SMITH & NEPHEW PLC
Form 20-F
March 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark One)

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

or

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

or

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-19003

Smith & Nephew plc

(Exact name of Registrant as specified in its charter)

England and Wales

(Jurisdiction of incorporation or organization)

15 Adam Street, London WC2N 6LA

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name on each exchange on which registered
American Depositary Shares	**New York Stock Exchange**
Ordinary Shares of 20¢ each	**New York Stock Exchange***

*** Not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.**

Securities registered or to be registered pursuant to Section 12(g) of the Act: None.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None.

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report: 940,638,300 Ordinary Shares of $12^{2}/_{9}$p each

Indicate by check mark if the registrant is a well seasoned issuer, as defined in Rule 405 of the Securities Act Yes x No ¨

If this Report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large Accelerated Filer x Accelerated Filer ¨ Non-accelerated filer ¨

Indicate by check mark which financial statement item the registrant has elected to follow: Item 17 ¨ Item 18 x

If this is an annual report, indicated by check mark whether the registrant is a shell company (as defined in Rule

12b-2 of the Exchange Act). Yes ¨ No x

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Dear Shareholder

As a consequence of the Company s Ordinary Shares being traded on the New York Stock Exchange (in the form of American Depositary Shares) we are required to prepare and file a Form 20-F with the US Securities and Exchange Commission. In order to provide the same information to both UK and US shareholders the Annual Report and Accounts and the Company s Form 20-F filing are combined as a single document. US shareholders receive the combined Annual Report and Form 20-F and the Summary Financial Statement.

For non-US shareholders, the combined Annual Report and Form 20-F contains a very large amount of information and you may not wish to receive such a large document in the future. If so, please complete the enclosed form of request to elect to receive the Company s Summary Financial Statement in future, which is sent to the vast majority of shareholders each year in place of the Combined Annual Report and Form 20-F. Alternatively you may elect to receive the Combined Annual Report and Form 20-F electronically by completing the enclosed form. Shareholders electing to receive the Summary Financial Statement, may subsequently choose to receive the full combined Annual Report and Form 20-F. Likewise shareholders electing to receive communications electronically can elect to revert to receiving paper copy versions.

Yours sincerely,

Dudley Eustace

Chairman

2 March 2006

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INTRODUCTION

The Smith & Nephew Group is a global medical devices business engaged in orthopaedics, endoscopy and advanced wound management having revenue of over £1.4 billion in 2005. Smith & Nephew plc is the parent company of the Smith & Nephew Group. It is an English public limited company with its shares listed on the official list of the UK Listing Authority which are traded on the London Stock Exchange and on the New York Stock Exchange in the form of ADSs.

This report is the Annual Report of Smith & Nephew plc for the year ended 31 December 2005. It comprises in a single document the Annual Report and Accounts of the company in accordance with UK requirements and the Annual Report on Form 20-F in accordance with the regulations of the Securities and Exchange Commission in the US.

A summary report on the year, the Summary Financial Statement 2005, intended for the investor not requiring the full detail of the Annual Report, is produced as a separate document. The Summary Financial Statement includes a summary review of operations, a summary remuneration report and summary financial statements.

Over 90% of non-US shareholders have chosen to receive only the Summary Financial Statement. The Annual Report is issued to US shareholders and those non-US shareholders who have elected to receive it. Both documents are available on Smith & Nephew s corporate website at www.smith-nephew.com/investors/annualreport2005.pdf. Shareholders can elect to receive communications electronically which reduces printing and postage costs and reduces the risk of documents getting lost in the post. To elect shareholders should complete the enclosed form or register with the Company s Registrars at www.shareview.co.uk.

The Group s fiscal year ends on 31 December of each year. References in this Annual Report to a particular year are to the fiscal year unless otherwise indicated. Except as the context otherwise requires, Ordinary Share or share refer to the Ordinary Shares of Smith & Nephew plc of 12 2/9p each.

For the convenience of the reader, a Glossary of technical and financial terms used in this document is included on page 177. The product names referred to in this document are identified by the use of capital letters and are trademarks owned by or licensed to members of the Smith & Nephew Group.

Smith & Nephew s corporate website, www.smith-nephew.com, gives additional information on the Group. Information made available on the website is not intended to be, and should not be regarded as being, part of this Annual Report.

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This Annual Report including the Report of the Directors was approved by the Board of Directors on 2 March 2006.

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FI NANCIAL SUMMARY

Financial Highlights

	2005	2004
	£ million	£ million
Revenue	1,407	1,249
Trading profit	290	250
Operating profit	237	165
Attributable profit for the year:		
Before the restructuring and rationalisation expenses, the fair value of hedge of anticipated sale proceeds of joint venture, macrotextured claim, related taxation relief thereon and amortisation of acquisition intangibles	223	195
After the items above	187	138
Adjusted basic earnings per Ordinary Share (EPSA) (i)	23.8p	20.8p
Basic earnings per Ordinary Share	19.9p	14.8p
Dividends per Ordinary Share	5.6p	5.1p

(i) Throughout this document earnings per share calculated in this way is termed adjusted basic earnings per Ordinary Share (EPSA) and profit calculated in this way is termed adjusted attributable profit . The calculation of adjusted attributable profit and EPSA is set out in Selected Financial Data (page 165).

Change in Accounting Policies

From 1 January 2005, as required by the European Union s IAS Regulation and the Companies Act 1985, the Group has prepared its accounts in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU). IFRSs as adopted by the EU differ in certain respects from IFRSs as issued by the International Accounting Standards Board (IASB). However the Group accounts for the years presented would be no different had the Group applied IFRSs as issued by the IASB. Reference to IFRS hereafter should be construed as reference to IFRSs as adopted by the EU.

Change in Functional and Reporting Currency

On 23 January 2006 the Sterling Ordinary Shares of Smith & Nephew plc were cancelled and new shares denominated in US Dollars were issued, carrying exactly the same rights. The redenomination aligns the capital base of the Group with its effective functional currency. Future dividends will be declared in US Dollars, commencing with the second interim dividend for 2005. The Group changed its reporting currency to US Dollars with effect from the beginning of 2006 so as to align it with the principal business activities. In 2005, only 9% of Group revenue arose in the UK compared with 49% in the US. These changes in functional and reporting currencies will reduce significantly the exposure of the Group s results to movements in translational exchange rates and thus reduce the volatility of reported revenues, profits and earnings.

2005 Dividends

Following the redenomination of share capital into US Dollars the Board has declared a second interim dividend of 6.1¢ per share. Shareholders with a registered UK address will receive 3.5p per share which together with the interim dividend of 2.1p, makes a total for 2005 of 5.6p. The second interim dividend will be paid on 12 May 2006 to shareholders on the register at the close of business on 21 April 2006.

Presentation

Smith & Nephew believes that the reporting of profit and earnings before items which may distort comparability, provides additional information on underlying returns and trends to shareholders. Such items arise from events or transactions that fall within the ordinary activities of the Group but which management believes should be separately identified to help explain trends as they are exceptional in nature or derive from specific accounting treatments. The Group s internal financial reporting focuses primarily on profit and earnings before these items and these are the key performance indicators used in budgets, monthly reporting, forecasts, long-term planning and incentive plans. Such items principally comprise restructuring, rationalisation and acquisition related expenses, the macrotextured claim, net profit on disposal of an associated undertaking and taxation thereon and amortisation of acquisition intangibles.

Management s key indicator of revenue performance is underlying growth in revenue. This is calculated by excluding the effects of foreign currency translation movements (constant currency) and acquisitions. Management believes that revenue growth on an underlying basis provides a consistent year-on-year measurement of performance without the distortions created by the translation effect of foreign currency

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movements and acquisitions which are separate from the Group s normal operations. Underlying revenue growth is used by management in its internal financial reporting, budgeting and planning. A reconciliation of reported revenue growth to underlying revenue growth is provided on page 29.

