

# THE EU CARBON BORDER ADJUSTMENT MECHANISM BEGINS TO BITE:

## WHAT DOES IT MEAN FOR BUSINESSES AND WHAT NEXT?

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# INTRODUCTION

On 1 October 2023, the reporting obligations under the European Union’s Carbon Border Adjustment Mechanism (“EU CBAM”) came into force. EU importers are now required to report on the greenhouse gas emissions embedded into certain of their imports, and face penalties if they fail to do so accurately. From 1 January 2026, EU importers will also be required to pay tariffs on those embedded emissions.

In this publication we:

- set out the background to the EU CBAM;
- discuss its current and future coverage;
- consider the geopolitical implications of the EU CBAM, in particular for exporters in less developed jurisdictions around the world; and
- highlight the CBAM proposals which the UK government is considering in parallel for the United Kingdom.

# KEY TAKEAWAYS FOR BUSINESSES

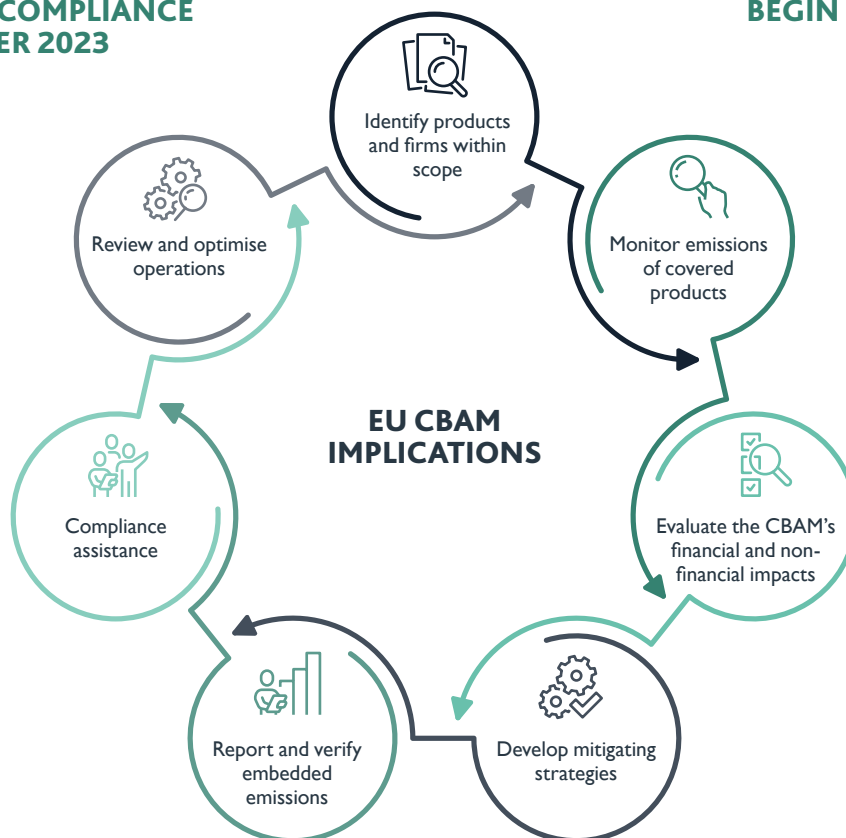
With the EU CBAM’s reporting obligations now applicable, EU importers as well as exporters to the EU (who will be asked by importers for information) must consider which of their products are within scope and establish robust processes for monitoring the embedded emissions within those products. This will enable them to ascertain the likely financial impact of the EU CBAM tariffs on their operations when those tariffs apply from 1 January 2026. Where the financial impact is anticipated to be significant, businesses will need to consider whether they can adopt mitigation strategies, including by reducing the level of embedded emissions in their products.

By its very nature, the EU CBAM will have an impact beyond the borders of the EU. Companies who export goods covered by the EU CBAM into the EU would be well advised to familiarise themselves with its requirements, in order to prepare for providing the necessary data to their EU customers, and to consider how best to optimise their operations in order to remain competitive. Figure 1 outlines the key steps which EU importers and exporters to the EU may wish to take to manage their EU CBAM exposure.

