CLEARY GOTTLIEB Alert Memo

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# Say on Pay and More: SEC's First Proposed Regulations Implementing Dodd-Frank's Executive Compensation and Governance Requirements

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law by President Obama on July 21, 2010. Reforms undertaken by the Dodd-Frank Act included executive compensation and corporate governance provisions applicable generally to U.S. public companies. On October 18, 2010, the SEC proposed regulations implementing the Say on Pay, Say When on Pay and Say on Golden Parachutes shareholder advisory votes[1] and the disclosure by institutional investment managers of their votes on those matters required by new Section 14A of the Securities Exchange Act of 1934, as amended (the "Exchange Act").[2] The comment period for the proposed regulations closes on **November 18, 2010**.

This memorandum highlights the key points and clarifications provided by the proposed regulations relating to the shareholder votes on executive compensation and briefly outlines the proposed related institutional investment manager reporting requirements.[3]

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[1] SEC Rel No. 33-9153; 34-63124 (Oct. 18, 2010). The text of the release is available at http://sec.gov/rules/proposed/2010/33-9153.pdf. The proposed regulations also contain provisions regarding the applicability of the rules to smaller reporting issuers, which we do not discuss in this memorandum.

[2] SEC Rel No. 34-63123 (Oct. 18, 2010). The text of the release is available at http://sec.gov/rules/proposed/2010/34-63123.pdf.

[3] Under the Dodd-Frank Act, the Say on Pay, Say When on Pay and Say on Golden Parachutes votes are now "non-routine" and brokers will be unable to vote uninstructed customer shares.

We note that, on October 21, the Department of Labor proposed regulations expanding the definition of "fiduciary" of a plan subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Although not entirely clear, the proposed regulations can be read to impose fiduciary responsibilities under ERISA on proxy advisory firms (registered as investment advisers under the Investment Advisers Act of 1940) advising plans. Such responsibilities would not only require that the proxy advisory firm act prudently and in the best interest of the plan, but also could prohibit the receipt of compensation from any issuer with respect to which the advice is given. For example, would it be a prohibited transaction under ERISA for a proxy advisory firm to provide a voting recommendation with respect to a company's equity plan and provide the company for a fee with advice, data or information regarding appropriate equity plan burn rates?

**Say on Pay, Say When on Pay and Say on Golden Parachutes Votes**

The proposed regulations answer many of the outstanding questions raised by Section 14A and also provide for transition relief, as the Say on Pay and Say When on Pay votes must be included in proxy statements filed with respect to annual meetings held after January 21, 2011 even if final regulations are not in place. The proposed regulations also clarify the effect of new Section 14A on companies subject to a mandatory annual Say on Pay vote under the Troubled Asset Relief Program ("TARP Companies"). As expected, the proposed regulations relating to the Say on Golden Parachutes votes have the most meat to them, including expanding required disclosure while maintaining the original scope of the shareholder vote. Unlike the Say on Pay and Say When on Pay votes at annual meetings, the Say on Golden Parachutes disclosure and vote are not required for merger proxy statements until after the effective date of the SEC's implementing rules.

1. **Say on Pay – Proposed Rule 14a-21(a)**

Section 14A(a) requires a company with equity securities registered under the Exchange Act to provide, in any proxy statement for a shareholder meeting occurring after January 21, 2011 for which the compensation disclosure is required, an advisory shareholder vote on the compensation of the company's named executive officers ("NEOs"), as disclosed. Companies must provide such a vote at least every three years thereafter.

- Form of the Resolution
  - The proposed regulations do not prescribe a form of resolution.
- What Compensation is Covered
  - The proposed regulations clarify that the Say on Pay vote:
    - Applies only to executive compensation disclosed in proxy statements in connection with shareholder meetings for which proxies are solicited for director elections.
    - Does not apply to disclosure regarding director compensation or disclosure made pursuant to Item 402(s)[4] about employee compensation practices that may promote excessive risk. The SEC notes, however, that, if risk considerations are material to a company's compensation policies for NEOs, they must be discussed in the Compensation Disclosure and Analysis contained in its proxy statement ("CD&A") and are accordingly subject to the Say on Pay vote.

[4] All references to Item 402 set forth herein are references to Item 402 of Regulation S-K.

        - May cover golden parachute compensation described under proposed Item 402(t) (see section 3 below) to the extent voluntarily included in the proxy statement by the company.

