world.

Unfortunately, at least as written, and without further discussion with the Agencies, the new TOTUS regime appears to be too narrow to prevent the full-scale export of the compliance regime required by the Final Rule to the trading desks of FBO operations outside the United States. First, the definition of U.S. entity in prong (v) is broad, reaching both the U.S.-based broker-dealer affiliates of FBOs and any affiliate of any U.S. banking organization or broker-dealer. Thus, any trade intermediated or facing those entities would not qualify for TOTUS. Second, it does not appear that the TOTUS exemption for trading with U.S. entities through market intermediaries ((v)(B) and (C) above) is broad enough to allow access to the U.S. market without use of the other exemptions. Both prongs of the exemption require the transaction to be cleared, but there will remain a wide variety of transactions, especially in the OTC derivatives field, that will remain bilateral.[3] If trading desks of FBOs outside the U.S. must use the exemptions for market-making, underwriting or

[3] Even transactions as common as foreign currency swaps (which are covered transactions under the Final Rule) generally are not cleared through derivatives clearing organizations today. It is also not clear whether the reference to clearing was intended to include typical bond settlement systems, though it seems reasonable that these should be covered.

hedging to trade in uncleared instruments with counterparties inside the U.S., they apparently will be forced to implement the detailed U.S.-specific Volcker compliance regime in their home (and other host) countries. Their only alternative will be to access the liquidity of the U.S. markets through the non-U.S. offices of U.S. banks.

Significantly, the availability of the TOTUS exemption continues to depend on the physical location of FBO personnel involved in a trade. In a manner similar (though not identical) to the Proposed Rule, if an FBO's personnel located in the U.S. "arrange, negotiate or execute" a trade, TOTUS is unavailable for that trade, no matter how little involvement such people otherwise had with the trade. This location-based restriction means that U.S.-based personnel cannot solicit, sell or arrange trades without triggering the more onerous compliance obligations of the Final Rule, though such personnel could engage in back-office functions such as trade clearing or settlement, without being seen to be arranging, negotiating or executing a trade.[4] This focus on personnel location presents a hurdle for FBOs that wish to manage part of their business in the U.S. while booking trades outside of the U.S. While the stated purpose of this provision is to keep the risk of non-U.S. proprietary trades outside of the U.S., it is hard to see how having U.S. personnel perform some (or any) function as part of a trade increases any U.S. risk.[5] In fact, this provision appears to contradict another statement in the preamble, relating to the non-U.S. trading activities of U.S. banking entities, that "[t]he risks of proprietary trading would continue to be borne by the U.S. banking entity whether the activity is conducted … through units physically located inside or outside of the United States."[6] That statement recognizes that risk lies where trades are booked, rather than where some personnel sit. Nevertheless, apparently in an effort to create a level playing field between the U.S. banking entities and the FBOs, the Agencies will require FBOs to use one of the other exemptions from the proprietary trading ban if any U.S.-based personnel or entities are modestly involved in the transaction.

Finally, the Final Rule adds a requirement to the effectiveness of TOTUS that the trade not be financed "directly or indirectly" by the U.S. branch or agency of an FBO located in the U.S. or organized under the laws of the U.S. It is unclear to what this provision refers. The preamble merely states that it is not intended to restrict the ability of U.S. branches and agencies of FBOs to provide funding to their foreign head offices.[7] FBOs seemingly must ensure that they raise funding for proprietary trading outside of the U.S. and document the non-U.S. source.

2. Trading Sovereign Debt (§_.6)(a and b)

Among the most contentious issues raised by the Proposed Rule was that it offered an exemption from the proprietary trading ban for trading in U.S. government securities, but the exemption covered only government securities issued by U.S. federal or State governmental entities (or by their subdivisions). This provision

[4] Preamble at 421.
[5] Id. at 423.
[6] Id. at 435.
[7] Id. at p. 422, footnote 1522.

meant that FBOs would be limited in their ability to effect proprietary trades in securities issued by their own sovereign, even potentially if traded from outside of the United States.[8]

Many commenters submitted comments to the Agencies arguing against the proposed provision on the grounds that it was unnecessary (since sovereign debt carries far less risk), was needlessly extra-territorial, would limit the ability of sovereign nations to fund their nations' activities, would violate treaties entered into by the United States, was discriminatory, and in many jurisdictions would have an adverse effect on the most liquid capital markets.