The results of the Group, as reported in Sterling, are affected by movements in exchange rates between Sterling and overseas currencies. The Group used the average exchange rates prevailing during the year to translate the results of overseas companies into Sterling. The currencies which most influenced these translations in the years covered by this report were the US Dollar and the Euro. During 2005 average Sterling exchange rates were weaker against the US Dollar by 2% and unchanged against the Euro compared with 2004.

The Group Accounts of Smith & Nephew in this Annual Report are presented in Sterling. Solely for the convenience of the reader, certain parts of this Annual Report contain translations of amounts in Sterling into US Dollars at specified rates. These translations should not be construed as representations that the Sterling amounts actually represent such US Dollar amounts or could be converted into US Dollars at the rate indicated. Except as where stated otherwise, the translation of pounds Sterling and pence to US Dollars and cents appearing in this Annual Report has been made at the noon buying rate in The City of New York for cable transfers in Sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) on the date indicated. On 24 February 2006, the Noon Buying Rate was US$1.74 per £1.

The Accounts of the Group in this Annual Report are presented in millions (m) unless otherwise indicated.

Special Note Regarding Forward-Looking Statements

The Group s reports filed with, or furnished to, the US Securities and Exchange Commission (SEC), including this document and written information released, or oral statements made, to the public in the future by or on behalf of the Group, constitute forward-looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995. In particular, statements regarding planned growth in our business and in our trading margins discussed under Outlook and Trend Information are forward-looking statements as are discussions of our product pipeline and discussions of the costs of future revisions of the macrotextured knee product under Recent Developments , Legal Proceedings and Operating and Financial Review, Liquidity and Prospects . When used in this Annual Report, the words aim , anticipate , believe consider , estimate , expect , intend , plan , well-placed , target and similar expressions are generally intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors (including, but not limited to, the outcome of litigation and regulatory approvals) that could cause the actual results, performance or achievements of Smith & Nephew, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Specific risks faced by the Group are described under Risk Factors on page 23 of this Annual Report.

All forward-looking statements in this Annual Report are based on information available to Smith & Nephew as of 2 March 2006. All written and oral forward-looking statements attributable to Smith & Nephew or any person acting on behalf of Smith & Nephew are expressly qualified in their entirety by the foregoing. Smith & Nephew does not undertake any obligation to update or revise any forward-looking statement contained herein to reflect any change in Smith & Nephew s expectation with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Market Data

Market data and market share estimates throughout this report are derived from a variety of sources including publicly available competitors information, internal management information and independent market research reports.

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DESCRIPTION OF THE GROUP

This section discusses the activities, resources and operating environment of the business under the following headings:

Discussion of the Group s management structure and corporate governance procedures is set out in the Corporate Governance section (pages 48 to 57).

The Remuneration Report gives details of the Group s policies on senior management s remuneration in 2005 (pages 58 to 67).

Discussion of the Group s operating and financial performance liquidity and financial resources for 2005 and 2004 is given in the Operating and Financial Review, Liquidity and Prospects (pages 27 to 47).

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THE BUSINESS

HISTORY AND DEVELOPMENT

Group Overview

Smith & Nephew is a global business engaged in the development, manufacture and marketing of medical devices in the sectors of orthopaedics, endoscopy and advanced wound management.

The Group has a history dating back 150 years to the family enterprise of Thomas James Smith who opened a small pharmacy in Hull, England in 1856. On his death in 1896, his nephew Horatio Nelson Smith took over the management of the business. Smith & Nephew was incorporated and listed on the London Stock Exchange in 1937. Today it is a public limited company incorporated in the UK registered in, and conducted under the laws of, England and Wales. Operations in countries other than the UK are under the laws of those countries. In November 1999, the Group was listed on the New York Stock Exchange. The corporate headquarters is in the UK and the registered address is:

Smith & Nephew plc

15 Adam Street

London WC2N 6LA

Tel: +44 (0) 20 7401 7646

Website: www.smith-nephew.com

In 2001, Smith & Nephew became a constituent member of the FTSE-100 index in the UK. This means that Smith & Nephew is included in the top 100 companies traded on the London Stock Exchange measured in terms of market capitalisation.

Recent Developments

In October 2005, the Group announced its intention to exit the tissue engineering operations of its advanced wound management business due to delays in achieving economic viability. Since no purchaser was found for the going concern, production ceased in December 2005 and the operation will be closed during the first quarter of 2006. A rationalisation charge of £39m was recorded in 2005.

In August 2005, Smith & Nephew announced that, together with its partner Beiersdorf AG, it was preparing for the divestment of its joint venture BSN Medical. Subsequently, on 16 December 2005 Smith & Nephew and Beiersdorf AG announced that they had signed an agreement to sell BSN Medical to Montagu Private Equity for an enterprise value of 1,030m. This agreement was conditional upon receipt of competition clearances and completion of the transaction was expected in the first quarter of 2006. The transaction was completed on 23 February 2006. The Group s share of the results of BSN Medical have been classified as Discontinued Operations in accordance with IFRS.

In March 2005 the US Attorney s Office in Newark, New Jersey issued a subpoena to the Group s orthopaedic business asking for copies of its consulting, professional service and remuneration agreements with orthopaedic reconstructive surgeons. Four of the divisions major competitors received similar subpoenas. The Company is co-operating fully with the US Attorney, has provided copies of the requested contracts and is gathering additional documents which have also been requested.

In August 2003, Smith & Nephew withdrew from all markets the macrotextured version of its OXINIUM femoral knee component. As at that date, 2,971 components had been implanted of which approximately 2,471 were in the USA, 450 in Australia and 50 in Europe. As at 24 February 2006, 964 revision surgeries had been carried out on affected patients and settlements were agreed with patients in respect of 796 of these revisions. As discussed more fully under Legal Proceedings , due to the denial of insurance coverage by certain of the Group s product liability insurers in respect of existing claims and future claims, a provision of £80m was recorded in 2004, representing unsettled insurance claims and an estimate of claims likely to arise in the future assuming that no further insurance cover is available. After adjusting for costs charged against the provision and for the effect of translational exchange rate movements £44m remains to settle pending and future claims. These estimates constitute forward looking statements that are subject to uncertainties. Depending on the number and average cost of actual revisions, costs to Smith & Nephew may be greater or less than the amount of this provision. See Legal Proceedings and Risk Factors .

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BUSINESS DESCRIPTION

Group Structure

Smith & Nephew operates on a worldwide basis. This has been achieved through a series of acquisitions, predominantly in the US but also in Europe, and through continued emphasis on the development and introduction of new products in the Group s principal markets.

During the period covered by the Annual Report Smith & Nephew was organised into three global business units of orthopaedics, endoscopy and advanced wound management and a separate indirect market unit. Each of the global business units manages its sales directly in ten international markets the US, Canada, the UK, Germany, Japan, Australia, France, Italy, New Zealand and Ireland and takes full responsibility for strategy, research and development (R&D), manufacturing, marketing, sales and financial performance. The remaining 23 markets in which the Group has selling companies are managed by country managers, with business responsibility for the whole of the Group s product range, and comprise the indirect market unit.

With effect from 2006, orthopaedics will be segmented organisationally into orthopaedic reconstruction and orthopaedic trauma, including clinical therapies, to create a fourth global business unit.

A head office team in London, England directs the overall business and supports the business units, primarily in the areas of business development, company secretarial, finance, human resources and investor relations, with a legal department based in Memphis, Tennessee. A central research facility in York, England is charged with the development of enabling technologies in both materials science and biology, particularly cell biology.

Orthopaedics

Overview

Orthopaedic products comprise reconstruction joint implants, trauma products and associated clinical therapies. Reconstruction implants include hip, knee and shoulder joints as well as ancillary products such as bone cement and mixing systems used in cemented reconstruction joint surgery. Trauma products consist of internal and external fixation devices and orthobiological solutions used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies consist of products applied in an orthopaedic office or clinic setting and currently comprise bone growth stimulators and a joint fluid therapy product.

