

Willis

THE WILLIS INDEX

Global Local Professional

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PROFESSIONAL INDEMNITY INSURANCE STRATEGY FOR PRINCIPALS OR EMPLOYERS



Prior to 1920, when consulting with **professionals**, any advice provided was treated with reverence, and rarely was such advice challenged.

“**Professionals** did not make mistakes, just slight miscalculations, based on insufficient or unsatisfactory information!” On the rare occasion an error was made, there might have been a (grudging) apology from the **professional**, and on rarer occasions, the **professional** may have been minded to waive or reduce his fee.

In hindsight this may appear an arrogant position by the **professional**; but it was just the way things were done, with problems resolved behind closed doors, or on the golf course, and rarely in a court of law.

However, things were to change radically. Some of the earliest Professional Indemnity (PI) Insurance policies date back to the 1920s, albeit these were often restricted to claims in contract for a select group of **professionals**, such as lawyers or accountants.

After *Hedley Byrne v Heller* (1963), the panorama changed significantly as this case recognized the possibility of liability for pure economic loss due to negligent statements not dependent on any contractual relationship. This increased risk of litigation and consumerism resulted in an explosion in the purchasing habits of **professionals**, and today the three main construction professional groups (architects, engineers and surveyors), have either compulsory or recommended PI Insurance regulations in place incorporating industry best practice.

Until quite recently it was not unusual for **professionals** to be prohibited from divulging details of PI Insurance to third parties, on the basis that this could increase the incidence and quantum of claims.

Any notion that a construction **professional** might entertain that he could rely on such arguments, and not disclose details of the PI Insurance, vanished in the early 1990s with the explosion of Collateral Warranties following the judgement in *D & F Estates Ltd v Church Commissioners for England* where the House of Lords held that pure economic losses were not recoverable in tort.

Almost immediately Employers and Principals were insisting – in contract – that construction **professionals** carry PI Insurance with Indemnity Limits higher than had hitherto been the case. Subjective risk assessments were being undertaken by

Employers/Principals – or their legal/insurance advisors – as to the adequacy of Indemnity Limits, and to protect their own position. However, it is unsurprising that solicitors and insurance brokers recommended higher Indemnity Limits.

And so to today, where the majority of UK construction **professionals** purchase moderate PI Limits to comply with contractual and regulatory requirements. The cost of such insurance is an overhead that is embedded within the fees charged, and most **professionals** are able to battle successfully with the vagaries associated with claims-made policies, where the cost of insurance cannot be guaranteed for a particular project. With this in mind, let us consider the various options open to Employers and Principals in respect of PI Insurance when developing / constructing building and civil engineering projects and the circumstances under which these options should be considered.

Within this Willis Index, we shall examine the various options and the conditions that may influence the strategy selected for a particular project – under the title “Single – to be... or not to be...”. The options being considered, including their Pros and Cons, are as follows:

- Fixed Period Single Project PI Policy
- Annual Single Project PI Policy
- Owners’ Protective PI Policy
- Reliance on the **professional’s** existing PI arrangements

SINGLE - TO BE . . . OR NOT TO BE . . .