Figure 1: Key steps for management of EU CBAM exposure

## MANDATORY COMPLIANCE FROM OCTOBER 2023

## BEGIN PREPARATIONS NOW



## BACKGROUND TO THE EU CBAM

In an effort to curb emissions of greenhouse gases (“GHG”), a number of jurisdictions have implemented some form of carbon pricing, with the aim of capturing the costs of GHGs to society.

One of the most developed of these schemes is the EU’s Emissions Trading System (the “EU ETS”), which requires EU entities to acquire and surrender certificates equivalent to their GHG emissions (with exceptions).

However, the adoption of carbon pricing is far from universal, leading to fears in those jurisdictions who have implemented carbon pricing that their exporters will become less competitive internationally and that carbon emitters will simply relocate their operations to other jurisdictions which have lower carbon costs, among others.

The EU has been concerned about these risks for some years. Those concerns were exacerbated when the EU decided to tighten its EU ETS by phasing out “Free Allowances” currently provided to certain heavy industry sectors to shield them from the consequences of high carbon pricing.

As a result, on 17 May 2023, the EU became the first jurisdiction to extend its domestic carbon price to certain imported emissions generated outside of its borders by implementing the EU CBAM Regulation.<sup>1</sup> The EU CBAM’s reporting obligations commenced on 1 October 2023, with importers obliged to pay tariffs from 1 January 2026.

Through the implementation of the EU CBAM, the EU hopes to ensure that there is a level playing field between EU producers who are subject to the EU ETS and foreign producers who are not, but who will from 1 January 2026 face equivalent measures at the EU’s borders.

## OVERVIEW OF THE EU CBAM

### How does the EU CBAM work?

The EU CBAM is a tariff paid by importers of specific emissions-intensive, trade-exposed goods entering the EU, which are not covered by the EU ETS. To comply with the mechanism, importers must purchase and surrender EU CBAM certificates equal to the calculated embedded emissions in the imported products covered under the scheme.<sup>2</sup> The price of certificates will correspond to the price of EU allowances auctioned under the EU ETS.<sup>3</sup>

### Scope of coverage

From inception, the EU CBAM applies to imports into the EU of iron, steel, cement, fertilisers (including ammonia), aluminium, electricity, and hydrogen (subject to various exceptions and extending to a number of sub-categories).<sup>4</sup>

The EU Commission will evaluate whether to further expand the scope of covered goods before the transition period concludes at the end of 2025. Additional categories under consideration include organic chemicals and polymers.

The EU’s stated intention is that the EU CBAM’s coverage will eventually complement the EU ETS by fully replicating the sectors covered by the EU ETS. However, the Commission is also reportedly evaluating methodologies for measuring “whole-of-lifecycle” emissions embodied in certain goods. These methodologies could serve as foundations for considerably expanding the categories of products—and potentially also services—covered by the EU CBAM.



### What is carbon leakage?

The EU’s Fit for 55 Package—announced in July 2021—intends to reduce EU-wide GHGs by at least 55 per cent, compared to 1990 levels, by 2030. That objective primarily relies upon lowering economy-wide emissions caps, while also expanding EU ETS coverage, to increase EU allowance prices. However, these efforts to raise carbon prices within the EU will increase EU producers’ operating costs, leading to significant disadvantages relative to competitor firms operating in less emissions-constrained jurisdictions. This could undermine the environmental effectiveness of EU climate policies, by encouraging the relocation of emissions-intensive production to non-EU jurisdictions—a phenomenon known as “carbon leakage”.<sup>5</sup>

The EU ETS currently endeavours to reduce carbon leakage risks by allocating free allowances to EU producers operating in sectors at high risk of carbon leakage. It provides free allowances of up to 100% of predetermined benchmarks, representing the average emissions per unit of the 10% most carbon-efficient EU producers of the product concerned.<sup>6</sup> Nonetheless, allocating free allowances imposes financial costs on governments, and undermines decarbonisation incentives.<sup>7</sup> Both costs will increase with tighter EU emissions caps. This may potentially prejudice the EU’s ability to achieve its decarbonisation targets.

<sup>1</sup> Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism OJ L130/105 (“EU CBAM Regulation”).

<sup>2</sup> Article 22, EU CBAM Regulation.

<sup>3</sup> Article 21, EU CBAM Regulation.

<sup>4</sup> Annex I, EU CBAM Regulation.