The orthopaedics business is managed worldwide from Memphis, Tennessee, which is also the site of its main manufacturing facility. Orthopaedic implants and trauma products are also manufactured at a small facility in Tuttlingen, Germany. As described in Property, Plant and Equipment continuing strong revenue growth has created the need for expansion in both manufacturing and administrative facilities.

The Group s reconstruction knee business is built on two major knee systems: GENESIS II, designed to facilitate the accuracy and efficiency of the operating procedure and provide improved long-term clinical results; and PROFIX, a reconstruction knee system featuring simpler instruments and surgical technique.

Within the reconstruction hip line, the SPECTRON cemented hip system and the REFLECTION acetabular cup system have documented positive long-term clinical performance. More recently, the success of SYNERGY, a tapered titanium stem system, ECHELON, a revision stem system and BIRMINGHAM HIP RESURFACING (BHR), a hip resurfacing system (approved for sale outside of the US) have established Smith & Nephew as a strong player in this product segment.

The BHR product was acquired with the purchase of Midland Medical Technologies (MMT) in 2004 for £69m in cash and loan notes. Additional payments of up to £10m in cash are contingent upon certain regulatory milestones being achieved.

The Group has developed and manufactures knee and hip implant components made from oxidised zirconium (OXINIUM) which is patent protected and which management believes possesses improved wear characteristics which may be of significant benefit to younger, more active patients.

Within the trauma business, internal fixation products, such as the TRIGEN intramedullary nail system and PERI-LOC lower extremity locked plating system and the IMHS CP JET-X and TAYLOR SPATIAL FRAME external fixators, provide orthopaedic surgeons with a comprehensive offering of products to address trauma and osteoporotic procedures. Orthobiologic products, including demineralised bone matrix are also offered for use in conjunction with reconstruction and trauma surgeries.

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The EXOGEN ultrasonic bone healing stimulator and SUPARTZ hyaluronic acid joint fluid therapy are the main products in the clinical therapies sector.

To compete effectively in the growing global orthopaedic market, management believes that as well as having a leading edge product range it is important to have a skilled sales force that can build strong relationships with surgeons and to provide high levels of customer service. At the end of 2005 the global sales force numbers 1,532 of whom 1,021 serve the US market.

Strategy

Smith & Nephew s orthopaedics strategy is for future growth through innovation in product development in its existing core business and expansion into fast-growing market areas including revision products for hip and knee, extremities fracture management and alternative therapies for pain management and fracture healing. Management believes that the orthopaedic market will continue to grow for the foreseeable future. This is largely attributable to the increasing proportion of the population aged over 55 and the increasing need for joint reconstruction products for this age group, increasing obesity and providing other orthopaedic therapies for younger, more active patients.

Smith & Nephew also intends to further penetrate these markets by expanding its sales force and by introducing less invasive and alternative therapies. The Group is also contributing to patient education and empowerment through its websites and other direct-to-consumer activities.

Management believes that future growth will be enhanced by segmenting the business into two separate global units, orthopaedic reconstruction and orthopaedic trauma including clinical therapies, effective from the beginning of 2006.

In June 2005, certain assets of Leading Kabushiki Kaisah (Leading Medical) orthopaedic distributor in Japan were acquired. This combination doubles the size of the Group s reconstruction sales force in Japan, enabling a greater level of service and coverage in what management believes to be the second largest orthopaedic market in the world.

New Products

In 2005, the orthopaedics business continued the promotion and roll-out of OXINIUM technology across the knee and hip product line. OXINIUM is a material exclusive to Smith & Nephew which has the strength of a metal with the wear properties of a ceramic material and expands the market for hip and knee implants. In November 2005 the LEGION Revision Knee System was released for sale. This system utilises OXINIUM technology in the revision implant. The full effect of LEGION, as well as continued extensions of the OXINIUM technology is anticipated in 2006.

In February 2005, the PERI-LOC Periarticular Locked Plating System was released for sale. PERI-LOC is a trauma plating device used to treat lower extremity bone fractures and allows the surgeon to save time in the operating room and perform less invasive surgeries. The upper extremity version of the system is expected to be launched in mid 2006.

In September 2005, MOBILAB, a comprehensive mobile surgical training facility for orthopaedic surgeons was introduced. By travelling to hospitals and clinics across the US, the MOBILAB enables surgeons to have local access to training in the latest surgical techniques. The unit is

scheduled to visit 48 US cities in the first 12 months of operation.

Recent Regulatory Approvals

In September 2005, the FDA Orthopaedic Advisory Panel recommended conditional approval of the BHR product to the FDA for use in the US.

In 2005 Smith & Nephew received clearance of the Stride (Onishi) Porous Hip Stem and GENESIS II minimally invasive (MIS) tibial base plates in Japan from the Ministry for Health Labour and Welfare.

Competition

Management estimates that the worldwide orthopaedic market (excluding spine) served by the Group grew by 11% in 2005 and is currently worth more than £8 billion per annum. Management believes that Smith & Nephew holds a 9% share of this market by value.

Principal global competitors in the orthopaedic market and their estimated global shares, are Zimmer (21%), Stryker (17%), De Puy/Johnson & Johnson (17%), Biomet (11%) and Synthes (11%).

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Endoscopy

Overview

Smith & Nephew s endoscopy business, headquartered in Andover, Massachusetts, develops and commercialises a range of endoscopic (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissue, articulating joints, spinal discs and vascular structures. The business focuses principally on the arthroscopy sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, shoulder and hip.

The endoscopy business offers surgeons endoscopic technologies for surgery, including: fluid management and insufflation equipment for surgical access; digital cameras, digital image capture, central control, multimedia broadcasting, scopes, light sources and monitors to assist with visualisation; radiofrequency wands, electromechanical and mechanical blades, and hand instruments for resecting damaged tissue; and specialised devices, fixation systems and bioabsorbable materials to repair damaged tissue. The business also designs, markets and provides services to its Digital Operating Room suites, which use computer and internet technology to put surgeons and other medical professionals in full control of the operating room environment.

Manufacturing facilities are located currently in Andover and Mansfield, Massachusetts and Oklahoma City, Oklahoma. It was announced in August 2005 that the Andover manufacturing facility will close by early 2007. Major service centres are located in the US, the UK, Germany, Japan and Australia.

Of the global sales force at the end of 2005 of 684, 374 serve the US market.

Strategy

Smith & Nephew s strategic intent is to establish the business as the leading provider of endoscopic techniques for joint and ligament repair and to use its core capabilities to penetrate other selected endoscopic markets. Management believes that the business capitalises on the growing acceptance of endoscopy as a preferred surgical choice among physicians, patients and payors.

To sustain growth and enhance its market position, the endoscopy business supports its strategy with surgeon education programmes, financing solutions, global fellowship support initiatives, partnerships with professional associations and surgeon advisory boards.

New Products

In 2005, the 400 Series Camera System, the latest generation of the Group s surgical camera and camera control unit (CCU) was introduced. This system automatically and instantaneously optimises settings in the camera head and CCU to provide the best image.

The launch of the DYONICS 25 Fluid Management System, a surgical pump for use during arthroscopy, provides an opportunity to market a pump using updated technology to replace an old product within the access range.

Smith & Nephew continues to expand its mechanical and radio frequency products, within arthroscopic resection, with the recent addition of the INCISOR Plus ELITE shaver blades and the GLIDER Articular Cartilage Probe. The INCISOR Plus ELITE s design represents the sharpest serrated cutting surface offered in the DYONICS POWER range. The GLIDER probe is designed to treat articular cartilage disease in weight-bearing joints, and features a pivoting head that emits radio frequency energy as it follows the contoured surface of the joint, restoring smoothness to a damaged cartilage surface while preserving the maximum amount of healthy tissue. A patent dispute with ArthroCare Inc., was resolved in 2005, enabling the Group to resume selling its DYONICS ELECTROBLADE Resector and SAPHYRE Bipolar Ablation Probe products.