FIXED PERIOD SINGLE PROJECT PROFESSIONAL INDEMNITY POLICY	ANNUAL SINGLE PROJECT PROFESSIONAL INDEMNITY POLICY
<p>A long period policy effected for the length of the contract plus run-off period covering consultants and contractors, purchased by the Consultant's team or the Employer/Principal on behalf of all parties.</p>	<p>An annual policy covering consultants and contractors purchased on behalf of all parties by the Employer/Principal.</p>
<p>PROS</p> <ul style="list-style-type: none"> - Cover and price will be fixed for the term of the policy. - The cost of insurance is fixed in advance. - The Employer and/or Principal will control the cost of insurance. - All parties can be insured avoiding difficulties if a professional is unable to renew its own PI policy. - The Employer and/or Principal can be indemnified for third party claims. - The policy can be dovetailed with the Contract Works policy where it is possible to insure consequential damage to the contract works resulting from faulty design, workmanship or materials. - No annual renewal process. 	<p>PROS</p> <ul style="list-style-type: none"> - The Employer and/or Principal can control the structure of the insurance programme on an integrated basis for the duration of the required project period. - The Employer and/or Principal can control the cost of insurance. - All parties can be insured avoiding difficulties if a professional is unable to renew its own PI policy. - The Employer and/or Principal can be indemnified for third party claims. - Where it is possible, the policy can be dovetailed with the Contract Works policy to insure consequential damage to the contract works resulting from faulty design, workmanship or materials. - As cover required could be over a number of years, a rapport should develop with the insurers. - An annual limit of indemnity. - Access to wider market capacity (probably £50,000,000+ in the annual aggregate). - More insurers may ease pressure on premiums.
<p>CONS</p> <ul style="list-style-type: none"> - The contractual liability may be broader in time and scope than that covered by the policy. - Insurers can become insolvent during the policy period. - It will be important to agree who will be responsible for any policy deductible. - Duplication of costs – unlikely that professionals will reduce their fees by the cost of their own PI insurance as they will probably insure their contingent risk in case the Project PI policy fails to respond. - The maximum policy period in the current market conditions is ten years but this is unusual and six years is more common. This must include any run-off period. - Market capacity is currently available for limits in the region of £25,000,000 in the aggregate for the policy period. - Limited number of insurers which makes this product expensive. - Cover provided by this market is more limited than that available to consultants and contractors on an annual basis. - The aggregate limit of indemnity will apply for the policy period – this could be eroded or exhausted long before completion. 	<p>CONS</p> <ul style="list-style-type: none"> - The contractual liability may be longer than the policy period. - Indeterminate cost at the outset. - It will be important to agree who will be responsible for any policy deductible. - Possibility that annual policy cannot be placed in future years. - Duplication of costs – unlikely that professionals will reduce their fees by the cost of their own PI insurance as they will probably insure their contingent risk in case the Project PI policy fails to respond.
<p>SCENARIOS WHERE OPTION IS FAVOURED</p> <ul style="list-style-type: none"> - Where the Employer and/or Principal favours control over cost. - The need to point the finger at the guilty party is avoided albeit legal liability has to be established against one or more of the professionals. - Where a professional does not carry its own PI insurance. - Joint Ventures where separate insurance protection is required or one-party of the Joint Venture does not carry PI insurance. - Where contract conditions can be tailored to dovetail with the policy cover. 	<p>SCENARIOS WHERE OPTION IS FAVOURED</p> <ul style="list-style-type: none"> - Where the Employer and/or Principal favours control over cost. - The need to point the finger at the guilty party is avoided albeit legal liability has to be established against one or more of the professionals. - Where a professional does not carry its own PI insurance. - Joint Ventures where separate insurance is required or one party of the Joint Venture does not carry PI insurance.