            - If a company includes Item 402(t) disclosure, it will also satisfy the disclosure otherwise required by Item 402(j) with respect to potential payments to NEOs upon a change in control of the issuer. However, the company must still provide the disclosure required by Item 402(j) with respect to potential payments to NEOs upon termination of employment other than in a change in control context.

- What New Disclosure is Required

    - The proposed regulations require a company:

        - To address in its CD&A whether and, if so, how its compensation policies and decisions have taken into account the results of previous Say on Pay votes required by Section 14A and (for TARP companies) Rule 14a-20.

            - The SEC requested comment on whether the requirement should relate only to the most recent Say on Pay vote. The proposed regulations do not specify how far back a company must look in respect of previous Say on Pay votes.

            - It does not appear that any company that voluntarily included a Say on Pay vote in prior proxy materials must disclose how the results of that vote has affected its compensation policies.

            - While not unexpected, this provision spotlights the issue that Say on Pay votes are intended to address – whether and how a company will react to the shareholder advisory vote. The SEC requested comment on whether this provision should be adopted and, if so, whether it should call for mandatory or voluntary disclosure.

              Given the undifferentiated nature of the vote, in the absence of a vote to disapprove NEO compensation, companies will have difficulty determining what action might be responsive to shareholder concerns. We expect that companies will engage in more significant shareholder outreach both before and after shareholder votes to anticipate reactions to pay policies and forestall negative votes.

        - To explain briefly the general effect of the Say on Pay vote (e.g., whether the vote is non-binding).

- Technical Issues and First Year Transition Guidance

    - The proposed regulations amend Exchange Act Rule 14a-6 to add Say on Pay votes to the list of items that do not trigger the filing of a preliminary proxy statement.

    - Prior to adoption of final regulations, the SEC will not object if a company does not file a preliminary proxy statement if the only trigger would be a Say on Pay or Say When on Pay vote (discussed in section 2 below).

- TARP Companies

    - The proposed regulations provide that TARP Companies would be exempt from the Say on Pay vote requirements under Rule 14a-21(a) until the first annual meeting of shareholders following repayment of all outstanding indebtedness under TARP.

- Steps to Consider

    - Companies should review the voting guidelines of significant shareholders regarding executive compensation and consider more vigorous shareholder outreach to assure that potential issues are surfaced in advance.

        - ISS has noted that, if concerns raised by a company's shareholders through a Say on Pay vote are not adequately addressed in the subsequent year, it may recommend withhold/against votes on the re-election of members of the compensation committee.

    - CD&A disclosure is becoming increasingly important as a communication tool. A premium should be placed on concise and clear disclosure, particularly around the correlation of pay and performance, including the operating environment of the company that drove compensation decisions. Executive summaries can be a useful way to highlight the most important points. More legalistic disclosures (e.g., equity incentive policies and tax considerations), while important, should not detract from the key messages and analysis of compensation decisions.

2. **Say When on Pay – Proposed Rule 14a-21(b)**

Section 14A(a) of the Exchange Act also requires companies to include in the first proxy statement containing a Say on Pay vote, and at least every six years thereafter, a separate shareholder advisory vote on whether the Say on Pay vote will occur every one, two or three years.

- What is Required
  - The proposed regulations clarify that:
    - While it is expected companies will include a recommendation as to frequency, shareholders must be given the opportunity to check a box for one, two or three years or abstain.
    - The vote is non-binding.
      - The proposed regulations amend Rule 14a-8 to permit a company to exclude a shareholder proposal regarding a Say on Pay vote (with substantially the same scope as the vote required under new Rule 14a-21(a)) or Say When on Pay vote as "substantially implemented" to the extent the company has adopted the frequency which received the plurality of votes cast in its most recent Say When on Pay vote. The SEC has requested comments on the scope of this provision.
- What New Disclosure is Required
  - The proposed regulations require a company:
    - To explain briefly in its proxy statement the general effect of the Say When on Pay vote (e.g., whether the vote is non-binding).
      - The SEC does not address how the required vote should be characterized in response to Item 21 of Schedule 14A and states that the plurality standard proposed for purposes of addressing shareholder proposals under the proposed amendment to Rule 14a-8 is limited to that Rule and does not purport to address whether a specific frequency "should be considered to have been adopted or approved by shareholder vote as a matter of state law."