Recent additions to the Group s repair product line include the GTS System for use in soft-tissue ACL reconstruction in the knee and the BIORAPTOR 2.9 Premium Anchor in the shoulder. The ACCU-PASS Suture Shuttle, a fully featured instrument for use in shoulder repair, was also launched.

Expanding its line of Spine products, Smith & Nephew introduced the Controlled Disc Stimulation (CDS) System, which provides a standard platform for discography, a method of diagnosing the source of disc-related back or neck pain.

Recent Regulatory Approvals

During 2005, the endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: CALAXO absorbable osteoconductive

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interference screw for fixation of an ACL graft; GLIDER Articular Cartilage radiofrequency probe for controlled smoothing of the articular cartilage surface; DYONICS 25 pump next generation arthroscopy fluid management system; CONDOR Controller, for centralised control of medical and audio-visual equipment in the Digital Operating Room; Controlled Disc Stimulation System for automated diagnosis of discogenic pain (Discography); and various other arthroscopy fixation devices.

Competition

Management estimates that the global arthroscopy market in which the business principally participates is worth £860 million a year and is growing at 8% annually, driven by increasing numbers of sports injuries, longer and more active lifestyles, patient desire for minimally invasive procedures, innovative technological developments and a need for cost effective procedures. Management believes that Smith & Nephew has a 29% share of the global arthroscopy market. Smith & Nephew also participates in the developing minimally invasive spinal and minimally invasive vascular markets and continues to seek ways to leverage its knowledge, experience and core capabilities in other selected endoscopic markets.

Smith & Nephew s main competitors and their estimated shares of the global arthroscopy market are: Mitek/Johnson & Johnson (19%), Arthrex (17%), Linvatec/Conmed (12%), Stryker (12%) and Arthrocare (6%).

Advanced Wound Management

Overview

Smith & Nephew s advanced wound management business is headquartered in Hull, England. It supplies a range of products and clinical support services for the treatment of chronic and acute skin wounds. It offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted particularly at chronic wounds connected with the older population, such as pressure sores and venous leg ulcers, burns and complex surgical wounds.

Advanced wound management products are manufactured in facilities in Hull and Gilberdyke, England; Largo, Florida and by certain third party manufacturers.

The advanced wound management business has continued to build its sales and marketing infrastructure in the world s major markets. These initiatives have led to increased levels of demand on the Group s manufacturing and global supply chain, which have been addressed with increased investment in the production capacity in Hull, Gilberdyke and Largo.

Strategy

The strategy for the advanced wound management business is to focus on the higher added value segments of wound bed preparation and moist and active healing.

The business has built its sales and marketing infrastructure in the world s major markets, largely through investment in additional sales teams particularly in the key markets of the US, Japan and Europe. At the end of 2005 the global sales force is 924 of whom 185 are in the US.

In October 2005, the Group announced its exit from its tissue engineering operations comprising DERMAGRAFT, a human dermal replacement product designed as a treatment for diabetic foot ulcers, and TRANSCYTE, a temporary wound covering for the treatment of burns. Both products were manufactured at La Jolla, California.

New Products

Management believes that the market will continue the trend towards advanced products with their ability to accelerate healing rates, reduce hospital stay times and cut the cost of nursing and clinician time and aftercare in the home.

The range of ALLEVYN hydrocellular dressings was extended with the re-launch of improved ALLEVYN Plus. Management believes that ALLEVYN is the largest selling dressing in its category in the world.

Sales of ACTICOAT have been augmented by the launch of ACTICOAT Moisture Control in the US and Canada, an antimicrobial barrier dressing with foam and waterproof film layers, and the completion of the European launches of ACTICOAT ABSORBENT. The moisture control product provides an effective barrier to bacterial penetration and is designed to help maintain a moist wound environment in the presence of exudate. The absorbent product is

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an antimicrobial alginate dressing that provides an effective wound barrier. The ACTICOAT range incorporates the smallest crystallised silver (nanocrystalline silver) used in the treatment of wounds or burns. The silver reduces the risk of bacterial colonisation and acts to kill micro-organisms that can cause infection and prevent or retard healing.

2005 was the first full year of VERSAJET, a fluid jet debridement system, acquired in 2004. The product has been launched in thirteen markets worldwide. A new handpiece was launched in the US during 2005 that enables faster debridement with enhanced precision.

Recent Regulatory Approvals

During 2005, the advanced wound management business secured over 200 medical device and 120 pharmaceutical registration approvals in various markets throughout the world. Among the most significant approvals were those for ACTICOAT Moisture Control in the US and CADEX (IODOSORB powder and ointment) in Japan. VERSAJET gained CE mark approval in Europe.

Competition

Management estimates that the sales value of the advanced wound management market worldwide is £2 billion a year, that this grew 10% in 2005, and that Smith & Nephew has a 18% market share. Growth is driven by an ageing population and by a steady advancement in technology and products that are more clinically efficient and cost effective than their conventional counterparts. Management believes that, with approximately only half of chronic wounds globally still treated with conventional dressings, there is strong growth potential for advanced technology products.

Worldwide competitors in advanced wound management and their estimated market shares comprise Kinetic Concepts (25%), the Convatec division of Bristol-Myers Squibb (11%), Johnson & Johnson (8%), and 3M (8%).

Joint Ventures and Discontinued Operations

Joint Ventures and Associated Undertakings

Joint ventures are those in which the Group holds an interest on a long-term basis and which are controlled by the Group and one other entity under a contractual agreement.

Smith & Nephew previously owned 50% of the BSN Medical joint venture, which became operational on 1 April 2001. It was jointly owned with Beiersdorf AG and was independently managed. BSN Medical comprises traditional woundcare, fracture casting and bandaging and compression hosiery businesses. Headquartered in Hamburg, Germany it has manufacturing facilities in US, UK, Germany, France, Republic of Ireland, South Africa, Mexico, Venezuela and Pakistan. During 2004 BSN Medical acquired the fracture casting and splinting business of DePuy, Inc., a Johnson & Johnson company and integrated it with its casting and bandaging business. In certain markets, Smith & Nephew s sales forces sell BSN Medical s products on an agency basis in return for an agency commission and in some markets, mainly in Asia, Smith & Nephew distributes BSN Medical products. Results were accounted for using the equity method up to 1 October 2005, whereby 50% of the profit after taxation was incorporated into Smith & Nephew s income statement as a single line item.

Following the Group s announcement in August 2005 to dispose of BSN Medical, Smith & Nephew and Beiersdorf AG announced in December 2005 that they had signed an agreement to sell BSN Medical to Montagu Private Equity for an enterprise value of 1,030m. The agreement was conditional upon receipt of competition clearances and completion of the transaction was expected in the first quarter of 2006. The transaction was completed on 23 February 2006. Consequently the results are now classified as discontinued operations.

Associated undertakings are those in which the Group has a beneficial interest of 50% or less in the equity capital and where the Group is able to exercise significant influence over commercial and financial policy decisions. In September 2003, the Group disposed of its 21.5% interest in AbilityOne Corporation (AbilityOne) to Patterson Dental Inc. From 1 April 2002 to 12 September 2003 this interest was included in the Group s accounts as an associated undertaking and accounted for under the equity method, whereby 21.5% of the profit after taxation was incorporated into Smith & Nephew s Income Statement as a single line item. This is also classified as a discontinued operation.

Discontinued Operations

Discontinued operations represent the share of results of the joint venture, BSN Medical, and in 2003 the associated undertaking, AbilityOne.

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OPERATING ENVIRONMENT

REGULATION

The international medical device industry is highly regulated. Regulatory requirements are a major factor in determining whether substances and materials can be developed into marketable products and the amount of time and expense that should be allotted to such development.

National regulatory authorities administer and enforce a complex series of laws and regulations that govern the testing, approval, manufacturing, labelling, marketing and sale of healthcare and pharmaceutical products. They also review data supporting the safety and efficacy of such products. Of particular importance is the requirement in many countries that products be authorised or registered prior to manufacture, marketing or sale and that such authorisation or registration be subsequently maintained. The major regulatory agencies for Smith & Nephew s products are the FDA in the US, the Medicines and Healthcare products Regulatory Agency in the UK and the Ministry for Health Labour and Welfare in Japan. Payment for many medical device products is governed by reimbursement tariff agencies in each individual country.