...THAT IS THE QUESTION

OWNER'S PROTECTIVE PROFESSIONAL INDEMNITY POLICY	RELIANCE ON PROFESSIONALS' OWN PROFESSIONAL INDEMNITY POLICY
An umbrella policy purchased by the Employer/ Principal for its own benefit sitting above the consultants' and contractors' own various policy limits.	No specific insurance arranged for a particular policy. The Principal will only rely on the consultants' and contractors' own policies.
<p>PROS</p> <ul style="list-style-type: none"> - Consultants and contractors will have some responsibility for their own mistakes. - The Employer and/or Principal can purchase cover in excess of all consultants' and contractors' policies up to a limit of their choosing (+/- £50,000,000). - The Employer and/or Principal can design a policy to cover any difference in conditions (DIC) between consultants' and contractors' own policies. - In the event that consultants and contractors are unable to renew policies as originally envisaged, this umbrella policy could drop down to ensure there are no gaps in cover. - Cover can be purchased for project hot-spots. - A cost-effective option. 	<p>PROS</p> <ul style="list-style-type: none"> - Leading consultants are able to arrange annual PI insurance cover up to £50,000,000+ each claim without difficulty in the current market conditions. - Smaller consultants and contractors will purchase lower limits appropriate to their risks. - The Employer and/or Principal will only have to purchase cover on a contingent basis and to cover any in-house design or project management work undertaken by the Employer and/or Principal. - Probably the least invasive option as PI insurance costs are within the consultants and contractors usual running costs.
<p>CONS</p> <ul style="list-style-type: none"> - Insurers will not be prepared to drop down below a minimum level. - Uncertainty of long-term cost. 	<p>CONS</p> <ul style="list-style-type: none"> - Consultants and contractors will negotiate strongly to restrict their liability under contract. - As consultants' and contractors' cover is purchased annually, there is no guarantee that cover will remain in place for the period required. - The cost will be charged back to the Employer and/or Principal, through the fees, although the cost of such cover should be made transparent. - There will be little control, and subsequent recourse, over the limit, breadth and quality of cover purchased.
<p>SCENARIOS WHERE OPTION IS FAVOURED</p> <ul style="list-style-type: none"> - Where the Employer and/or Principal wishes to exert a certain degree of control with a cost effective solution. - Where the Employer and/or Principal wishes to procure cover for a potential large loss, over and above the usual limits effected by consultants and/or contractors. - Where the Employer and/or Principal requires protection for their contingent risks, excess liability and difference-in-conditions (DIC) cover should the consultants, or contractors, policies fail to respond to a claim. 	<p>SCENARIOS WHERE OPTION IS FAVOURED</p> <ul style="list-style-type: none"> - Where the Employer and/or Principal are satisfied that consultants' and contractors' PI cover is sufficient and satisfactory for the risks inherent within the project. - Where the Employer and/or Principal believes that the consultants and contractors will have no difficulty in procuring PI insurance in future years. - Where consultants and contractors do not limit their financial liabilities under contract. - Where Employer and/or Principal would not be indemnified under a PI policy for third party claims as they will not be a joint insured under the consultants' or contractors' PI policy.

CONTRACT NEGOTIATION CONSIDERATIONS FOR CONSTRUCTION PROFESSIONALS

DUTY OF CARE

The duty of care obligation at common law is to use **reasonable skill and care**. In addition, Section 13 of the Supply of Goods and Services Act 1982 provides that in any contract for the supply of a service, there is an implied term that it shall be rendered with **reasonable skill and care**. PI Insurance policies generally cover the insured for **reasonable skill and care** to reflect the common law and statutory implied position.

The standard forms of appointment and collateral warranties generally require the consultant to exercise **reasonable skill and care**. This is consistent with the common law and statutory position and therefore acceptable to insurers. Bespoke forms of appointment and collateral warranties often refer to **reasonable skill and care** (or variations of the same). However, it is important to ensure that there are no other warranties, guarantees or words used which could impose a higher duty. This may not be immediately apparent. As PI Insurance is intended to cover the insured for **reasonable skill and care** in exercise of the services, you should resist any provision(s) which could increase the duty of care and potentially take you outside of the protection of your policy.

When considering the duty of care obligation, you should be wary of any words which are subjective (e.g. **properly qualified**) or phrases which vary the **reasonable skill and care** wording (e.g. **will exercise the skill and care reasonably to be expected of...**). Any wording which varies the common law position is likely to have been drafted with the intention of increasing the duty of care obligation.

You should pay particular attention to any terminology which could amount to a **fitness for purpose** obligation. A PI Insurance policy could only be expected to cover you for a liability arising from a failure to exercise **reasonable skill and care**. **Fitness for purpose** obligations are often seen in bespoke forms of appointment and collateral warranty. For example, an appointment or collateral warranty may require you to warrant that the building when complete will be **fit for its intended purpose** or **will satisfy a performance specification** or **will satisfy the employer's requirements**. Provisions such as these are onerous and could be construed as a guarantee, which could be excluded under a PI Insurance policy. An obligation to exercise **reasonable skill and care** requires proof of negligence, whereas stricter obligations or guarantees may not require such proof, and could prejudice you and your Insurer's ability to defend a claim or the Insurer may avoid liability altogether.

You should avoid strict obligations (which could be construed as a guarantee) unless you are comfortable with your ability to satisfy them. Examples of the words commonly used, include: **ensure, comply, procure** or **secure**. Where, for example, you see the word **ensure** with regard to the satisfaction of a performance specification or the employer's requirements, we would recommend that you make the obligation subject to **reasonable skill and care** e.g. "use **reasonable skill and care** to see that...".