In response, the Final Rule divides the exemption for trading in government securities into separate sections: one for U.S. government obligations and a separate section for foreign government obligations.[9] Proprietary trading in U.S. obligations is expressly permitted in (i) obligations issued or guaranteed by the United States, (ii) obligations, participations or other instruments issued or guaranteed by an agency of the United States or certain government sponsored enterprises,[10] (iii) obligations of any State, political subdivision or municipality, and (iv) obligations directly or indirectly issued by the FDIC. With respect to U.S. government obligations, any branch, subsidiary, or affiliate of an FBO (and domestic banking entities) may enter into a proprietary trade with any other counterparty anywhere in the world.

Home Country Relief for FBOs

The exemption for trading in foreign government obligations is politically balanced, but also limited. FBOs may enter into proprietary trades in certain types of securities, derivatives, and futures transactions that are obligations of, or issued or guaranteed by, the foreign sovereign under the laws of their "home country," that is, the country where the FBO is organized. Permissible instruments under this exemption include (i) obligations of a multinational central bank of which the home country sovereign is a member (such as the European Central Bank for banking entities organized under the laws of a country in the European Union), and (ii) instruments issued by any agency or political subdivision of the relevant foreign sovereign. The only restriction to this narrow exemption is that a U.S. insured depository institution controlled by an FBO may not engage in proprietary trading in the government obligations of its parents' home country. Helpfully, an FBO no longer needs to be concerned about the legality of trading the sovereign obligations of its home country (or any subdivision thereof), whether traded within or outside of the U.S. and no matter who the counterparty.

[8] Such trading might have been permissible under other exemptions, such as the exemptions for trading outside of the U.S., market-making or liquidity management.

[9] Final Rule at §_.6(a) and (b).

[10] Government-sponsored enterprises are the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971.

Host Country Relief for Foreign Subsidiaries of U.S. Banks

Finally, we note that the Final Rule provides limited relief to non-U.S. subsidiaries of U.S. banking entities, which is similar to its treatment of FBO branches and subsidiaries, but does not extend to non-U.S. branches of U.S. depository institutions. These non-U.S. subsidiaries (if licensed or treated under applicable non-U.S. law as banks or securities dealers) may trade for their own account in the obligations of the sovereign of their chartering country in the types of sovereign obligations discussed above. This modification represents a concession and a significant change of interpretation by the Agencies, which had previously stated (and state again in the preamble) that U.S. banking entities must comply with the Volcker Rule worldwide.[11] The Agencies apparently accepted the comments of U.S. banks that they needed limited relief of this kind in order to compete effectively outside of the U.S., as well as the comments from non-U.S. governments concerned that a worldwide prohibition applied to U.S. banks could significantly reduce liquidity in important local sovereign markets.

No "Third Country" Relief

The Agencies declined, however, to extend the exemption to sovereign debt other than of the "home" and "host" countries. Thus, both FBOs and U.S. banking entities will need to find another exemption when trading in sovereign debt of countries other than the home country of organization of the banking entity's parent or the country in which the branch or subsidiary is located. It is clear from the preamble that the Agencies expect the markets in sovereign debt to continue unimpeded outside the U.S.[12]

3. Investing in Covered Funds Outside of the U.S. (§_.13(b))

The Proposed Rule offered an exemption for FBOs to make investments in, and sponsor, covered funds without restriction outside of the U.S., similar to the SOTUS exemption for proprietary trading. As with proprietary trading, the proposed exemption was too narrow to fully cover most FBOs' non-U.S. business. The Final Rule provides significant relief with respect to targeted forms of cross-border covered funds business; however, certain issues raised by the Proposed Rule remain and there are some new hurdles.

The "foreign fund exemption" in the Final Rule is available to FBOs (or banking entities) (i) that satisfy certain tests to ensure that they and their activities remain primarily outside of the U.S., (ii) that engage in activities outside of the U.S. pursuant to Section 4(c)(9) or (13) of the Bank Holding Company Act of 1956, as amended,[13] (iii) where no ownership interest in a covered fund is offered for sale or sold to a U.S. resident, and (iv) where the activity of the investment occurs solely outside of the U.S.

[11] Preamble at 378.
[12] Id. at 379.
[13] 12 U.S.C. § 1843(c)(9 and 13) (2013).