The trend in recent years has been towards greater regulation and higher standards of technical appraisal, which generally entail lengthy inspections for compliance with appropriate standards, including regulations such as good manufacturing practices. Smith & Nephew believes that these recent changes will not have a material adverse effect on the Group s financial condition and the results of operations. All significant facilities within the Group are subject to regular internal audit for medical device regulatory compliance with national and Group standards and policies.

Smith & Nephew believes that the Group s operations currently comply in all material respects with applicable environmental laws and regulations. Although the Group continues to make capital expenditure for environmental compliance, it is not currently aware of any significant expenditure that would be required as a result of such laws and regulations that would have a material adverse impact upon the Group s financial condition.

PRODUCT LIABILITY

The Group monitors the safety of its products from initial product development through to product use or application. In addition, the businesses of the Group analyse on a worldwide basis reports of adverse reactions and complaints relating to its products. Each business reviews these adverse reactions and complaints and any safety matters arising with independent medical advisors. These conclusions are subsequently reviewed by the Group s independent medical advisor.

Product liability is a commercial risk for the industry of which the Group is a part, particularly in the US. Smith & Nephew has implemented systems it believes are appropriate in respect of loss control techniques. These include reporting mechanisms to ensure early notification of complaints and a legal department which manages product liability claims and lawsuits.

The Group carries product liability insurance to cover exposure as far as practicable. With the exception of the macrotextured product liability claim, discussed under Legal Proceedings , and Risk Factors instances of loss to the Group arising from product liability claims have been covered either directly by the Group or by insurance. Apart from the macrotextured claims, there are no individual product liability claims, and no group of similar claims, that are expected to have a material adverse effect on the Group s financial position.

There can be no assurance that consumers, particularly in the US, will not bring product liability or related claims that would have a material adverse effect on the Group s financial position or results of operations in the future or that the Group will continue to resolve such claims within insurance limits in view of changing legal doctrines and attitudes regarding such matters. See Risk Factors Product Liability Claims and Loss of Reputation .

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RISK MANAGEMENT

Smith & Nephew s products include implantable devices but are not life support medical devices. If these devices malfunction, they could damage or impair the repair of body functions. Management believes that the Group s quality, regulatory and medical controls and insurance cover is adequate and appropriate for this class of products. The Group s reputation is crucially dependent on strong performance in this area and on appropriate crisis management if a serious medical incident or product recall should occur.

The Board is responsible for the maintenance of the Group s systems of risk management and internal control and for reviewing their effectiveness. These systems, which accord with the Turnbull Guidance and have been in place for 2005 and to the date of approval of the report and accounts, involve: the identification, evaluation and management of key risks through a Risk Committee, which reports to the Board annually; business reviews by the Board; and the review by the Audit Committee of internal financial controls and the risk management process. These systems are reviewed annually by the Board. Whilst not providing absolute assurance against material misstatements or loss, these systems are designed to identify and manage those risks that could adversely impact the achievement of the Group s objectives.

The Group maintains insurance against product, employers and directors and officers liabilities, and physical and consequential loss, subject to limits and deductibles. The Group maintains liability provisions to cover known uninsured risks. The Group has been advised that three insurers have declined coverage for macrotextured knee claims. See Legal Proceedings .

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OPERATING ACTIVITIES

MARKETING AND DISTRIBUTION

Smith & Nephew s customers are the various providers of medical and surgical services worldwide. In certain parts of the world, including the UK, much of Continental Europe, Australia, Canada and South Africa, these are largely governmental organisations funded by tax revenues. In the US, the Group s major customers are public and private hospitals, many of which have combined to form large purchasing groups and receive revenue from private health insurance and governmental reimbursement programmes. In the US, Medicare is the major source of reimbursement for knee and hip reconstruction procedures and for wound healing treatment regimes.

Competition exists among healthcare providers to gain patients on the basis of quality, service and price. In many countries, providers are under pressure to reduce the total cost of healthcare delivery. There has been some consolidation in the Group s customer base, as well as amongst the Group s competitors, and these trends are expected to continue in the long term. Smith & Nephew competes against both specialised and multinational corporations, including those with greater financial, marketing and other resources.

The Group s customers reflect the wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are the National Health Service in the UK and HealthTrust in the US. Sales to these customers in 2005 represented approximately 5% and 4% of the Group s worldwide revenue respectively.

In the US the Group s products are marketed directly to doctors, hospitals and other healthcare facilities. Each business unit operates a separate specialised sales force. Within the orthopaedics business further specialisation of the sales force continues to be introduced progressively for reconstruction, trauma and clinical therapy products. In both orthopaedics reconstruction and endoscopy the US sales forces consist largely of independent commissioned sales agents who are managed by a mix of independent agents and the Group s own managers. These agents are not permitted contractually to sell products that compete with Smith & Nephew s. In both businesses, products are shipped and invoiced directly to the ultimate customer. The trauma and clinical therapies and advanced wound management businesses in the US operate sales forces of their own employees who market directly to the ultimate customer. In the US, trauma and clinical therapy products are shipped and invoiced directly to the ultimate customer whereas advanced wound management products are shipped and invoiced to a number of large wholesale distributors.

In the other direct markets of the UK, Ireland, France, Germany, Italy, Australia, New Zealand, Canada and Japan the business units manage separate sales forces directly. Except in Australia and New Zealand where independent sales agents are used the sales forces of the direct markets comprise employees and market directly to the ultimate customer.

The indirect markets unit comprises direct selling and marketing operations in Austria, Belgium, Denmark, Eastern Europe, Finland, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland, China, Hong Kong, Korea, Malaysia, Singapore, Taiwan, Thailand, the United Arab Emirates, South Africa, Mexico and Puerto Rico. In these markets orthopaedics and endoscopy frequently share sales resources. The advanced wound management sales force is separate since it calls on different customers. In all other countries Smith & Nephew sells to third party distributors which market the Group s products locally.

In Continental Europe, the Group operates three centralised distribution facilities. Orthopaedics operates a facility in Paris which acts as a central holding and consolidation point for Continental European stock and stock returns. Product is shipped to Group companies who hold small amounts of stock locally for immediate or urgent customer requirements. Advanced wound management operates distribution centres at Nijmegen, Netherlands and Gothenburg, Sweden from where stock is shipped directly to the ultimate customer in most European markets.

MANUFACTURE AND SUPPLY

Where management considers that the Group possesses a core competence its policy is to manufacture products internally whenever possible to ensure quality, regulatory and cost goals are met. The Group invests in the expansion of its manufacturing facilities and equipment to meet these aims. The Group may outsource some manufacturing for several reasons including requirements for specialised expertise, where appropriate to achieve lower costs of production and due to capacity constraints.

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Where products and services are outsourced, suppliers are determined based on a number of factors which include the complexity of the product, manufacturing technology, manufacturing capabilities, cost competitiveness and intellectual property. Suppliers are selected based on their capability to provide products and services, their ability to establish and maintain a quality system and their financial stability. Suppliers are monitored by on-site assessments and on-going monitoring of delivered products. Ongoing product assurance is maintained by effective quality plans.

Each business unit purchases raw materials, components, finished products and packaging materials from certain key suppliers. These comprise principally metal forgings and stampings for orthopaedics, optical and electronic sub-components and finished goods for endoscopy, active ingredients and finished goods for advanced wound management and packaging materials for all businesses. Management believes that whilst prices of principal raw materials can be volatile the effect is not material to the Group. Finished goods purchased for resale are primarily SUPARTZ joint lubricant and the BHR hip resurfacing product in the orthopaedic business, screen displays and electrical devices in the endoscopy business and enzyme debrider agents and ACTICOAT in the advanced wound management business.