With regard to collateral warranties, you should always remember that the warranty is collateral to the underlying appointment. Many warranties refer back to obligations in the appointment so you should always satisfy yourself as to the content of the appointment so that no onerous obligations are imported into the warranty.

DELETERIOUS MATERIALS

The obligation not to specify deleterious materials is often expressed as a guarantee (e.g. **has not and will not specify**). This strict obligation is often expressed by reference to a list of deleterious materials or (as is more commonly seen) by reference to an industry publication. As with the duty of care obligation, you should only warrant that you have used or exercised **reasonable skill and care** to see that none of the materials referred to have been specified or used. For example, where you see the words "has not and will not specify", we would typically recommend that you replace this with "has used and will use **reasonable skill and care** to see that...".

Where reference is made to a publication, we recommend you check whether it refers to a specific edition. If not, you should specify the current edition or the version current at the date of specification and satisfy yourself as to its content. When reviewing the clause you should be aware of any words which are subjective or ambiguous. As with the duty of care obligation, you should avoid any strict obligation not to specify deleterious materials as there is no requirement to prove negligence.

PROFESSIONAL INDEMNITY INSURANCE

It is common for an **appointment** or collateral warranty to require you to effect and maintain PI Insurance for a period of 12 years. This is because most construction **appointments** and collateral warranties are intended to be executed as a Deed rather than a simple contract to which a 6 year limitation period normally applies. The obligation to maintain PI Insurance in the collateral warranty should reflect the same provision within the **appointment**.

Since PI Insurance is only available on an annually renewable basis, you should only undertake to use **reasonable endeavours** to maintain it for the required period. You cannot guarantee that PI Insurance will be available indefinitely, irrespective of any provision, making the obligation subject to such insurance being available at commercially reasonable rates or on commercially reasonable terms.

It is acceptable for your own claims records to be taken into account when considering what constitutes commercially reasonable rates. However you should resist any wording which takes into account **any other acts omissions matters or things peculiar to** the warrantor (or other similar wording). You should also resist any provision permitting a client or beneficiary to take out PI Insurance, in the event that you have failed to maintain such insurance as you have no control over the extent of cover or the premium. If the client or beneficiary insists on including such provisions, the client or beneficiary should be under a duty to mitigate its loss rather than simply being permitted to take out whichever policy it chooses and recovering the cost from the **professional** either as a debt or by way of an indemnity.

You should resist or delete any requirement that PI Insurance is not subject to **any unusual or onerous exclusions** as this wording is subjective and may mean something else to the client or beneficiary. Equally, you should avoid or delete any requirements to maintain cover for **all liabilities under the warranty** as you cannot guarantee that your policy will extend to cover all liabilities. If your PI Insurance has an aggregate limit for pollution and contamination, you should ensure that this is clearly expressed in the agreement.

In terms of providing documentary evidence of your PI Insurance, you should agree to provide **documentary evidence** only. We would normally advise you to provide a confirmation in the form of a broker's letter. You should avoid subjective words such as **satisfactory evidence** as the client or beneficiary could interpret this to include the policy wording. You should avoid disclosing your policy wording, wherever possible, as to do so could materially prejudice you and your insurer's position in the event of a claim and / or could assist the claimant in bringing a claim.

ASSIGNMENT

Standard form appointments and collateral warranties generally restrict assignment to one or two assignments. Bespoke forms of appointment and warranty often limit the assignment by the beneficiary to one or two assignments but permit further assignments with the consent of the consultant/warrantor (such consent not to be unreasonably withheld or delayed). This kind of provision is effectively open ended as it is difficult to envisage any circumstances where a consultant/warrantor would be acting reasonably in withholding its consent to a request for a further assignment. Where you see such a provision, we would generally recommend you try to restrict assignment to one or two assignments by deleting the wording permitting further assignments with your consent. If this cannot be agreed you should consider deleting the proviso that your consent should not be unreasonably withheld or delayed. This will at least give you control to decide whether to permit any further assignment.

We would generally recommend that any assignment provision should be made conditional upon you having received written notice of the assignment. This allows you to identify the client or beneficiary at any given time and should be a reasonable compromise as it does not require the client or beneficiary to obtain your consent, it simply requires that they give you notice of the assignment.

