

Clients & Friends Memo

CRA3 – New Requirements Affect Issuers, Originators and Sponsors as well as Rating Agencies

30 July 2013

On 20 June 2013, the European Regulation known as CRA3¹ (“**CRA3**”) came into force. CRA3 not only amends the European regulatory framework for credit rating agencies (“**CRAs**”), but also contains certain important obligations for issuers, originators and sponsors.

CRA3 introduces the following new provisions:

- a requirement to appoint at least two CRAs in respect of rated structured finance instruments;
- a requirement to consider appointing at least one small CRA;
- a joint obligation for issuers, originators and sponsors of structured finance instruments to publish certain information in relation to the underlying assets and the transaction;
- measures intended to reduce over-reliance on credit ratings; and
- rotation requirements for CRAs in relation to re-securitisations,

as well as other requirements which expand the previous regulatory framework for CRAs.

Background

Regulation (EC) No. 1060/2009 of 16 September 2009 on credit rating agencies (as amended, the “**CRA Regulation**”)² established a framework for credit ratings issued by CRAs

¹ Regulation (EU) No. 462/2013 of 21 May 2013, which can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:146:0001:0033:EN:PDF>.

² The CRA Regulation can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF>.

It was amended by Regulation (EC) No. 513/2011 of 11 May 2011 which can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:145:0030:0056:EN:PDF>.

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within the European Community.³ The CRA Regulation includes the following provisions:

- requirements for CRAs established in the European Community⁴ to be registered;
- requirements in relation to the conduct of business of CRAs, including measures intended to avoid conflicts of interest, to ensure the quality of credit ratings and rating methodologies and to ensure transparency; and
- requirements for the supervision of CRAs in the EU by the European Securities and Markets Authority (“ESMA”).

CRA3 amends the regulatory framework established under the CRA Regulation in order to address issues such as:

- over-reliance on external credit ratings;
- potential conflicts of interest, including those arising from the “issuer-pays” model;
- lack of transparency in relation to sovereign debt ratings; and
- limited liability of CRAs in relation to the credit ratings they have issued.

Below is a summary of some of the new requirements under CRA3.

Two credit ratings required for rated structured finance instruments

Where an issuer or a related third party⁵ intends to solicit a credit rating for a structured finance instrument,⁶ it is required to appoint at least two independent CRAs.

This requirement will apply only to new transactions and transactions where a new credit rating is sought, as it applies where an issuer or related third party “intends to solicit” a credit rating. There are some questions over the jurisdictional scope of this provision.

³ References to the “Community” (i.e. the European Community) in the CRA Regulation have now been replaced under CRA3 with references to the Union (i.e. the European Union).

⁴ See previous footnote.

⁵ “related third party” means “the originator, arranger, sponsor, servicer or any other party that interacts with a credit rating agency on behalf of a rated entity, including any person directly or indirectly linked to that rated entity by control”.

⁶ “structured finance instrument” is defined in the CRA Regulation as “a financial instrument or other assets resulting from a securitisation transaction or scheme referred to in Article 4(36) of Directive 2006/48/EC”. Under Article 4(36) of Directive 2006/48/EC, “securitisation” means “a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics:

- (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and
- (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.”

Since the majority of rated securitisation transactions have two ratings, this requirement should not in itself be a significant issue for those transactions (although note the requirement to consider appointing a small CRA which is described below). However, this requirement is likely to lead to additional transaction costs in some cases, for example, in relation to subordinated tranches in certain securitisation transactions where previously only one rating would have been sought, and the question might be posed as to how this requirement fits within the aim of decreasing reliance on ratings.

Requirement to consider appointing small CRAs

Where an issuer or a related third party intends to appoint at least two CRAs to provide a credit rating for the same issuance or entity, it is required to consider appointing at least one CRA with no more than 10% of the total market share⁷ (a “**Small CRA**”) that is capable of rating the relevant issuance or entity. ESMA will publish a list of registered CRAs on an annual basis. If a Small CRA is not appointed, this is required to be documented.

The recitals to CRA3 indicate that these measures are intended to increase competition in the credit ratings market, which has been dominated by Moody's, Standard & Poor's and Fitch, and to encourage the use of smaller CRAs. The extent to which market participants find that there are sufficient Small CRAs able, and with the relevant experience, to provide the relevant ratings remains to be seen.

