



# The Clean Development Mechanism

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## Introduction

The Clean Development Mechanism (CDM) is one of three market-based mechanisms<sup>1</sup> in the Kyoto Protocol, which are aimed at assisting developed countries meet their greenhouse gas (GHG) emission targets at the least cost under the Protocol.

The CDM allows countries with an emission reduction target (that is, developed countries – also referred to as “Annex I Parties”) to implement greenhouse gas reduction or removal projects in developing countries (“non-Annex I Parties”) in order to generate Certified Emission Reductions (CERs). Like all Kyoto units, CERs can be used by Annex I Parties to meet their Kyoto targets. They can also be traded on the international carbon markets.

The UNFCCC and its Kyoto Protocol are unique in international law, being the only treaty instruments that enable the direct participation of private entities.

The main aims of the CDM are to:

- contribute to the stabilization of greenhouse gas concentrations in the atmosphere;
- assist industrialized countries achieve compliance with their emission targets under the Kyoto Protocol at the least cost;
- encourage the private sector and developing countries to contribute to emission reduction efforts, and
- assist developing countries in achieving sustainable development.

The international framework containing the rules governing the CDM expires in 2012. However the continuance of the CDM post-2012 has been supported through a commitment by regional and domestic emission trading markets to allow entities to use CERs to meet their compliance obligations under these systems, most notably in the EU Emissions Trading Scheme (EU ETS).

For more information on the rules governing the CDM, Australia’s proposed legislation establishing an emissions trading scheme (CPRS Bill), and investment possibilities in the CDM, please contact:

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<sup>1</sup> The other two mechanisms are Emissions Trading and Joint Implementation. See Arts 17 and 6 (respectively) of the Kyoto Protocol.

## What are CDM projects?

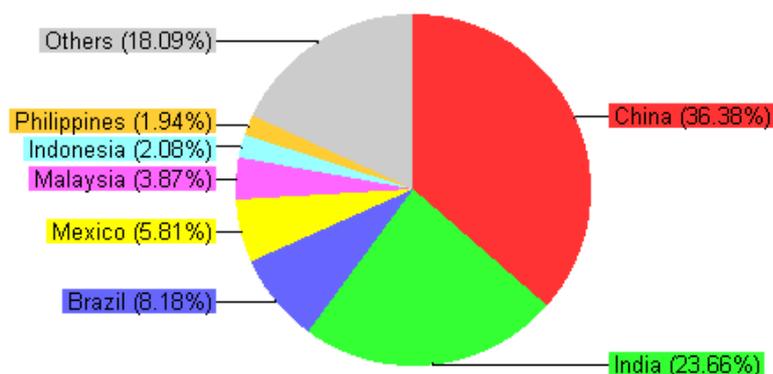
As of 13 January 2010, 2014 project activities had been registered with the CDM Executive Board (CDM EB) as CDM projects. They include projects which generate clean and renewable energy (such as wind farm projects and hydro power projects); projects which reduce emissions by using fossil fuel alternatives (such as biogas projects, landfill gas to electricity projects) and projects which avoid emissions through better treatment of waste (such as composting projects) and the sequestration of carbon through forestry sinks.

All types of CDM project are required to show that they reduce GHG emissions as compared to a baseline, and that they are both financially and environmental “additional” to the business as usual scenario. For more information on the “additionality” process, see <http://www.cdmrulebook.org/>.

Refer to the final page of this guide for examples of current or recently registered CDM projects in Asia.