<sup>5</sup> The EU’s definition of carbon leakage can be found [here](#).

<sup>6</sup> Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814, OJ L 76, 19.3.2018, pp. 3-27.

<sup>7</sup> European Commission, ‘Impact Assessment Report: Proposal for a regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism’, SED(2021) 643, p. 9; European Court of Auditors, *The EU’s ETS: Free Allocation of Allowances Need Better Targeting*, Report 18/2020.

## Phase out of free allowances and phase in of the EU CBAM

The EU's desire to phase out free allowances helped shape the EU CBAM's policy design. Allocating free allowances initially avoided political sensitivities associated with the trade competitiveness implications of the EU ETS. Firms receiving free allowances were able to reduce their effective carbon price liabilities, enabling them to allocate capital for other purposes. But an emissions trading scheme functions most efficiently, both from a climate and economic perspective, when its allowances are "perfectly" allocated, such as through periodic auctions without free allocations. For these reasons, the EU Commission considers that replacing annual free allowance allocations with import tariffs would strengthen the EU ETS's capacity to achieve the EU's emissions targets. By creating a level playing field, the EU intends that the reformed EU ETS will not competitively disadvantage its importers or producers.

As a result, the EU intends to phase out free allowance allocations from the EU ETS for sectors and subsectors covered by the EU CBAM completely by 2034. Figure 2 compares the EU's schedule for phasing out free allowances and the commensurate phased implementation of the EU CBAM, and illustrates the symmetry between the phasing out of free allowances and the phasing in of EU CBAM tariff adjustments.

Figure 2: Free allowance allocations from 2026 to 2034<sup>8</sup>

EU ETS FREE ALLOWANCES %	EU CBAM ADJUSTMENT %	YEAR
97.5	2.5	2026
95	5	2027
90	10	2028
77.5	22.5	2029
51.5	48.5	2030
39	61	2031
26.5	73.5	2032
14	86	2033
0	100	2034

<sup>8</sup> Directive (EU) 2023/959 of the European Parliament and of the Council.

# FROM REPORTING TO ACTION

## Reporting requirements have begun to apply

Implementation of EU CBAM has begun, with a transitional period running from 1 October 2023 to 31 December 2025. During this time, EU importers must submit reports containing information on the goods within scope of the EU CBAM, but are not yet required to pay tariffs on embedded emissions within those goods.

On 17 August 2023, the European Commission published an EU CBAM Implementing Regulation,<sup>9</sup> which details the reporting obligations for EU importers of CBAM-covered goods. This Implementing Regulation also includes methodologies for calculating the embedded emissions of covered goods. It requires importers—known as CBAM “reporting declarants”<sup>10</sup>—to submit quarterly reports at the end of the month following the close of each quarter. See the text box for details of the reporting requirements. Reporting declarants must submit the reports through a new electronic CBAM Transition Registry, with the first report (for Q4 2023) due on 31 January 2024.



### The following information is required for each imported good:

- The **CN code** and **quantity** (expressed in MWh for electricity, and tonnes for all other goods).<sup>11</sup>
- The **country of origin** and **installation** in which the good was produced. For steel-related goods, this includes the identification number for the steel mill from which its raw materials originated.<sup>12</sup>
- The **production route** (or production process) used to manufacture the goods. This reflects the manufacturer’s choice of specific technologies and parameters, which may affect the goods’ embedded emissions profile.<sup>13</sup>
- The **specific embedded direct emissions** contained in one tonne of an imported covered good (as identified in Annex II of the EU CBAM Regulation). These include emissions released during the production of the goods, including the embedded emissions of materials consumed in the production process. Annex III of the Implementing Regulation details methods for calculating these emissions.<sup>14</sup>
- For **specific embedded indirect emissions** contained in one tonne of an imported covered good (as identified in Annex I, but not in Annex II, of the EU CBAM Regulation), the electricity consumption (in MWh) of the production process per tonne of the good, emissions calculation method and applicable emissions factor, as well as the amount of specific embedded indirect emissions.<sup>15</sup>
- The amount of any **carbon price paid** in the country of origin for the imported goods’ embedded emissions.<sup>16</sup>

<sup>9</sup> Commission Implementing Regulation (EU) 2023/1773 of 17 August 2023 laying down the rules for the application of Regulation (EU) 2023/956 of the European Parliament and of the Council as regards reporting obligations for the purposes of the carbon border adjustment mechanism during the transitional period (“EU CBAM Implementing Regulation”).