Joint disclosure requirements in relation to structured finance instruments

The issuer, originator and sponsor⁸ of a structured finance instrument established in the European Union will be required, jointly, to publish information in relation to:

- the credit quality and performance of the underlying assets;
- the structure of the securitisation transaction;
- the cash flows; and
- any collateral supporting a securitisation exposure,

⁷ Total market share of the relevant CRA is to be measured with reference to annual turnover generated from credit rating activities and ancillary services, at group level.

⁸ “issuer” is defined in CRA3 by reference to the definition in Article 2(1)(h) of Directive 2003/71/EC, i.e. “a legal entity which issues or proposes to issue securities”.

“originator” is defined in CRA3 by reference to the definition in point (41) of Article 4 of Directive 2006/48/EC, i.e. “either of the following: (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them”.

“sponsor” is defined in CRA3 by reference to the definition in point (42) of Article 4 of Directive 2006/48/EC, i.e. “a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities”.

together with any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures (the “**Joint Disclosure Requirements**”). Such information is to be published on a website which is to be established by ESMA. The Joint Disclosure Requirements do not require information to be disclosed where this would breach national or EU law in relation to confidentiality or the processing of personal data.

The aim of this measure is to improve the ability of investors to make an informed assessment of the creditworthiness of structured finance instruments, thereby reducing their reliance on credit ratings. It is also expected that the publication of such information will reinforce competition between CRAs by encouraging unsolicited credit ratings.

The Joint Disclosure Requirements are in addition to the disclosure requirements under the Prospectus Directive⁹ (which apply in relation to prospectuses), Article 122a¹⁰ (which apply only to sponsor and originator credit institutions) or Article 409 of CRD IV¹¹ (which apply only to sponsors and originators who are credit institutions or investment firms), and the reporting requirements for eligible collateral under the liquidity schemes put in place by the Bank of England and the European Central Bank, as well as the disclosure obligations imposed under Rule 17g-5.¹² Consequently, market participants will need to establish what additional reporting obligations will be imposed by the Joint Disclosure Requirements.

The details of what is required will not be known until the publication of draft regulatory technical standards (“**RTS**”) which will set out the information which is required to be published and the frequency with which such information must be updated, together with a form of disclosure template.

On 10 July 2013, ESMA published a Discussion Paper (the “**Discussion Paper**”) requesting comments from market participants in preparation for drafting various RTS required under CRA3, including the RTS for the Joint Disclosure Requirements.¹³

⁹ Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

¹⁰ Article 122a was added to the Capital Requirements Directive (Directive 2006/48/EC and Directive 2006/49/EC) by Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.

¹¹ Directive 2013/36/EU on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and the regulation on prudential requirements for credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (the “**CRR**”). Articles 404-410 of the CRR will replace the previous risk retention provisions under Article 122a of Directive 2006/48/EC with effect from 1 January 2014.

¹² Rule 17g-5 under the United States Exchange Act of 1934, as amended.

¹³ Discussion Paper on CRA Implementation, 10 July 2013, ESMA/2013/891, which can be found at http://www.esma.europa.eu/system/files/2013-891_discussion_paper_on_cra3_implementation.pdf

We note that the Discussion Paper indicates that the Joint Disclosure Requirements apply not only to issuers, originators and sponsors established in the EU, but also to issuers, originators and sponsors whose structured finance instruments are traded in the EU. This is a new development and potentially widens the scope of the Joint Disclosure Requirements to issuers, originators and sponsors outside the EU. The Discussion Paper asks whether the Joint Disclosure Requirements should be limited to structured finance instruments which are covered by the Prospectus Directive and the Transparency Directive, or whether they should cover all structured finance instruments traded in the EU.

The Discussion Paper also asks how structured finance instruments should be categorised in terms of asset class for the purposes of the Joint Disclosure Requirements and makes reference to various other disclosure requirements as possibilities for consideration, including the European Central Bank and Bank of England templates.

In addition, the Discussion Paper considers how frequently disclosure should be made of the relevant information. Possible options are an event-based approach, a periodic disclosure approach or a combination of the two. It also asks whether the Joint Disclosure Requirements should apply to “live” structured finance instruments or only to structured finance instruments issued after the RTS come into force.

Market participants have the opportunity to submit comments on these important questions in the Discussion Paper before 10 October 2013. ESMA intends to issue a consultation paper in early 2014, containing a summary of the responses and the draft RTS. The RTS must be submitted to the European Commission (the “**Commission**”) by 21 June 2014.