You should obviously be wary of any provision in a collateral warranty which requires you to enter into any further collateral warranties with a party notified to you by the beneficiary. Such provisions often appear as a separate clause at the end of a warranty and should be resisted on the basis that it contradicts and circumvents the assignment provisions. Furthermore, a collateral warranty is collateral to the **appointment** between you and the client, and as such the warranty is not the appropriate document in which to include an obligation to provide further warranties. Such an obligation should be set out in the **appointment**.

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INTELLECTUAL PROPERTY (COPYRIGHT)

The majority of standard and bespoke forms of **appointment** and collateral warranties provide for an irrevocable royalty-free non exclusive licence in favour of the beneficiary. This is generally acceptable although some of the standard forms of **appointment** and collateral warranties entitle the consultant to revoke the licence in the event that the **appointment** is terminated or the consultant's fees are unpaid.

You should carefully check the purposes for which the intellectual property can be used. If the permitted purpose is too wide (or silent) you could potentially be accepting liability for something you had not envisaged. For example, bespoke forms of **appointment** and collateral warranties often permit the beneficiary to copy, use and reproduce the copyright material for any purpose connected with the development. This could lead to a position where the beneficiary reproduces the design in a drawing for an extension to another part of the building for which the design was never intended. For this reason, some of the standard forms of **appointment** and collateral warranties carve out **extension** from the permitted uses by providing that the beneficiary may copy and use the copyright material in connection with any extension of the development but excluding the right to reproduce any design contained in them. The same principle applies where you see the words **modification** and **alteration**. If the client or beneficiary insists that it should have permission to copy and use the copyright material for the purposes of extension, **modification** or **alteration**, you should look to include a specific wording to exclude liability arising out of any **extension**, **modification** or **alteration**.

LIMITATION OF LIABILITY

- Limitation Period
- Net Contribution

The majority of standard and bespoke forms of **appointment** and collateral warranties provide for some form of limitation on liability, whether by way of a financial cap, net contribution clause or aggregate liability for pollution and contamination or more simply by an express 6 or 12 year limitation period by reference to a specific date (such as the completion of the services or practical completion under the building contract). A **net contribution** clause provides that the warrantor is liable only for that proportion of any loss or damage for which it is just and equitable having regard to his responsibilities under the contract or **appointment**. It assumes that other parties, whether consultants or contractors, who may have responsibility for any loss or damage caused by their actions, have also entered into warranties with the same beneficiary. Some standard forms, particularly warranties to tenants, also include a provision which limits the consultants' liability to the cost of repair, reinstatement or renewal and thus excludes liability for all consequential losses. This provision, however, is not wide spread. The benefit of a net contribution clause to a consultant is that it overrides the principle of joint and several liability so that if two consultants are jointly responsible for the same loss, then the claimant can only recover 50% of that loss (rather than 100%).

It is not essential to include these provisions but your insurer may offer a reduced premium if such provisions are included in all **appointments**

and collateral warranties. Such provisions only serve to reduce and/or restrict the beneficiary's rights of recovery to the common law position.

If possible, we would recommend that you try to include an express limitation period in the warranty by reference to a specific date (such as a period of 12 years from the date of practical completion of the works) as the law of limitation can be very complicated. It is preferable to have contract certainty. However, when considering the limitation period you should ensure that the period of liability under a collateral warranty reflects your liability under the **appointment**.

A common amendment which you may wish to consider is a provision which provides that your liability under the collateral warranty is no greater in scope, time or amount than under your **appointment**. Many collateral warranties do in fact state that liability will be no greater than if the beneficiary had been named as the client under the **appointment**.

INDEMNITIES

Indemnities are often found in bespoke forms of **appointment** and collateral warranties in relation to claims against the client/beneficiary in respect of breach of copyright.

Occasionally, bespoke forms of **appointment** and collateral warranties provide that the consultant / warrantor shall indemnify the client / beneficiary in relation to all losses. You should resist any clause which provides for an indemnity as it removes the common law duty of mitigation. An indemnity also makes it very difficult for you and your insurer to defend any claim. The beneficiary will have to prove negligence but once proved, the client / beneficiary may be entitled to be indemnified in respect of all of its loss caused by the negligent act or omission. Inevitably, this will have an adverse effect on future premiums.