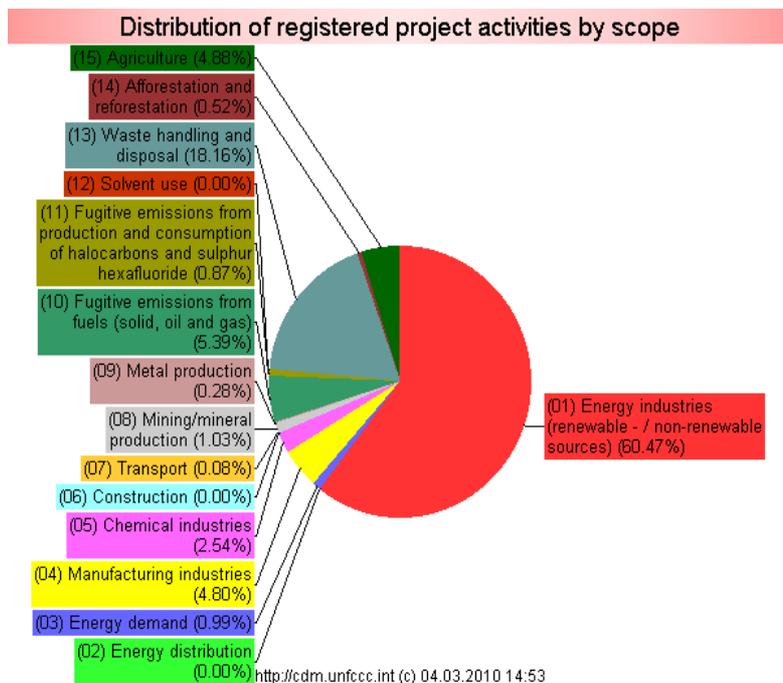
The following table shows the proportion of registered CDM projects by host country; with China and India leading the rest of the developing world.

Registered project activities by host party. Total: 2,067



<http://cdm.unfccc.int> (c) 04.03.2010 14:53

The table below shows the proportion of CDM projects by project scope.<sup>2</sup> Energy industry projects, such as hydro and solar power make up the bulk of CDM projects.



For more information (including current statistics on CDM) see the UNFCCC's website at: <http://cdm.unfccc.int/index.html>.

## How has the global CDM market evolved?

The CDM has been the main vehicle through which private sector finance has flowed into developing countries to fund clean and renewable energy projects. The global carbon market has grown exponentially to be worth billions of dollars.<sup>3</sup> In 2008, while the primary CDM market slowed for the first time, the secondary market continued to grow;<sup>4</sup> a total volume of more than one billion secondary CERs were transacted in 2008 for a value of US\$26.3 billion.

Buyers in the CDM market consist predominantly of Annex I states under Kyoto Protocol, liable entities under the EU ETS (European utilities such as EoN), investment banks (such as JPMorgan, Deutsche Bank, Merrill Lynch), carbon origination companies (such as Camco, EcoSecurities), and carbon funds (such as the funds managed by Climate Change Capital and European Carbon Fund). Most of the demand for CERs to date has come from the EU, as a result of liable entities' obligations under the EU ETS. In order to see the companies involved in CDM projects, go to the UNFCCC CDM project pages at <http://cdm.unfccc.int/Projects/index.html>.

<sup>2</sup> Note that these categories have been created by the United Nations Framework Convention on Climate Change (UNFCCC). The Kyoto Protocol is one part of the UNFCCC treaty.

<sup>3</sup> The value of the international carbon market was estimated to be US\$64 billion in 2007, more than double its value in 2006. Whilst the EU ETS dominates the carbon market, project based activities such as CDM and JI represented approximately US\$13.4 billion in 2007 with the CDM representing over \$US 12.8 billion of that amount. See State and Trends of the Carbon Market 2009, World Bank, 2009

<sup>4</sup> For an explanation of the reasons for this growth, see State and Trends of the Carbon Market 2009, World Bank, 2009.

Carbon funds have also seen prolific growth in recent years. Two types of fund have emerged in the carbon market: funds that return financial profits generated from investments in carbon-related assets, and funds that return carbon credits in return for investments in the fund. The second type of fund may more properly be described as a “carbon procurement vehicle”.

Carbon procurement vehicles were the first type of carbon fund to enter the market, for example the Prototype Carbon Fund and the Umbrella Carbon Facility. Most of the European national carbon funds are also funds of this type, such as the Netherlands Carbon Facility and the Italian Carbon Fund. More recent private carbon funds, such as the funds launched by Climate Change Capital, are structured to provide investors with financial returns instead of carbon assets.