Reduction of reliance on credit ratings

Financial institutions

CRA3 includes a new provision requiring credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties (together, “**Financial Institutions**”) to make their own credit risk assessment and not to rely solely or mechanistically on credit ratings for assessing the creditworthiness of an entity or financial instrument.

The intention is that credit institutions and investment firms should put in place internal procedures in order to make their own credit risk assessment and encourage investors to carry out due diligence. The recitals to CRA3 also state that financial institutions should avoid using credit ratings in contracts as the only parameter to assess the creditworthiness of investments or to decide whether to invest or divest.

National supervisory authorities are required to monitor the adequacy of the credit risk assessment processes of Financial Institutions, assess the use of contractual references to

credit ratings and encourage Financial Institutions to mitigate the impact of such references, with a view to reducing sole and mechanistic reliance on credit ratings.

In addition, similar requirements are imposed under Directive 2013/14/EU of 21 May 2013¹⁴ in order to reduce sole and mechanistic reliance on credit ratings by IORPs, UCITS and AIFMs.¹⁵

European Supervisory Authorities and the European Systemic Risk Board

The European Banking Authority (“EBA”), the European Insurance and Occupational Pensions Authority (“EIOPA”) and ESMA are now prohibited from referring to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings. Similar requirements apply to the European Systemic Risk Board in relation to its warnings and recommendations. EBA, EIOPA and ESMA are required to review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations by 31 December 2013.

EU law

The European Commission will continue to review whether references to credit ratings in EU law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings, with a view to removing all references to credit ratings in EU law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and put in place.

These new requirements are in line with the principles drawn up at the international level by the Financial Stability Board, which aim to reduce reliance on CRA ratings in standards, laws and regulations.¹⁶ The principles state that wherever possible, references to such ratings should be removed or replaced with suitable alternative standards of creditworthiness assessment, and that banks, investment managers and institutional investors should not mechanistically rely on external credit ratings for assessing the creditworthiness of assets but should make their own credit assessments. This is also consistent with the aim of reducing over-reliance on external credit ratings described in CRD IV and the proposals by the Basel Committee on Banking Supervision to reduce over-reliance on CRA ratings in the regulatory capital framework.¹⁷

¹⁴ The Directive can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:145:0001:0003:EN:PDF>.

¹⁵ Institutions for occupational retirement provision, undertakings for collective investment in transferable securities and alternative investment fund managers, respectively.

¹⁶ Principles for Reducing Reliance on CRA Ratings, published by the Financial Stability Board on 27 October 2010, which can be found here http://www.financialstabilityboard.org/publications/r_101027.pdf.

¹⁷ As illustrated, for example, by the proposed revisions to the Basel securitisation framework which are intended to mitigate mechanistic reliance on external credit ratings, as described in the consultative paper entitled “Revisions to the Basel Securitisation Framework” which was published in December 2012 and can be found here <http://www.bis.org/publ/bcbs236.pdf>. See the Cadwalader Clients & Friends Memo entitled “What’s Next for the Basel Securitisation Framework?” for more information: http://www.cadwalader.com/assets/client_friend/050913WhatsNextfortheBaselSecuritisationFramework.pdf.

Parallels may also be drawn with Section 939A of Dodd-Frank¹⁸ which requires the removal of any reference to credit ratings in regulations. However, in the case of CRA3, the removal of references to credit ratings is conditional upon identifying and implementing appropriate alternatives. It remains to be seen whether suitable alternatives will be found to such references to credit ratings and, if found, what such alternatives will be.

Rotation in relation to re-securitisations

Where a CRA has entered into a contract for the issuance of credit ratings in relation to re-securitisations,¹⁹ that CRA will not be permitted to issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years from the date of entry into the contract (the “**Maximum Ratings Period**”). There is an exemption where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations with underlying assets from the same originator (the “**Multiple Rating Agencies Exemption**”). In addition, the rotation requirements do not apply to CRAs with fewer than 50 employees at group level involved in credit rating activities or with an annual turnover generated from credit rating activities of less than €10 million at group level.

Following the expiry of a contract for the rating of re-securitisations, the relevant CRA is not permitted to enter into a new contract for the issuance of credit ratings on re-securitisations with underlying assets from the same originator for a period equal to the duration of the expired contract (but not exceeding four years) (the “**Non-Ratings Period**”). Notwithstanding these requirements, a CRA is still permitted to monitor and update credit ratings which it has issued in relation to re-securitisations before the end of the Maximum Ratings Period.