SEASONALITY

Smith & Nephew s revenues are generally at their highest in quarter four of any year. This is caused by the relatively high number of accidents and sports injuries which occur in the North American and European autumn and winter seasons which increase revenues of orthopaedic and endoscopy products and by the higher rates of elective surgery in the quarter.

RESEARCH AND DEVELOPMENT

The business units each manage a portfolio of short and long-term product development projects designed to meet the future needs of their customers and to continue to provide growth opportunities for their businesses. The Group s research and development is directed towards all three business segments. Expenditure on research and development amounted to £67m in 2005 (2004 £66m, 2003 £67m), representing approximately 5% of group turnover (2004 5%, 2003 6%).

The Group s principal research facility is located in York, England. The Group s research programme seeks to underpin the longer-term technology requirements for its businesses and to provide a flow of innovative products. The Group continues to invest in future technology opportunities, particularly bio-resorbable materials, tissue engineering and non-invasive healing devices across the Group. In-house research is supplemented by work performed by academic institutions and other external research organisations principally in the UK and the US.

Product development is carried out at the Group s principal locations, notably in Memphis, Tennessee (orthopaedics), Andover and Mansfield, Massachusetts (endoscopy) and Hull, England (advanced wound management).

INTELLECTUAL PROPERTY

Management believes that the Group s policy concerning intellectual property rights promotes innovation in its businesses. Smith & Nephew has a policy of protecting, with patents, the results of the research and development carried out by the Group. Patents have been obtained for a wide range of products, including those in the fields of orthopaedic, endoscopic and advanced wound management technologies. Patent protection for Group products is sought routinely in the Group s principal markets. Currently, the Group s patent portfolio stands at over 2,300 existing patents and patent applications.

Smith & Nephew also has a policy of protecting the Group s products in the markets in which they are sold by registering trademarks as soon as possible under local laws. The Group vigorously protects its trademarks against infringement and currently is not aware of any significant infringement of its trademark registrations. The present trademark portfolio of the Group consists of over 3,300 trademarks and design rights.

Smith & Nephew s principal products are protected by intellectual property comprising patents, licences and know-how, and it strives to provide a collection of intellectual property for each major product that reduces the risk associated with failure of any individual piece of intellectual property. In addition, most pieces of intellectual property protect a relatively small proportion of the Groups annual revenue. As a result, the Group tries to ensure that its overall business is not sensitive to the loss (however caused) of any single piece of intellectual property.

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In addition to maintaining a policy of protecting its market position by the filing and enforcement of patents and trademarks, Smith & Nephew has a policy of opposing third party patents and trademarks in those areas that might conflict with the Group s business interests.

In the ordinary course of its business, the Group enters into a number of licensing arrangements with respect to its products. None of these arrangements individually is considered material to the operations and the financial results of the Group.

PROPERTY, PLANT AND EQUIPMENT

The Group s principal locations are as follows:

	Approximate area (Square feet 000 s)
Group Head Office in London, England	15
Group research facility in York, England	83
Orthopaedics headquarters and manufacturing facilities in Memphis, Tennessee	784
Orthopaedics distribution facility in Memphis, Tennessee	102
Orthopaedics administration facility in Memphis, Tennessee	84
Endoscopy headquarters in Andover, Massachusetts	112
Endoscopy manufacturing facility in Mansfield, Massachusetts	98
Endoscopy manufacturing facility in Oklahoma City, Oklahoma	100
Advanced Wound Management headquarters and manufacturing facility in Hull, England	546
Advanced Wound Management manufacturing facility in Gilberdyke, England	269
Advanced Wound Management manufacturing facility in Largo, Florida	188

The orthopaedic headquarters and manufacturing facilities in Memphis and the advanced wound management facilities in Hull, Gilberdyke and Largo are freehold while all other principal locations are leasehold. The Group has freehold and leasehold interests in real estate in other countries throughout the world, but no other is significant individually to the Group. Where required, the appropriate governmental authorities have approved the facilities.

During 2005 the Group announced the closure of two of its manufacturing locations. The endoscopy facility ifont>

2010
First Quarter

69.25

58.68

Second Quarter

74.14

		61.08
Third Quarter		
		67.67
		59.04
Fourth Quarter		
		79.22
		66.94
2011		
First Quarter		
		84.17
		77.18
Second Quarter		
		86.37
		77.77
Third Quarter		
		85.65
		64.25
Fourth Quarter		
		76.45
		60.97
2012		
First Quarter		
		84.41
		74.56
Second Quarter		
		83.79
		73.64
Third Quarter		
		86.40
		76.68
Fourth Quarter		
		84.69
		76.88
2013		
First Quarter		
		94.80
		86.65
Second Quarter		
		99.51

	89.58
Third Quarter (through the Pricing Date)	
	104.54
	98.08

Examples of the Hypothetical Payment at Maturity for a $1,000 Investment in the Notes

The following table illustrates the hypothetical payments on a note at maturity that is not automatically called on the first Call Date. The hypothetical payments are based on a $1,000 investment in the note, the Initial Stock Price of $104.12 (the closing price of the Reference Stock on the pricing date), the Trigger Price of $88.50 (85.00% of the Initial Stock Price, rounded to two decimal places), the final Call Price of $1,210.00, and a range of hypothetical Final Stock Prices and the effect on the payment at maturity: (i) if the Final Stock Price of the Reference Stock is above the Initial Stock Price on the Valuation Date (which is the final Call Date), your payment at maturity will be the final Call Price; (ii) if the Final Stock Price of the Reference Stock is less than the Initial Stock Price but does not fall below the Trigger Price, your payment at maturity will be 100% of the principal amount; however, (iii) if the Final Stock Price is less than the Trigger Price, the value of the cash payment that you receive will be less than your principal amount.

The hypothetical examples shown below are intended to help you understand the terms of the notes. If the notes are not automatically called before the final Call Date, the actual cash amount that you will receive at maturity will depend upon the Final Stock Price of the Reference Stock, and whether its closing price is below the Trigger Price on the Valuation Date. If the notes are automatically called prior to maturity, the hypothetical examples below will not be relevant, and you will receive on the applicable Call Settlement Date, for each $1,000 principal amount, the applicable Call Price.

Hypothetical Final Stock Price	Hypothetical Final Stock Price Expressed as a Percentage of the Initial Stock Price	Payment at Maturity
$156.18	150.00%	$1,210.00
$130.15	125.00%	$1,210.00
$114.53	110.00%	$1,210.00
$104.12	100.00%	$1,000.00
$93.71	90.00%	$1,000.00
$88.50	85.00%	$1,000.00
$83.30	80.00%	$800.00
$72.88	70.00%	$700.00
$52.06	50.00%	$500.00
$26.03	25.00%	$250.00
$0.00	0%	$0.00

Supplemental U.S. Federal Income Tax Considerations

The following is a general description of the material U.S. tax considerations relating to the notes. It does not purport to be a complete analysis of all tax considerations relating to the notes. Prospective purchasers of the notes should consult their tax advisors as to the consequences under the tax laws of the country of which they are resident for tax purposes and the tax laws of Canada and the U.S. of acquiring, holding and disposing of the notes and receiving payments under the notes. This summary is based upon the law as in effect on the date of this pricing supplement and is subject to any change in law that may take effect after such date.

The following section supplements the discussion of U.S. federal income taxation in the accompanying prospectus and prospectus supplement with respect to United States holders (as defined in the accompanying prospectus). The following section supersedes the discussion of U.S. federal income taxation in the accompanying product supplement in its entirety. Except as otherwise noted under "Non-United States Holders" and "Foreign Account Tax Compliance Act" below, it applies only to those United States holders who are not excluded from the discussion of U.S. federal income taxation in the accompanying prospectus. In addition, the discussion below assumes that an investor in the notes will be subject to a significant risk that it will lose a significant amount of its investment in the notes.

You should consult your tax advisor concerning the U.S. federal income tax and other tax consequences of your investment in the notes in your particular circumstances, including the application of state, local or other tax laws and the possible effects of changes in federal or other tax laws.