<sup>10</sup> Reporting declarants may fall within the following categories: (1) an importer that lodges a customs declaration for release for free circulation of goods in its own name and on its own behalf; (2) a person authorised to lodge a customs declaration; or (3) an indirect customs representative appointed by an importer. See Article 2(1), EU CBAM Implementing Regulation.

<sup>11</sup> Article 3(1), EU CBAM Implementing Regulation.

<sup>12</sup> Article 3(2)(a) and (b), EU CBAM Implementing Regulation.

<sup>13</sup> Article 3(2)(d), EU CBAM Implementing Regulation.

<sup>14</sup> Article 3(2)(d) and Annex III, sections F and G, EU CBAM Implementing Regulation.

<sup>15</sup> Article 3(3) and Annex I, EU CBAM Implementing Regulation.

<sup>16</sup> Article 7, EU CBAM Implementing Regulation.

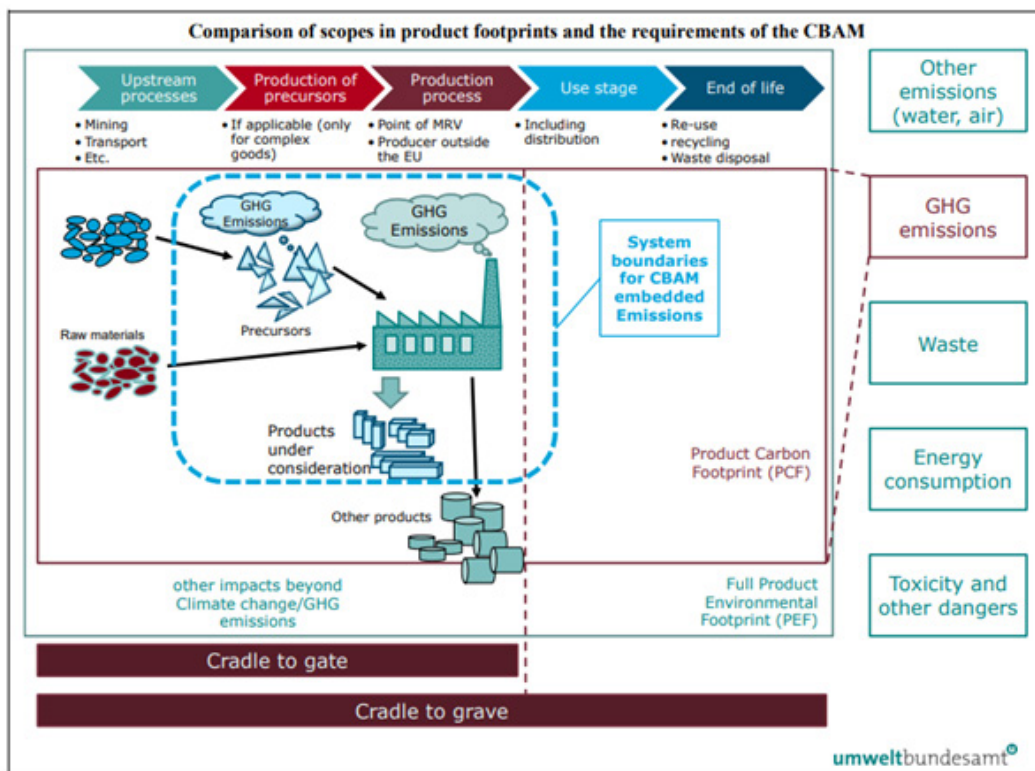
## What are considered to be “embedded emissions” of covered goods?

The EU CBAM is intended to cover the same emissions as would be covered by the EU ETS if the production were situated in the EU. The system boundaries of emissions covered by the EU CBAM are therefore narrower than those in a product’s carbon footprint. Downstream emissions (i.e., covering use stage and end-of-life) are outside the scope of the EU CBAM, as well as emissions from the transport of materials and from processes further upstream. The position is summarised in Figure 3 below.