While the CRA Regulation already included a rotation mechanism in relation to individuals in analytical teams and credit rating committees, this was not considered to be a sufficient guarantee against possible conflicts of interest from long-standing relationships with CRAs, and consequently it was thought necessary to bring in a rotation mechanism for the CRAs themselves. It is acknowledged in the recitals to CRA3 that frequent rotation could result in increased costs for both issuers and CRAs (since the cost of a new rating is typically higher than for ongoing monitoring of a rating). It is also recognised that it can take time and resources for new CRAs to be established and that rotation could have “a significant impact on the quality and continuity of credit ratings”. However, the intention is that rotation should lead to greater diversity in, and consequently improve, the credit assessment process.

Although many market participants may dislike the concept of rotation, we note that the rotation requirements for CRAs have been watered down from the original proposals, which included different time periods and were not limited to re-securitisations. Market participants may regard the final rule as a better outcome, particularly as it appears likely that its application may be less

¹⁸ The Dodd-Frank Wall Street Reform and Consumer Protection Act.

¹⁹ “re-securitisation” is defined in CRA3 by reference to the definition in point (40a) of Article 4 of Directive 2006/48/EC. Such definition was included in that Directive under Directive 2010/76/EU of 24 November 2010, which added the following definition of “re-securitisation”: “a securitisation where the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitisation position”.

widespread owing to potentially reduced interest in entering into re-securitisation transactions following the financial crisis, due to their perceived complexity and punitive risk weights for regulatory capital purposes²⁰ (although care will need to be taken to check whether a transaction could unintentionally fall into the re-securitisation definition). The rotation requirements have been applied to re-securitisations in the first instance on the basis that this class of securitisation transactions has underperformed since the financial crisis and therefore this is where the need to address conflicts of interest is greatest. However, the requirements may change, since the European Commission will be reviewing whether rotation should be applied to other asset classes, as well as whether it is appropriate to maintain a rotation mechanism.

For re-securitisations, the parties will need to find suitable replacement CRAs at the end of the relevant Maximum Ratings Period and will need to allow time for the replacement CRAs to analyse the transaction. Additionally, there may be a risk of fluctuations in ratings since the replacement CRAs may well assess the transaction using different methodologies and it is likely that the rotation requirements will lead to increased transaction costs.

European rating platform

CRAs are required to submit credit ratings, rating outlooks and other relevant information to ESMA, which is required to publish this information on a website referred to as the European rating platform. This is intended to allow investors to compare all credit ratings (except for credit ratings provided under the “investor-pays” model) and to allow smaller and new CRAs to gain more visibility.

The Discussion Paper asks for comments on the content, timing and format of the information to be published on the European rating platform. It also asks what information should be provided to enable investors to compare credit ratings, given that credit ratings are defined differently by various CRAs and are based on different methodologies.

Advance notice of publication of ratings

CRAs are now required to notify a rated entity of any change to a credit rating or rating outlook within working hours and at least one full working day before publication, to allow the rated entity to draw the relevant CRA's attention to any errors.²¹

Sovereign ratings

While CRAs have an obligation to review their credit ratings on an ongoing basis and at least annually, they will now be required to review sovereign ratings at least every six months. CRAs are required to publish a calendar in December for the following 12 months setting out a maximum of three dates for the publication of unsolicited sovereign ratings and rating outlooks

²⁰ See the Cadwalader Clients & Friends Memo entitled “What's Next for the Basel Securitisation Framework?” which summarises the treatment of re-securitisation exposures under the proposed revisions to the Basel securitisation framework referred to in footnote 17 above. This Clients & Friends Memo can be found at http://www.cadwalader.com/assets/client_friend/050913WhatsNextfortheBaselSecuritisationFramework.pdf.

²¹ Previously, CRAs had to inform the relevant rated entity at least 12 hours before publication of the credit rating.

and setting the dates for the publication of solicited sovereign ratings and rating outlooks. Those dates must be set on a Friday and deviation from those dates is permitted only in certain specified circumstances.

Advance notice of changes to rating methodologies

If a CRA intends to make a material change to, or use, new rating methodologies, models or key rating assumptions which could have an impact on a credit rating, it is required to publish the proposed material changes or methodologies on its website for one month with a detailed explanation of the reasons for, and implications of, such changes or methodologies and to invite stakeholders to submit comments.