NO STATUTORY, JUDICIAL OR ADMINISTRATIVE AUTHORITY DIRECTLY DISCUSSES HOW THE NOTES SHOULD BE TREATED FOR U.S. FEDERAL INCOME TAX PURPOSES. AS A RESULT, THE U.S. FEDERAL INCOME TAX CONSEQUENCES OF AN INVESTMENT IN THE NOTES ARE UNCERTAIN. BECAUSE OF THE UNCERTAINTY, YOU SHOULD CONSULT YOUR TAX ADVISOR IN DETERMINING THE U.S. FEDERAL INCOME TAX AND OTHER TAX CONSEQUENCES OF YOUR INVESTMENT IN THE NOTES, INCLUDING THE APPLICATION OF STATE, LOCAL OR OTHER TAX LAWS AND THE POSSIBLE EFFECTS OF CHANGES IN FEDERAL OR OTHER TAX LAWS.

We will not attempt to ascertain whether the Reference Stock or the issuer of any component stock included in the Reference Stock would be treated as a "passive foreign investment company" within the meaning of Section 1297 of the Code or a "U.S. real property holding corporation" within the meaning of Section 897 of the Code. If the Reference Stock or the issuer of any component stock included in the Reference Stock were so treated, certain adverse U.S. federal income tax consequences could possibly apply. You should refer to any available information filed with the SEC by the Reference Stock and each issuer of any component stock included in the Reference Stock and consult your tax advisor regarding the possible consequences to you in this regard.

In the opinion of our counsel, Morrison & Foerster LLP, it would generally be reasonable to treat a note with terms described in this pricing supplement as a callable pre-paid cash settled derivative contract in respect of the Reference Stock for U.S. federal income tax purposes, and the terms of the notes require a holder and us (in the absence of a change in law or an administrative or judicial ruling to the contrary) to treat the notes for all tax purposes in accordance with such characterization. If the notes are so treated, subject to the discussion below concerning the potential application of the "constructive ownership" rules under Section 1260 of the Code, a United States holder should generally recognize capital gain or loss upon the sale, call or maturity of the notes in an amount equal to the difference between the amount a United States holder receives at such time and the United States holder's tax basis in the notes. In general, a United States holder's tax basis in the notes will be equal to the price the holder paid for the notes. Capital gain recognized by an individual United States holder is generally taxed at preferential rates where the property is held for more than one year and is generally taxed at ordinary income rates where the property is held for one year or less. The deductibility of capital losses is subject to limitations.

Potential Application of Section 1260 of the Code

Since the Reference Stock is the type of financial asset described under Section 1260 of the Code (including, among others, any equity interest in pass-thru entities such as ETFs, regulated investment companies, real estate investment trusts, partnerships, and passive foreign investment companies, each a "Section 1260 Financial Asset"), while the matter is not entirely clear, there exists a substantial risk that an investment in a note is, in whole or in part, a "constructive ownership transaction" to which Section 1260 of the Code applies. If Section 1260 of the Code applies, all or a portion of any long-term capital gain recognized by a United States holder in respect of a note will be recharacterized as ordinary income (the "Excess Gain"). In addition, an interest charge will also apply to any deemed underpayment of tax in respect of any Excess Gain to the extent such gain would have resulted in gross income inclusion for the United States holder in taxable years prior to the taxable year of the sale, exchange, or settlement (assuming such income accrued at a constant rate equal to the applicable federal rate as of the date of sale, exchange, or settlement).

If an investment in a note is treated as a constructive ownership transaction, it is not clear to what extent any long-term capital gain of a United States holder in respect of the note will be recharacterized as ordinary income. It is possible, for example, that the amount of the Excess Gain (if any) that would be recharacterized as ordinary income in respect of the note will equal the excess of (i) any long-term capital gain recognized by the United States holder in respect of the note and attributable to Section 1260 Financial Assets, over (ii) the "net underlying long-term capital gain" (as defined in Section 1260 of the Code) such United States holder would have had if such United States holder had acquired an amount of the corresponding Section 1260 Financial Assets at fair market value on the original issue date for an amount equal to the portion of the issue price of the note attributable to the corresponding Section 1260 Financial Assets and sold such amount of Section 1260 Financial Assets upon the date of sale, exchange, or settlement of the note at fair market value (and appropriately taking into account any leveraged upside exposure). To the extent any gain is treated as long-term capital gain after application of the recharacterization rules of Section 1260 of the Code, such gain would be subject to U.S. federal income tax at the rates that would have been applicable to the net underlying long-term capital gain. United States holders should consult their tax advisors regarding the potential application of Section 1260 of the Code to an investment in the note.

Alternative Treatments

Alternative tax treatments of the notes are also possible and the Internal Revenue Service might assert that a treatment other than that described above is more appropriate. For example, it would also be possible to treat the notes, and the Internal Revenue Service might assert that the notes should be treated, as a single debt instrument. Since the notes have a term that exceeds one year, such a debt instrument would be subject to the special tax rules governing contingent payment debt instruments. If the notes are so treated, a United States holder would generally be required to accrue interest currently over the term of the notes irrespective of the amount of interest paid on the notes. In addition, any gain a United States holder might recognize upon the sale or maturity of the notes would be ordinary income and any loss recognized by a holder at such time would be ordinary loss to the extent of interest that same holder included in income in the current or previous taxable years in respect of the notes, and thereafter, would be capital loss.

If the Reference Stock periodically rebalances, it is possible that the notes could be treated as a series of callable pre-paid derivative contracts, each of which matures on the next rebalancing date. If the notes were properly characterized in such a manner, a United States holder would be treated as disposing of the notes on each rebalancing date in return for new callable pre-paid derivative contracts that mature on the next rebalancing date, and a holder would accordingly likely recognize capital gain or loss on each rebalancing date equal to the difference between the holder's basis in the notes (which would be adjusted to take into account any prior recognition of gain or loss) and the fair market value of the notes on such date.

Because of the absence of authority regarding the appropriate tax characterization of the notes, it is also possible that the Internal Revenue Service could seek to characterize the notes in a manner that results in tax consequences that are different from those described above. For example, the Internal Revenue Service could possibly assert that any gain or loss that a holder may recognize upon the sale, call or maturity of the notes should be treated as ordinary gain or loss.

The Internal Revenue Service has released a notice that may affect the taxation of holders of the notes. According to the notice, the Internal Revenue Service and the Treasury Department are actively considering whether the holder of an instrument such as the notes should be required to accrue ordinary income on a current basis, and they are seeking taxpayer comments on the subject. It is not possible to determine what guidance they will ultimately issue, if any. It is possible, however, that under such guidance, holders of the notes will ultimately be required to accrue income currently and this could be applied on a retroactive basis. The Internal Revenue Service and the Treasury Department are also considering other relevant issues, including whether additional gain or loss from such instruments should be treated as ordinary or capital and whether the special "constructive ownership rules" of Section 1260 of the Code might be applied to such instruments. Holders are urged to consult their tax advisors concerning the significance, and the potential impact, of the above considerations. We intend to treat the notes for U.S. federal income tax purposes in accordance with the treatment described in this pricing supplement unless and until such time as the Treasury Department and Internal Revenue Service determine that some other treatment is more appropriate.

Backup Withholding and Information Reporting

Please see the discussion under "United States Federal Income Taxation—Other Considerations—Backup Withholding and Information Reporting" in the accompanying prospectus for a description of the applicability of the backup withholding and information reporting rules to payments made on your notes.

Non-United States Holders

The following discussion applies to non-United States holders of the notes. A non-United States holder is a beneficial owner of a note that, for U.S. federal income tax purposes, is a non-resident alien individual, a foreign corporation, or a foreign estate or trust.