In Europe, institutional investors have been active investors in carbon funds, for example, the European Carbon Fund, launched in 2005 and worth 143 million Euro consists of 13 institutional investors.

## How does a project qualify for CDM and generate CERs?

All CDM projects must satisfy certain requirements specified in either the Kyoto Protocol or the Marrakesh Accords.<sup>5</sup> These criteria include:

- the project must comply with the eligibility criteria (e.g. sustainable development criteria) of the host country and other parties;
- the project must provide real, measurable, and long-term benefits related to the mitigation of climate change using an approved baseline and monitoring methodology;<sup>6</sup>
- the project must deliver reductions in emissions that are additional to any that would occur in the absence of the project activity;<sup>7</sup>
- the project must not result in significant environmental impacts and public consultation must have been undertaken; and
- the project does not result in the diversion of official development assistance.

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<sup>5</sup> The Marrakech Accords is a set of agreements reached in 2001 on the rules of meeting the targets set out in the Kyoto Protocol.

<sup>6</sup> See the UNFCCC CDM website <http://cdm.unfccc.int> for an updated list of approved methodologies. Note that new methodologies may also be proposed, but have a record of much longer time frames due to revision requirements (Guidebook to Financing CDM Projects).

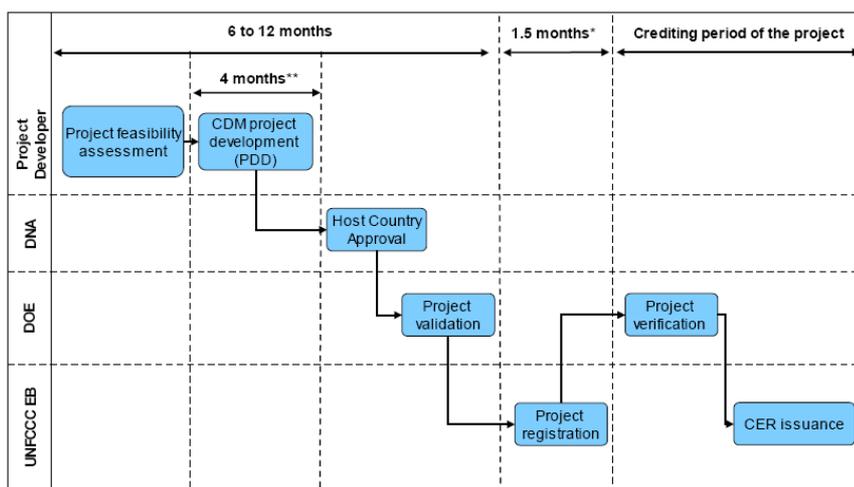
<sup>7</sup> “Additionality” is a key eligibility requirement for a CDM project, ie, the planned reductions would not occur without the additional incentive provided by emission reductions credits. There can be two interpretations for additionality:

- ‘environmental additionality’ - a project is additional if the emissions from the project are lower than the baseline. It generally looks at what would have happened without the project.
- ‘project additionality’ - the project would not have happened without the CDM.

If the Host Country is satisfied that the eligibility criteria are satisfied then it will issue a Letter of Approval to the project entity wishing to operate and sell the CERs issued from the project. Such a letter is required in order for the project to be registered by the CDM Executive Board. Registration is a critical step in the process, as it is at this point that the CDM Executive Board confirms that the project qualifies as a CDM project.

CERs are issued by the CDM Executive Board through a process of verification, certification and issuance. The rules governing these procedures are set out in the CDM Modalities and Procedures<sup>8</sup> and the rules are also expanded and revised in the CDM Executive Board monthly decisions. The GHG Reductions must be verified by an independent third party verifier, which has been accredited by the CDM EB and is referred to as a Designated Operational Entity (DOE). The CDM Executive Board then certifies that the verification is valid and then it authorizes the CERs to be issued to the relevant project participant's accounts, as directed by the Focal Point<sup>9</sup> in the project.