An activity is solely outside of the U.S. if (i) the banking entity, acting as sponsor or investor, is not organized under U.S. law or controlled by a U.S. entity, (ii) the banking entity and its relevant personnel making the decision to invest are not located in the U.S.,[14] (iii) the investment or sponsorship is not booked as principal in the U.S. by a branch or affiliate of the FBO that is located in the U.S. or organized under U.S. law, and (iv) no financing of the ownership or sponsorship of a fund interest is provided, directly or indirectly, by any branch, affiliate or subsidiary of an FBO located in the U.S. or organized under U.S. law. For these purposes only, a U.S. branch, agency or U.S. depository subsidiary is considered to be located in the U.S., but the rest of an FBO located outside of the U.S. is not.

The foreign fund exemption in the Final Rule continues several problematic limitations for FBOs, however. It is important to note that the Agencies acknowledge that the "statute does not explicitly define what is meant by 'solely outside of the United States'."[15] Therefore, the Agencies appear to have interpreted these words to conform with, or at least not violate, certain public policy considerations that they believe underlie the covered fund restrictions in the Final Rule. Any application of the foreign fund exemption to specific factual circumstances should keep these policy considerations in mind as well.

The most problematic limitation of the foreign fund exemption is the requirement that no person relevant to the decision to enter into an investment or sponsorship of a covered fund may be located in the U.S. The Agencies state that the foreign fund exemption of the Final Rule was intended to "better reflect the purpose of the statute by ensuring that the principal risks of covered fund investments and sponsorship … occur and remain solely outside of the United States."[16] In implementing this purpose, the Agencies claim to have adopted a "risk-based approach."[17] However, this claim cannot be squared with the provisions of the foreign fund exemption that act to disqualify an FBO from using the exemption should a decision-maker be located in the U.S., even if the investment is booked outside of the U.S. Neither the Final Rule nor the preamble offers useful guidance regarding how FBOs should analyze how decisions are made and who within their framework is a "decision" maker. The Final Rule does state that "back-office" activities engaged in by U.S. personnel do not amount to decision-making.[18] The preamble lists such back-office activities to include the provision of administrative or similar functions to a covered fund, such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund, and also acting as investment advisor in certain circumstances.[19] But there is no discussion of whether the use of U.S. personnel helping to structure, arrange,

[14] Unlike the TOTUS exemption in the proprietary trading portion of the Final Rule, the SOTUS exemption for covered funds appears to remain available if personnel located in the U.S. "arrange, negotiate or execute" certain aspects of the transactions related to the creation of the fund.
[15] Preamble at 726.
[16] Id. at 735.
[17] Id. at 736.
[18] Id. at 737.
[19] Id. at 737-38.

analyze or otherwise create or review an investment in a covered fund (short of making the decision to invest or sponsor) would make the foreign fund exemption unavailable.

4. Foreign Public Funds (§_.10(c)(1))

Closely related to the foreign fund exemption is the definition in the Final Rule of foreign public funds. Many commenters noted that the Proposed Rule did not define as covered funds U.S. mutual funds and similar retail investment structures, but captured highly similar non-U.S. structures. While some suggested that FBOs could organize and invest in those structures (such as non-U.S. mutual funds and UCITS) pursuant to the foreign fund exemption, the Agencies answer definitively in the Final Rule that such structures are not covered funds and are therefore entirely outside the scope of the Final Rule.

A foreign public fund refers to an issuer that (i) is organized or established outside of the U.S., (ii) is authorized to offer and sell interests to retail investors in its home jurisdiction, and (iii) sells interests predominantly through public offerings outside of the U.S. If a U.S. banking entity wishes to organize a foreign public fund, it can do so if the interests in such fund are sold predominantly to persons other than (A) the U.S. banking entity, (B) the issuer, (C) affiliates of either, and (D) directors or employees of either. The Final Rule defines a "public offering" in this provision as a distribution of securities outside of the U.S. to investors that include retail investors if (1) the distribution complies with all applicable country regulatory requirements, (2) it is not restricted to investors having a minimum level of net worth or assets, and (3) the issuer has filed or submitted offering disclosure documents to a relevant regulatory authority.