## Calculating embedded emissions

The Implementing Regulation offers declarants some initial flexibility on how to calculate the embedded emissions of imported goods, until 1 January 2025. Declarants can either use a “calculation-based method” (which determines emissions from source streams based on activity data and calculation factors derived from either laboratory analyses or standard values), or a “measurement-based method” (which determines emissions through continuous measurement of GHG concentrations in the flue gas and flue gas flow) (together, “the EU method”).<sup>18</sup> Whilst declarants can use other methods during the first year of implementation, such as methods used under monitoring, reporting and verification (known as “MRV”) systems and methods based on compulsory carbon pricing schemes in exporting jurisdictions with MRV requirements, from 1 January 2025, only the EU method will be permitted.<sup>19</sup>

Figure 3: System boundaries for CBAM embedded emissions<sup>17</sup>



<sup>17</sup> European Commission, Guidance document on CBAM implementation for installation operators outside the EU (26 October 2023), p. 85.

<sup>18</sup> Article 4, EU CBAM Implementing Regulation.

<sup>19</sup> Article 4(2), EU CBAM Implementing Regulation.

## Purpose of the transition period

The transition period is intended to allow firms to build internal capacity to comply with the EU CBAM. It will also enable information sharing between reporting companies and EU officials on best practices for implementing the mechanism. The European Commission is also developing dedicated IT tools, guidance, training materials, and tutorial aids to assist firms in complying with the EU CBAM. In addition, non-EU governments may use the transition period to implement equivalent carbon pricing policies, with views to expedite domestic climate mitigation efforts and potentially avoid EU CBAM tariffs.

## Governance

The EU CBAM requires each EU Member State to designate a competent authority to carry out the functions and duties under it.<sup>20</sup> Those competent authorities will, as part of carrying out a Member States' functions and duties in respect of EU CBAM, be tasked with enforcement of the regime, including the imposition of penalties for non-compliant undertakings.

## Penalties for non-compliance with reporting requirements

The EU CBAM Implementing Regulation empowers Member States to impose penalties for non-compliance where declarants have not complied with the obligation to submit a CBAM report, or where the CBAM report is incorrect or incomplete and has not been corrected. These penalties range from €10 to €50 per tonne of unreported embedded emissions. Competent authorities have the discretion to determine the penalty amount by considering several factors, including the extent of unreported information, intentional or negligent behaviour, and past behaviour.<sup>21</sup>

## Requirements from 2026 onwards: declarations and certificates

After the end of the transition period, from 2026, authorised declarants representing the importers of certain goods will be required to purchase and surrender CBAM certificates for the embedded emissions of their imported goods, with the price for those certificates deriving from the EU ETS allowance price.

Authorised declarants will be required to submit an annual CBAM declaration by 31 May each year (for the preceding calendar year), beginning from 2027, through the CBAM registry. Each annual EU CBAM declaration must contain the following information:<sup>22</sup>

- The **total quantity** of each type of covered goods imported during the preceding calendar year (expressed in MWh for electricity, and tonnes for all other goods).
- The **total embedded emissions** of covered goods (expressed in tCO<sub>2</sub>e per MWh for electricity, and tCO<sub>2</sub>e per tonne for other goods).
- The **total number of CBAM certificates** to be surrendered (corresponding to the total embedded emissions, less the carbon price paid in the country of origin).
- The **verification reports** issued by accredited verifiers.

## Penalties for non-compliance with certificate surrender requirements

Where EU CBAM declarants have not surrendered the necessary certificates, competent authorities will be able to impose penalties on the declarants, who will be liable for the same excess emissions penalty that operators face under the EU ETS: specifically, €100 per tCO<sub>2</sub>e of embedded emissions of a covered good for which the importer has not surrendered EU CBAM certificates, in addition to surrendering an amount of EU CBAM certificates equal to the excess emissions in the following calendar year.<sup>23</sup>

By contrast, where covered goods are imported by a person (natural or legal) not authorised as an EU CBAM declarant, that person will be liable to pay a penalty, being an amount between three and five times the excess emissions penalty (or between €300 to €500 per tCO<sub>2</sub>e of embedded emissions). In determining the precise penalty, competent authorities will take into account the gravity, scope, intention, repetition of non-compliance, and cooperation of the person.<sup>24</sup>

The EU CBAM also contains measures designed to avoid circumvention of the Regulation. This relates, for example, to the slight modification of goods to ensure that they do not fall within the product codes covered under the EU CBAM, or artificially splitting up shipments so that their value falls below EU CBAM thresholds. Upon becoming aware of such circumvention attempts, the European Commission will investigate and may amend the list of covered goods to include the relevant modified goods.<sup>25</sup>

<sup>20</sup> Articles 11 and 12, EU CBAM Regulation.