The key stages are shown in the CDM project cycle<sup>10</sup> diagram below.



**Notes**

- \*can be extended depending on the EB decision
- \*\* for each submission and additional to normal process
- EB = CDM Executive Board
- DOE = Designated Operational Entity
- DNA = Designated National Authority

For more explanation of each of these steps in the CDM project cycle see: <http://www.cdmmrulebook.org/>

<sup>8</sup> See the UNFCCC CDM website <http://cdm.unfccc.int> for the CDM Modalities and Procedures.

<sup>9</sup> For more information on the role of the Focal Point, please refer to the CDM Rulebook at <http://www.cdmmrulebook.org/>.

<sup>10</sup> Source: Guidebook to Financing CDM Projects p13.

## What are the requirements for investors wanting to participate in the CDM in Australia?

Australia ratified the Kyoto Protocol on 3 December 2007, and consequently became eligible to participate in (and to authorize private entities' participation in) CDM projects. Domestic implementation of the CDM requires certain enabling steps to be taken to give effect to the International Rules.

One of these requirements is the establishment of a Designated National Authority (DNA) to approve private entities' participation in CDM projects. Australia's DNA is the Department of Climate Change (DCC) and it is referred to as Australia's National Authority for the CDM. Like all DNAs, Australia's National Authority provides authorisation to private entities to participate in projects through the issuance of Letters of Approval.

Another requirement of the International Rules is the creation of a National Registry. Australia established its registry in September 2009, which will track the ownership, transfer, and surrender of eligible units under the Carbon Pollution Reduction Scheme (CPRS) (once enacted into legislation).

The current CPRS Bill allows liable entities to use unlimited CERs to meet their obligations under the scheme. This unlimited import of CERs creates significant opportunities for investors in Australia.

Investors can participate in the CDM directly or indirectly (investment opportunities in the CDM are discussed further below). In order to receive CERs directly from a CDM project, it will be necessary for the entity to:

- establish an account in Australia's National Registry of Emissions Units.  
For more information on how to set up an account, please see: [https://nationalregistry.climatechange.gov.au/eats/au/index.cfm?fuseaction=homehome&clearfuseattribs=true](https://nationalregistry.climatechange.gov.au/eats/au/index.cfm?fuseaction=homehome&clearfuseattribs=true;); and
- receive a Letter of Approval from Australia's DNA in relation to that CDM project activity.  
For more information on the criteria that need to be satisfied in order to receive a LoA, please see: <http://www.climatechange.gov.au/government/initiatives/~//media/publications/kyoto/AustraliasNationalGuidelinesproceduresv11.ashx>.
- If the investor is not receiving CERs directly from a project, then it will still be necessary for such entity to establish an account in the National Registry, however it will not be required to obtain a LOA from Australia's DNA, as it not participating directly in the project.

## What are the expected implications for the CDM after the Copenhagen COP?

While the weak signal from Copenhagen is likely to dampen the carbon market over the next two years as negotiations on a post-2012 agreement continue, the result at Copenhagen is not likely to have a significant impact on the CER market.

This is for two main reasons. First, the carbon market community was not realistically expecting a binding agreement to be reached at Copenhagen, so the political accord was generally in line with expectations. Secondly, it is likely that post-2012 demand for CERs will be determined more by domestic and regional action in the main demand centres (such as US, EU, Japan and Australia) rather than by the agreement of Annex I targets or a post-2012 framework. For example, fixed regulation of EU ETS out to 2020 has given some certainty to the CDM market indicating that demand will exist past 2012 regardless of the result of the international negotiations. If the CPRS becomes law in Australia this year then this will give the CDM further impetus as the current CPRS Bill allows unlimited import of CERs for compliance by liable entities in Australia.

Thus, as New Energy Finance points out, it is likely that long term CER demand will eventually be determined by regional and national cap and trade legislation rather than at the international level. It will crucially depend on the degree to which individual governments of developed countries allow their pledged targets to be achieved through the use of international market mechanisms.