If you are unable to negotiate the deletion of an indemnity clause altogether, you should look to replace the word **indemnity** or **indemnify** with an alternative wording agreeing to pay legally proven losses which are reasonably foreseeable subject always to the client's/beneficiary's duty to mitigate its loss.

**By Craig Smith
Hugh James Solicitors**

OTHER RISKS FOR DEVELOPERS AND PROPERTY INVESTORS TO CONSIDER

AN OWNER COORDINATED INSURANCE PROGRAMME (OCIP)

The Willis approach to insurance procurement for development projects is that we recognise the importance of addressing the key material damage, liability and financial risks associated with development projects and addressing this by providing an Owner Coordinated Insurance Programme (OCIP) largely controlled and procured by the project owner, employer or principal party. An OCIP can be arranged on the basis of either:

- An annual policy to provide automatic cover for all defined projects or
- A policy arranged for each specific project as they arise.

THE BENEFITS OF AN OCIP

The majority of developers take control of their project insurances, rather than leaving the arrangements with contractors or other parties, by arranging an OCIP in respect of refurbishment AND also new build projects to gain benefits which include:

- Competitive premium rates, since they are not based upon the various activities or claims experience of the contractors and do not include contractors, profit or insurance overheads.

- Control of direct insurance expenditure since the owner/employer pays the OCIP premiums.
- Purchasing broad bespoke protection for the duration of a project which covers the many diverse interests, liabilities and risks of those involved.
- Arranging a programme that meets investors, future owners, tenants, joint venture partners and financiers specific insurance requirements.
- An opportunity to purchase key financial protection e.g. Advance Loss of Revenue for the owners benefit. Such cover can now only be purchased in direct conjunction with the contract works cover.
- Increased insurer security.
- The ability to avoid situations where following the insolvency of a contractor their insurance programme is terminated, thereby leaving the owner/employer exposed without cover in place.
- The provision of more structured and coordinated claims reporting and handling procedures.
- Ease of transfer to operational insurance programme.



THE OCIP COVER

The following insurance covers can be included within an OCIP:

- 1. Contract Works** – All Risks of Loss or Damage to the Contract Works excluding constructional plant and equipment.
- 2. Existing Property** – All Risks or Specified Perils Cover for the retained/existing structures.
- 3. Increased Costs of Constructing Incomplete and Unbuilt Works following damage to the works.**
- 4. Public Liability** – Cover for Legal liability of the Employer or All Parties in respect of death of or bodily injury to third party persons or damage to third party property.
- 5. Non Negligence (JCT 2005 Clause 6.5.1. or similar)** – Provides cover as per the clause.
- 6. Advance Loss of Revenue (Loss of Rent, Profit, etc.)** – arising from damage to the works.

Other insurances can also be considered such as Latent Defects Insurance (LDI), Environmental and Legal Indemnity (property ownership and use restrictions typically discovered during the acquisition process).

OPERATIONAL INSURANCE PROGRAMME

Following completion of the construction phase we can within our Property Investors Division provide advice on the smooth transfer to an Operational Insurance Programme. Cover may include:

- **Assets** – Cover on buildings, including common areas and fit-out, the Landlord's responsibilities under lease and other losses that a property investor may face following damage to an asset.
- **Income** – Rent, service charge and other building-related income following insured damage to the building.
- **Terrorism** – The insurance of the assets and income may be extended to provide indemnity for damage resulting from terrorist attack.
- **Legal Liability** – Compensation and legal costs payable in relation to injury to third parties or third party property damage.
- **Engineering** – Machinery and plant against damage by risks unique to its use, for instance pressure vessel explosion or lift collapse. Insurers also provide services to inspect machinery and plant to meet statutory Health & Safety regulations.



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BREAKING NEWS

We will soon be moving to our new London building.

Our new address will be:

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Willis Limited, Registered number: 181116 England and Wales.
Registered address: Ten Trinity Square, London EC3P 3AX.
A Lloyd's Broker. Authorised and regulated by the Financial Services Authority.

With effect from 31 March 2008 this will change to:
51 Lime Street, London, EC3M 7DQ

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