A non-United States holder will generally not be subject to U.S. federal income or withholding tax for amounts paid in respect of the notes, provided that (i) the holder complies with any applicable certification requirements, (ii) the payment is not effectively connected with the conduct by the holder of a U.S. trade or business, and (iii) if the holder is a non-resident alien individual, such holder is not present in the U.S. for 183 days or more during the taxable year of the sale or maturity of the notes. In the case of (ii) above, the holder generally would be subject to U.S. federal income tax with respect to any income or gain in the same manner as if the holder were a United States holder and, in the case of a holder that is a corporation, the holder may also be subject to a branch profits tax equal to 30% (or such lower rate provided by an applicable U.S. income tax treaty) of a portion of its earnings and profits for the taxable year that are effectively connected with its conduct of a trade or business in the U.S., subject to certain adjustments. Payments made to a non-United States holder may be subject to information reporting and to backup withholding unless the holder complies with applicable certification and identification requirements as to its foreign status.

A "dividend equivalent" payment is treated as a dividend from sources within the U.S. and such payments generally would be subject to a 30% U.S. withholding tax if paid to a non-United States holder. Under proposed Treasury Department regulations, certain payments that are contingent upon or determined by reference to U.S. source dividends, including payments reflecting adjustments for extraordinary dividends, with respect to equity-linked instruments, including the notes, may be treated as dividend equivalents. If enacted in their current form, the regulations will impose a withholding tax on payments made on the notes on or after January 1, 2014 that are treated as dividend equivalents. In that case, we (or the applicable paying agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to amounts so withheld. Further, non-United States holders may be required to provide certifications prior to, or upon the sale, redemption or maturity of the notes in order to minimize or avoid U.S. withholding taxes.

As discussed above, alternative characterizations of the notes for U.S. federal income tax purposes are possible. Should an alternative characterization, by reason of change or clarification of the law, by regulation or otherwise, cause payments as to the notes to become subject to withholding tax, we will withhold tax at the applicable statutory rate. The Internal Revenue Service has also indicated that it is considering whether income in respect of instruments such as the notes should be subject to withholding tax. Prospective investors should consult their own tax advisors in this regard.

Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act was enacted on March 18, 2010 and will impose a 30% U.S. withholding tax on certain U.S. source payments, including interest (and OID), dividends, other fixed or determinable annual or periodical gain, profits, and income, and on the gross proceeds from a disposition of property of a type which can produce U.S. source interest or dividends ("Withholdable Payments"), if paid to a foreign financial institution (including amounts paid to a foreign financial institution on behalf of a holder), unless such institution enters into an agreement with the Treasury Department to collect and provide to the Treasury Department substantial information regarding U.S. account holders, including certain account holders that are foreign entities with U.S. owners, with such institution. The legislation also generally imposes a withholding tax of 30% on Withholdable Payments made to a non-financial foreign entity unless such entity provides the withholding agent with a certification that it does not have any substantial U.S. owners or a certification identifying the direct and indirect substantial U.S. owners of the entity.

These withholding and reporting requirements will generally apply to payments made after June 30, 2014. However, this withholding tax will not be imposed on payments pursuant to obligations outstanding on July 1, 2014. Account holders subject to information reporting requirements pursuant to the Foreign Account Tax Compliance Act may include holders of the notes. Holders are urged to consult with their own tax advisors regarding the possible implications of this recently enacted legislation on their investment in the notes.

Supplemental Plan of Distribution (Conflicts of Interest)

BMOCM will purchase the notes from us at a purchase price reflecting the commission set forth on the cover page of this pricing supplement. BMOCM has informed us that, as part of its distribution of the notes, it will reoffer the notes to other dealers who will sell them. Each such dealer, or further engaged by a dealer to whom BMOCM reoffers the notes, will purchase the notes at an agreed discount to the initial offering price.

We own, directly or indirectly, all of the outstanding equity securities of BMOCM, the agent for this offering. In accordance with FINRA Rule 5121, BMOCM may not make sales in this offering to any of its discretionary accounts without the prior written approval of the customer.

You should not construe the offering of the notes as a recommendation of the merits of acquiring an investment linked to the Reference Stock or as to the suitability of an investment in the notes.

BMOCM may, but is not obligated to, make a market in the notes. BMOCM will determine any secondary market prices that it is prepared to offer in its sole discretion.

We may use this pricing supplement in the initial sale of the notes. In addition, BMOCM or another of our affiliates may use this pricing supplement in market-making transactions in the notes after their initial sale. Unless BMOCM or we inform you otherwise in the confirmation of sale, this pricing supplement is being used by BMOCM in a market-making transaction.

For a period of approximately three months following issuance of the notes, the price, if any, at which we or our affiliates would be willing to buy the notes from investors, and the value that BMOCM may also publish for the notes through one or more financial information vendors and which could be indicated for the notes on any brokerage account statements, will reflect a temporary upward adjustment from our estimated value of the notes that would otherwise be determined and applicable at that time. This temporary upward adjustment represents a portion of (a) the hedging profit that we or our affiliates expect to realize over the term of the notes and (b) the selling concessions paid in connection with this offering. The amount of this temporary upward adjustment will decline to zero on a straight-line basis over the three-month period.

Additional Information Relating to the Estimated Initial Value of the Notes

Our estimated initial value of the notes that is set forth on the cover page of this pricing supplement equals the sum of the values of the following hypothetical components:

- a fixed-income debt component with the same tenor as the notes, valued using our internal funding rate for structured notes; and
- one or more derivative transactions relating to the economic terms of the notes.

The internal funding rate used in the determination of the initial estimated value generally represents a discount from the credit spreads for our conventional fixed-rate debt. The value of these derivative transactions are derived from our internal pricing models. These models are based on factors such as the traded market prices of comparable derivative instruments and on other inputs, which include volatility, dividend rates, interest rates and other factors. As a result, the estimated initial value of the notes on the Pricing Date was determined based on market conditions on the Pricing Date.

Validity of the Notes

In the opinion of Osler, Hoskin & Harcourt LLP, the issue and sale of the notes has been duly authorized by all necessary corporate action of the Bank in conformity with the Senior Indenture, and when this pricing supplement has been attached to, and duly notated on, the master note that represents the notes, the notes will have been validly executed and issued and, to the extent validity of the notes is a matter governed by the laws of the Province of Ontario, or the laws of Canada applicable therein, and will be valid obligations of the Bank, subject to the following limitations (i) the enforceability of the Senior Indenture may be limited by the Canada Deposit Insurance Corporation Act (Canada), the Winding-up and Restructuring Act (Canada) and bankruptcy, insolvency, reorganization, receivership, moratorium, arrangement or winding-up laws or other similar laws affecting the enforcement of creditors' rights generally; (ii) the enforceability of the Senior Indenture may be limited by equitable principles, including the principle that equitable remedies such as specific performance and injunction may only be granted in the discretion of a court of competent jurisdiction; (iii) pursuant to the Currency Act (Canada) a judgment by a Canadian court must be awarded in Canadian currency and that such judgment may be based on a rate of exchange in existence on a day other than the day of payment; and (iv) the enforceability of the Senior Indenture will be subject to the limitations contained in the Limitations Act, 2002 (Ontario), and such counsel expresses no opinion as to whether a court may find any provision of the Senior Debt Indenture to be unenforceable as an attempt to vary or exclude a limitation period under that Act. This opinion is given as of the date hereof and is limited to the laws of the Provinces of Ontario and the federal laws of Canada applicable thereto. In addition, this opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and certain factual matters, all as stated in the letter of such counsel dated October 22, 2012, which has been filed as Exhibit 5.1 to Bank of Montreal's Form 6-K filed with the SEC on October 22, 2012.

In the opinion of Morrison & Foerster LLP, when the pricing supplement has been attached to, and duly notated on, the master note that represents the notes, and the notes have been issued and sold as contemplated by the prospectus supplement and the prospectus, the notes will be valid, binding and enforceable obligations of Bank of Montreal, entitled to the benefits of the Indenture, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith). This opinion is given as of the date hereof and is limited to the laws of the State of New York. This opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and to such counsel's reliance on the Bank and other sources as to certain factual matters, all as stated in the legal opinion dated October 22, 2012, which has been filed as Exhibit 5.2 to the Bank's Form 6-K dated October 22, 2012.