In relation to the Copenhagen COP/MOP, two positive outcomes in relation to the CDM should be highlighted.

### Decision on CDM: Further guidance relating to the clean development mechanism

A significant outcome in Copenhagen was the decision taken by the COP/MOP in relation to the CDM (*Further guidance relating to the clean development mechanism* ("the Decision")) which contains a number of recommended actions for the CDM EB and the UNFCCC Secretariat to implement in order to expand and improve the efficiency of the CDM.<sup>11</sup>

The background to this Decision extends back to the 2nd COP in Poznan, at which the COP requested that the EB provide it with recommendations for improving the efficiency of the operation of the CDM in time for the 15th COP.

The CDM EB responded at its 50th meeting in April 2009 by setting out its recommendations to the COP/MOP on how the CDM could be improved. Its recommendations included measures to improve the performance of the CDM EB (including measures for review of EB decisions and to increase the transparency and accountability of the EB), measures to improve the expediency of CDM EB approval of CDM projects and measures to address regional distribution of projects.

The COP/MOP took these recommendations into account in its decision at Copenhagen, which contains many of the CDM EB's recommendations, as well as expanding on these.

The Decision sets out an extensive work plan in which the CDM EB is authorized to implement measures to improve and expand its authority to govern the CDM and would allow the CDM to be scaled up.

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<sup>11</sup> A copy of the decision can be found at [http://unfccc.int/files/meetings/cop\\_15/application/pdf/cmp5\\_cdm\\_auv.pdf](http://unfccc.int/files/meetings/cop_15/application/pdf/cmp5_cdm_auv.pdf)

## Copenhagen Accord

The CDM is not explicitly mentioned in the Accord, however there is a brief reference to markets being included in the range of approaches employed to achieve the deep cuts in the greenhouse gases required. Perhaps the strongest statement in the Accord is the recognition that “*deep cuts in global emissions are required according to science, and as documented by the IPCC Fourth Assessment Report with a view to reduce global emissions so as to hold the increase in global temperatures below 2 degrees Celsius, and take action to meet this objective consistent with science and on the basis of equity*”<sup>12</sup>. This implies that existing market mechanisms will be required to be scaled up significantly in order to be able to deliver the cuts necessary to limit global temperatures rises to 2C, in addition to new market mechanisms being implemented. However the fact that there are no 2020 or 2050 targets mentioned in the Accord limits the significance of this statement.

## What are the investment opportunities generated by the CDM?

Institutional investors have a critical role to play in responding to climate change. However they are distinct from other investors in that due to the strict fiduciary obligations that they owe to their investors, they typically adopt a more risk averse investment strategy than other types of funds and thus require a higher degree of certainty in the markets in which they make investments.

In relation to the CDM, there are a number of ways through which investors can be involved. The main distinction to make is between investing in the primary and secondary CDM markets. In broad terms, investments in the primary market mean that the Buyer receives CERs directly from the project developer (and in this case the investor would require a Letter of Approval (LOA) from an Annex I state). Investment in the secondary market means that the buyer receives CERs from a third party that is not the project entity (that is from a secondary market entity and in this case a Letter of Approval from an Annex I state would not be required by the investor).

The main forms of investment possibilities in the CDM market are:

- equity investment into the project company which operates (in part or full) the CDM project. This will enable the investor to share in other profit streams generated by the project, such as electricity sales;
- investment into a carbon fund (which will return either CERs or a financial return from the profits generated from the sale of CERs);
- purchase of CERs directly from the project company, but without equitable investment in the company, this is referred to as off-taking the CERs in the primary market; and
- purchase of CERs from a third party entity (secondary market purchase).

The CDM Bazaar is a Web-based facility where stakeholders in the CDM post information, such as potential emission reduction projects looking for financing, CERs available for sale, buyers looking for carbon credits to purchase, services available, carbon market related events, and employment opportunities.