The Agencies note that the Proposed Rule covered any entity that, but for Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 ("40 Act"), would be investment companies under the 40 Act. Many funds that were not entities similar to the hedge funds or private equity funds intended to be covered by Congress were captured by this expansive definition, even if they were eligible for exemptions provided in the Proposed Rule. The Final Rule remedies some of these concerns by providing expressly that certain classes of entities that would have been covered pursuant to the Proposed Rule are expressly exempted from being covered funds. As the Agencies stated, they have moved from the approach of the Proposed Rule of a "default definition" of a covered fund to a more "tailored definition" of a covered fund.[20]

The foreign public fund exclusion is intended to exempt widely offered, non-U.S. funds, and it largely appears to accomplish this goal. Therefore, UCITS, non-U.S. mutual fund equivalents, foreign exchange-traded funds, foreign unit trusts, and non-U.S. issuers of asset-backed securities should all qualify for the exclusion. FBOs must review a few detailed requirements in order to ensure that specific foreign public funds qualify. First, they must be sold predominantly to retail investors.

[20] Id. at 478.

While not defined in the Proposed Rule, retail investors are listed in the preamble as members of the general public not possessing financial sophistication or investment experience, and who are entitled to the full protection of their home country securities laws.[21] Second, the Agencies state that in order to be considered to be selling interests predominantly outside of the U.S., they expect that an offering would qualify if "85 percent or more of the fund's interests are sold to investors that are not residents of the United States."[22] Third, a foreign public fund must offer its interests in a public offering, which is defined in the Final Rule to mean a "distribution" under (§_.4(a)(3)) of securities (and other interests, presumably) as described above. In all, an offering must be publicly available as is usual under its home country markets.[23]

Finally, as noted above, this exclusion represents one of the few parts within the Final Rule that permits a U.S. entity to engage outside of the U.S. in activities that are prohibited inside the U.S. Under the conditions we describe above, a U.S. banking entity can sponsor a foreign public fund and rely on this exclusion so long as it sells the interests predominantly to third parties, which again is described as 85 percent or more.[24] The Agencies note, however, that the foreign fund exclusion is not intended to permit U.S. banking entities to purchase non-U.S. fund interests and that they will monitor the holdings of U.S. banking entities to ensure compliance.[25]

5. Reporting Requirements (§_.20(d))

FBOs with substantial trading operations in the U.S. will now have to submit to the relevant Agency periodic reports on the proprietary trading activities that each trading desk conducts under available exemptions. These reports are intended to assist the Agency in determining whether the banking entity is complying with the proprietary trading provisions of the Final Rule. Within a relatively short timeframe, FBOs will have to develop systems that will enable them to gather a tremendous amount of data and make various detailed calculations on a daily basis since the reports must include seven quantitative measurements, including, among other things, the position limits for each trading desk, the value-at-risk of the trading activities of each desk, and the extent to which trades at each trading desk are customer-facing. Notably, the Final Rule requires this data on a trading desk basis, which is defined in part as the "smallest discrete unit of organization" of an FBO that trades a financial product.[26] So, even if an FBO currently collects any of this data on a consolidated basis, it may still face considerable systems challenges to reorganize the data on a trading desk basis.

In contrast to a U.S. banking entity, which is subject to the reporting requirements based on the amount of its global trading assets, an FBO generally will only be

[21] Id at 505.
[22] Id. at 506.
[23] Id. at 507.
[24] Id. at 507-08.
[25] Id. at 509.
[26] Final Rule, Appendix A, 2. Definitions.

subject to these requirements if the average gross sum of the trading assets and liabilities of the operations of all of its U.S. subsidiaries, affiliates, branches and agencies (excluding obligations of or guaranteed by the U.S. government or agency) over the previous consecutive four quarters is at least $50 billion (although this reporting threshold will decrease over time). This provides some relief for FBOs with substantial global trading activities but with U.S. trading activities below this threshold as those FBOs could otherwise be subject to the reporting requirements. It is not clear from the Final Rule how the Agencies will define "trading assets and liabilities," but our initial view is that this reporting should be consistent with the booking of transactions for regulatory accounting purposes. Thus, an FBO that books trades outside of the U.S. should not have to include those trades in its calculation of its trading assets and liabilities, even if those trades have a nexus to the U.S. and would presumably be covered as proprietary trades under the Final Rule.

An FBO meeting the $50 billion threshold must begin submitting these reports in August 2014 (that is, 30 days from the end of July 2014) with respect to data covering July 2014. For the first half-year that this requirement is effective, an FBO will have 30 days from the end of each calendar month to submit each report, but starting January 2015 it will have to submit a report within 10 days.

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