Liability

If a CRA commits an infringement under Annex III of the CRA Regulation, either intentionally or with gross negligence, which has an impact on a credit rating, an investor or an issuer may claim damages if:

- (i) in the case of an investor, it can establish that it reasonably relied on such credit rating; or
- (ii) in the case of an issuer, it or its financial instruments are covered by such credit rating and the infringement was not caused by misleading or inaccurate information provided by such issuer.

The civil liability provisions of the CRA Regulation provide that terms which are not defined therein should be interpreted and applied in accordance with the applicable national law. As far as the UK is concerned, the Credit Rating Agencies (Civil Liability) Regulations 2013, which came into force on 25 July 2013, define certain terms used in the civil liability provisions and also set out certain factors which a court may consider in relation to whether limitations on liability are reasonable and proportionate, the general approach to determining damages, which will be subject to a duty to mitigate, and a limitation period.²²

It is apparent that, even though CRA3 and other new legislation in the EU and in the US have the aim of reducing investors' reliance on ratings, CRAs could be subject to civil liability claims resulting from breaches of their obligations under Annex III of the CRA Regulation (which are extensive). While there may be some who will welcome these changes, the new provisions will be of concern to CRAs and may restrict the availability of ratings.

Independence and avoidance of conflicts of interest due to shareholdings

CRA3 contains further provisions aimed at ensuring the independence of CRAs and the avoidance of conflicts of interest, by requiring effective internal control structures governing the implementation of policies and procedures to address these matters and by prohibiting shareholders or members with 5% or more of the capital or voting rights in a CRA from holding 5% or more of the capital or voting rights or exercising control over any other CRA.

²² SI 2013/1637, which can be found at http://www.legislation.gov.uk/uksi/2013/1637/pdfs/uksi_20131637_en.pdf.

In addition, a CRA is not permitted to issue a credit rating or rating outlook if a shareholder or member of a CRA holding 10% or more of the capital or voting rights of the CRA, or with significant influence on its business activities, holds 10% or more of the capital or voting rights of the rated entity, a related third party or an ownership interest in any such entity.

Future review of the CRA Regulation

The European Commission is required to report to the European Parliament and the European Council on various issues arising from the CRA Regulation, including:

- (i) by 31 December 2013, on the feasibility of a network of smaller CRAs in order to increase competition in the market, including evaluation of financial and non-financial support for such a network, taking into account potential conflicts of interest arising from public funding. This may lead to re-evaluation and amendment of the requirement to consider appointing at least one Small CRA, as described above;
- (ii) by 31 December 2014, on the appropriateness of the development of a European creditworthiness assessment for sovereign debt;
- (iii) by 31 December 2015, on the steps taken regarding the removal of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance on credit ratings, and alternative tools to enable investors to make their own credit risk assessments, with a view to deleting all references to credit ratings in EU law for regulatory purposes by 1 January 2020;
- (iv) by 1 July 2016, on:
 - the availability of sufficient choice to comply with the requirement to appoint at least two CRAs when soliciting a credit rating;
 - whether the Joint Disclosure Requirements should be extended to any other financial credit products;
 - the availability of sufficient choice to comply with the rotation requirements in relation to re-securitisations;
 - whether the Maximum Ratings Period and the Non-Ratings Period in relation to the rotation requirements for re-securitisations should be shortened or extended;
 - whether the Multiple Rating Agencies Exemption should be amended;
 - whether the scope of the rotation mechanism should be extended to other asset classes and whether different periods should be applicable for various asset classes;
 - whether various provisions such as those intended to avoid conflicts of interest have sufficiently mitigated such conflicts of interest; and

- whether there is a need to propose measures to address contractual over-reliance on credit ratings; and
- (v) by 31 December 2016, on the appropriateness and feasibility of supporting a European CRA for assessing the creditworthiness of the sovereign debt of Member States and/or a European credit rating foundation for all other credit ratings.

Clearly, the European regulatory framework in relation to credit ratings remains under continued review and it is highly likely that there will be further developments.

Conclusion

Issuers, sponsors and originators will need to be aware of the requirements introduced under CRA3, particularly when soliciting ratings and if they are involved in transactions that could fall within the definition of re-securitisations. They will also need to review the RTS in relation to the Joint Disclosure Requirements, when they are made available, to consider what information will be required to be disclosed by issuers, originators and sponsors. In addition, given the number of matters which are the subject of further review over the next few years, market participants will need to monitor the situation closely to consider how they will be affected by any additional regulation in this evolving area.

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