<sup>21</sup> Article 16, EU CBAM Implementing Regulation.

<sup>22</sup> Article 6(2), EU CBAM Regulation.

<sup>23</sup> Article 26(1), EU CBAM Regulation; Article 16(3), Directive 2003/87/EC.

<sup>24</sup> Article 26(2), EU CBAM Regulation.

<sup>25</sup> Article 27, EU CBAM Regulation.

## Exemptions

EU CBAM declarants will be able to claim a reduction in the amount of EU CBAM certificates that they must surrender for a foreign carbon price effectively paid for covered goods imported into the EU.<sup>26</sup>

EU CBAM declarants seeking to make use of this exemption will need to provide evidence of their having paid a carbon price elsewhere, and have this information independently certified.

The extent to which non-EU countries' climate measures could offer exemptions from the EU CBAM, or enable importing firms to reduce their compliance burdens, remains uncertain. While the scope of acceptable explicit carbon pricing policies under the EU CBAM remains subject to future guidance, it may, at least initially, be narrowly construed (and for example may exclude voluntary regimes including carbon crediting mechanisms).

## INTERNATIONAL TRADE AND THE GEOPOLITICAL IMPLICATIONS OF THE EU CBAM

From an international trade perspective, the introduction of the EU CBAM comes at a critical juncture in UK-EU—and global—cooperation on trade and climate change. The EU CBAM links trade and climate change policies in an unprecedented way. It establishes a strong precedent for introducing environmental and social measures into trade policy.

Several countries—including India, Indonesia, and China—have already expressed strong concerns about the EU CBAM, and are considering bringing World Trade Organisation (“WTO”) disputes against the EU. They argue that the EU CBAM is likely to have de facto discriminatory impacts on certain countries, sectors, and smaller companies. This is because EU importers will likely seek to shift the information gathering and compliance burden, and the tariff cost, onto exporters in those third countries.<sup>27</sup>

The EU CBAM could also create incentives for the EU's trading partners to implement their own carbon pricing policies, or to seek to negotiate exemptions or bilateral agreements with the EU in respect of equivalence of domestic carbon policies.

Furthermore, certain countries may respond to the EU CBAM by forming so-called “climate clubs” with the EU. These could be either sector-specific or broader in scope, between countries with similar levels of climate ambition. For example, the United States and the EU issued a joint statement agreeing to expand market access and suspend ongoing trade disputes over steel and aluminium tariffs at the WTO.<sup>28</sup>

Separately, Brazil, India, China, and South Africa issued a joint statement<sup>29</sup> condemning the EU CBAM, including for its disregard of the “common but differentiated responsibilities” principle under the Paris Climate Agreement and United Nations Framework Convention on Climate Change.<sup>30</sup> Some UN agencies have similarly urged that the EU CBAM must be adjusted to account for the “Common But Differentiated Responsibilities” or “CBDR” principle.<sup>31</sup>

<sup>26</sup> Article 9, EU CBAM Regulation.

<sup>27</sup> It should however be noted that the EU CBAM currently only covers approximately 3.2% of goods imported into the EU, meaning that its impact may not be as great as feared by third countries. Nevertheless, it is possible that the EU CBAM pushes third countries to deploy retaliatory measures, such as import taxes, targeting the EU's goods in attempts to rebalance trade flows.

<sup>28</sup> See Steel and Aluminum U.S.-EU Joint Statement issued on 31 October 2021: [Steel and Aluminum U.S.-EU Joint Statement | U.S. Department of Commerce](#).

<sup>29</sup> See South African Government, Joint Statement issued at the conclusion of the 30th BASIC Ministerial Meeting on Climate Change (8 April 2021): [here](#).

<sup>30</sup> Article 2, Paris Climate Agreement; Article 3, UNFCCC.

<sup>31</sup> UNCTAD (2021), [A European Union Carbon Border Adjustment Mechanism: Implications for developing countries](#).