Go to <http://www.cdmbazaar.net/>

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<sup>12</sup> A copy of the Copenhagen Accord can be found at [http://unfccc.int/files/meetings/cop\\_15/application/pdf/cop15\\_cph\\_auv.pdf](http://unfccc.int/files/meetings/cop_15/application/pdf/cop15_cph_auv.pdf)

## CDM Project Examples

<ul style="list-style-type: none"> <li><b>Project Name</b></li> <li>Gikoko-Makassar - LFG Flaring Project**</li> </ul>	<ul style="list-style-type: none"> <li><b>Host Parties</b></li> <li>Indonesia - PT Gikoko Kogyo the Municipal Government of the city of Makassar, South Sulawesi Indonesia The Municipal Government of the City of Makassar, South Sulawesi, Indonesia</li> </ul>	<ul style="list-style-type: none"> <li><b>Other Parties Involved</b></li> <li>Netherlands - International Bank for Reconstruction and Development (IBRD) acting as the trustee of the Netherlands Clean Development Mechanism Facility (NCDMF)</li> </ul>
<ul style="list-style-type: none"> <li><b>Project Description</b></li> <li>The installation of a Landfill Gas (LFG) collection system and flaring facility which will destroy the methane gas that is being generated within the City of Makassar's landfill, TPA Tamangapa. The project will also utilize some of the collected LFG to generate electricity required to meet the parasitic load of the facility.</li> <li>Annual average of estimated reductions: 61,891 tonnes of CO<sub>2</sub>e each year over 7 years.</li> </ul>		
<ul style="list-style-type: none"> <li><b>Project Name</b></li> <li>Methane Recovery Project of Huguan Yufeng Brewing Co., Ltd</li> </ul>	<ul style="list-style-type: none"> <li><b>Host Parties</b></li> <li>China - Huguan Yufeng Brewing Co., Ltd.</li> </ul>	<ul style="list-style-type: none"> <li><b>Other Parties Involved</b></li> <li>Japan - Energy Initiative Japan Inc.</li> </ul>
<ul style="list-style-type: none"> <li><b>Project Description</b></li> <li>A wastewater methane recovery and heat generation project. In addition to the installation of a sequential wastewater treatment system, the project activity will install a boiler to produce steam utilizing biogas recovered from the wastewater treatment reactors. The Project will reduce GHG emissions through avoidance of methane emissions to the atmosphere from wastewater treatment and reduction of coal consumption for steam generation.</li> <li>Annual average of estimated reductions: 72,483 tonnes of CO<sub>2</sub>e each year over 10 years.</li> </ul>		
<ul style="list-style-type: none"> <li><b>Host Parties</b></li> <li>Vietnam - Forest Development Fund</li> </ul>	<ul style="list-style-type: none"> <li><b>Other Parties Involved</b></li> <li>N/A</li> </ul>	<ul style="list-style-type: none"> <li></li> </ul>
<ul style="list-style-type: none"> <li><b>Project Description</b></li> <li>Establishment of 365 ha of tree plantations on grass and shrub land that has become degraded due to intensive crop cultivation. Carbon dioxide will be removed from the atmosphere and stored in carbon pools within the project boundary through the photosynthesis of the planted trees.</li> <li>Annual average over the crediting period of estimated net anthropogenic GHG removals by sinks: 2,665 tonnes of CO<sub>2</sub>e each year over 16 years.</li> </ul>		
<ul style="list-style-type: none"> <li><b>Host Parties</b></li> <li>China - Dengfeng Jinling CMM Power Generation Co. Ltd.</li> </ul>	<ul style="list-style-type: none"> <li><b>Other Parties Involved</b></li> <li>United Kingdom of Great Britain and Northern Ireland - Arreon Carbon UK Ltd</li> </ul>	<ul style="list-style-type: none"> <li></li> </ul>
<ul style="list-style-type: none"> <li><b>Project Description</b></li> <li>This project will capture the coal mine methane (CMM) gas that is currently being vented from Jinling coal mine and use it to fuel a boiler and a power generation plant with a total capacity of 3000kW. The plant and the boiler will then displace electricity transferred from regional power grid, as well as an existing coal-fired boiler.</li> <li>Annual average of estimated reductions: 53,743 tonnes of CO<sub>2</sub>e each year over 10 years.</li> </ul>		