<sup>32</sup> [Addressing Carbon Leakage Risk to Support Decarbonisation](#).



# IMPLICATIONS OF THE EU CBAM FOR THE UK AND UK POLICY RESPONSE

UK companies importing products into the EU, as well as (indirectly) UK exporters to the EU, are subject to the EU CBAM.

Whilst the UK implements an emissions trading scheme (“UK ETS”) which mirrors that of the EU such that in principle exemptions from the tariffs may apply, we have observed a material decoupling of the price of EU allowances and UK allowances. It is also anticipated that there will be further divergences in the designs of the UK ETS and EU ETS in future.

In light of this, we expect that EU importers of covered goods from the UK will likely need to surrender EU CBAM certificates (from 1 January 2026) to calibrate their carbon costs with those faced by EU producers. As a result, they may seek to pass on compliance costs and reporting obligations to UK exporters, or they may choose to source the goods from EU producers instead.

It should however be noted that the exposure of UK products to the EU CBAM is likely to be considerably lower than other countries due to the limited trade in goods covered under the scheme, and the lower emissions intensity of UK-produced covered goods.

## Development of a UK CBAM?

The UK government is considering several of its own domestic policy options to protect against carbon leakage. The UK government launched a consultation as part of the Net Zero Growth Plan in March 2023.<sup>32</sup> The consultation sought views on the appropriateness of implementing a range of potential carbon leakage measures in the UK, including a carbon border adjustment mechanism. We discussed the consultation in our [Powering Up Britain](#) article earlier this year.

The UK government noted that the earliest point at which it would consider implementing a UK CBAM is in 2026. This timing means that, if the UK CBAM commences with a transition period (as the EU CBAM did), then there may be a degree of time lag between the two mechanisms.

A challenge for the UK government will be to develop its own CBAM in parallel with the EU CBAM. Significant policy divergences between the two mechanisms risk exacerbating the compliance burden for companies with obligations under both a UK CBAM and the EU CBAM. Such overlapping, but different, compliance regimes could increase the transaction and operational costs of maintaining operations in both the EU and UK.

Fundamental policy differences may also present political barriers to linking the UK ETS and EU ETS. In addition, delays in developing a UK CBAM may result in UK exporters to the EU facing higher EU CBAM liabilities (due to costs being passed on by EU importers), particularly if growing divergences between the UK ETS and EU ETS make demonstrating carbon pricing equivalence more difficult.

## CONCLUSION

As highlighted previously in Section 2, with reporting obligations now applicable, producers, exporters and importers into the EU will need to implement measures to meet the data requirements, to assess the cost of compliance and to consider how best to optimise their operations in order to remain competitive prior to the full implementation of the EU CBAM from 1 January 2026.

<sup>32</sup> [Addressing Carbon Leakage Risk to Support Decarbonisation.](#)

# SLAUGHTER AND MAY/



**Samantha Brady**  
**Head of Environment & Climate**  
T +44 (0)20 7090 4279  
E [samantha.brady@slaughterandmay.com](mailto:samantha.brady@slaughterandmay.com)



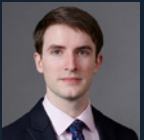
**Samay Shah**  
**Partner**  
T +44 (0)20 7090 5104  
E [samay.shah@slaughterandmay.com](mailto:samay.shah@slaughterandmay.com)



**Oliver Moir**  
**Partner**  
T +44 (0)20 7090 3307  
E [oliver.moir@slaughterandmay.com](mailto:oliver.moir@slaughterandmay.com)



**Aaron Wu**  
**Senior PSL, Infrastructure, Energy  
and Natural Resources**  
T +44 (0)20 7090 3328  
E [aaron.wu@slaughterandmay.com](mailto:aaron.wu@slaughterandmay.com)



**Daniel Mewton**  
**Associate**  
T +44 (0)20 7090 5909  
E [daniel.mewton@slaughterandmay.com](mailto:daniel.mewton@slaughterandmay.com)



**Helena Cameron**  
**Associate**  
T +44 (0)20 7090 4046  
E [helena.cameron@slaughterandmay.com](mailto:helena.cameron@slaughterandmay.com)

Please get in touch with the authors or your usual contact at Slaughter and May if you would like to discuss any of the issues raised in this publication.

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