<ul style="list-style-type: none"> <li>• <b>Host Parties</b></li> <li>• Indonesia - PT. Sumi Rubber Indonesia (SURINDO); PT. Nusantara Energy Solution(NES)</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Other Parties Involved</b></li> <li>• Japan - Toshiba Corporation (TOSHIBA)</li> </ul>	<ul style="list-style-type: none"> <li>•</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Project Description</b></li> <li>• This project activity aims to reduce the GHG emissions by introducing a natural gas turbine co-generation system at the plant of P.T. Sumi Rubber Indonesia (SURINDO), which manufactures automobile tires and golf balls at the Indotaisei Industrial Estate, in Cikampek, Indonesia. Previously the plant has used oil-fired burners and purchased electricity from coal based plants.</li> <li>• Annual average of estimated reductions: 22,796 tonnes of CO<sub>2</sub>e each year over 10 years.</li> </ul>		

\* large-scale project

Refer to <http://cdm.unfccc.int/Projects/index.html> for the complete database of registered CDM projects.

## Glossary of Terms

<b><i>Annex I Parties</i></b>	Developed countries listed under Annex I to the UNFCCC which have committed themselves under Article 4 of the Kyoto Protocol to achieve certain quantified emission limitation and reduction objectives.
<b><i>CDM</i></b>	Clean Development Mechanism; one of three flexible mechanisms developed under the Kyoto Protocol to facilitate compliance by Annex B countries with specific targets to reduce or limit their greenhouse gas emissions by reference to their 1990 emissions levels.
<b><i>CDM EB</i></b>	Clean Development Mechanism Executive Board; the supervisory body of the CDM.
<b><i>CER</i></b>	Certified Emission Reduction; tradeable units under the CDM representing one tonne of carbon dioxide-equivalent (CO <sub>2</sub> -e) sequestered or abated, using global warming potentials defined by 2/CP.3.
<b><i>COP</i></b>	The Conference of the Parties to the UNFCCC.
<b><i>COP/MOP</i></b>	The Conference of the Parties to the UNFCCC serving as the meeting of the Parties to the Kyoto Protocol.
<b><i>DOE</i></b>	Designated Operational Facility; independent auditors that assess whether a potential project meets all the eligibility requirements of the CDM and whether the project has achieved greenhouse gas emission reductions.
<b><i>EU ETS</i></b>	The European Union Emissions Trading Scheme.
<b><i>Focal Point</i></b>	The project participant nominated in the statement of modalities of communication as the point of contact for that particular CDM project and who is solely or jointly (as the case may be) responsible for all communications with the CDM Executive Board.
<b><i>Host Country</i></b>	A country which is a Party to the Kyoto Protocol and eligible under the CDM to host CDM projects.
<b><i>IPCC</i></b>	Intergovernmental Panel on Climate Change.
<b><i>JI</i></b>	Joint Implementation; one of three flexible mechanisms developed under the Kyoto Protocol to facilitate compliance by Annex B countries with specific targets to reduce or limit their greenhouse gas emissions by reference to their 1990 emissions levels.
<b><i>LOA</i></b>	Letter of Approval; authorization from a particular country of the participation by a project participant in the proposed project activity.
<b><i>MOP</i></b>	The meeting of the Parties to the Kyoto Protocol
<b><i>Non-Annex I Country</i></b>	Countries that are Parties to the Kyoto Protocol but are not listed in Annex I to the UNFCCC and are generally developing countries that are eligible to be host parties for CDM projects.
<b><i>Primary CERs</i></b>	CERs issued to a project participant in a CDM project in respect of greenhouse gas emission reductions achieved by that project and/or purchased from that project participant.
<b><i>Secondary CERs</i></b>	CERs traded between parties on a secondary basis, that is, where the buyer is not purchasing

***UNFCCC***

CERs directly from the project developer.

United Nations Framework Convention on Climate Change.

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