        In view of the status of the Say When on Pay vote as a creature of federal law, and a vote which is advisory only in nature, we believe that it is not subject to charter, bylaw or state law voting provisions and, therefore, that companies need not amend existing voting provisions to accommodate the new requirement.

Whether companies will choose, in response to Item 21, to specify a standard is uncertain. Boards and their compensation committees may wish to retain flexibility in considering vote outcomes in light of all the facts and circumstances and may so specify in the company's Item 21 disclosure. Companies should, in any event, amend their compensation committee charters to reflect that the committee will take into account vote outcomes (among other factors it deems relevant) in discharging its responsibility with respect to executive compensation programs and arrangements.

        - To disclose its decision regarding the frequency of its Say on Pay vote in light of the vote outcome in the Form 10-Q for the period in which the advisory vote occurs (or, if occurring in the fourth quarter, in its Form 10-K).

            - The SEC has asked for comment as to whether a company could disclose the frequency of its Say on Pay vote in its IPO registration statement and be exempted from conducting either a Say on Pay or Say When on Pay vote until the year it disclosed.

- Technical Issues

    - The proposed regulations:

        - Amend Rule 14a-4 to permit four choices to be included on a proxy card for a Say When on Pay vote.

        - Amend Rule 14a-6 to add a Say When on Pay vote to the list of items that do not trigger the filing of a preliminary proxy statement.

    - The SEC requested comment as to whether the plurality standard suggested by the proposed amendment to Rule 14a-8 should vary if a company has multiple classes of voting stock.

- First Year Transition Guidance

    - Prior to final regulations being adopted, the SEC will not object if

        - Companies do not file a preliminary proxy statement if the only trigger would be Say on Pay votes or Say When on Pay votes.

        - Proxy cards give shareholders the opportunity to specify by box a choice among one, two or three years or abstain (despite current Rule 14a-4).

            - If proxy service providers are unable to reprogram their systems to accommodate four choices in time for the required votes, the proxy card may give shareholders a choice of one, two or three years and provide that if no selection is made, the shareholder is deemed not to have voted (i.e., a shareholder would have no opportunity to abstain).

- TARP Companies

    - The proposed regulations provide that companies subject to TARP's mandatory annual Say on Pay vote would be exempt from the Say When on Pay requirements under Rule 14a-21(b) until the first annual meeting of shareholders following repayment of all outstanding indebtedness under TARP.

- Steps to Consider

    - Determine what voting frequency makes sense. While the majority of voluntary Say on Pay adopters has held annual votes, some have chosen biennial and triennial votes.[5]

    - Reach out to significant shareholders to discuss their preference.

        - The United Brotherhood of Carpenters has, for example, consistently championed the idea of a triennial vote.

    - Contact the proxy service provider about the format of the ballot.

### 3. Say on Golden Parachutes – Proposed Item 402(t) and Rule 14a-21(c)

Unlike the Say on Pay and Say When on Pay votes, the Say on Golden Parachutes vote is not self-executing. As a result, the Say on Golden Parachutes disclosure and vote are not required for merger proxy statements until after the effective date of the SEC's implementing rules.

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[5] *See* Janet Fisher, Arthur Kohn & Katie Sykes, *Say-on-Pay: Less May be More*, N.Y. Law Journal, Nov. 30, 2009.

A. Disclosure Requirements – Proposed Item 402(t)

The Dodd-Frank Act added Section 14A(b) to the Exchange Act to require that, in any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets occurring after January 21, 2011, the company must describe "Golden Parachute" arrangements (generally, arrangements for compensation that are affected by a change in control transaction) covering any of its NEOs "in a clear and simple form" and disclose the aggregate total for each NEO.

- What Disclosure is Required
    - The proposed regulations require:
        - Disclosure be provided of all Golden Parachutes relating to the transaction among the target and acquiring companies and the NEOs of each of the target and acquiring companies.
            - For this purpose, NEOs do not include any individuals included in a company's Summary Compensation Table who were no longer executive officers at the end of the last completed fiscal year.
            - The proposed regulations pick up Golden Parachutes not covered by Section 14A, i.e., Golden Parachutes between an acquiring company and the NEOs of a soliciting target company.
        - Quantitative disclosure be presented in a "Golden Parachute Compensation" table with separate columns for:
            - Cash severance payments (including pro rata bonuses),
            - Value of stock-based awards which are cashed out or for which vesting is accelerated (using intrinsic value for stock options),
            - Enhancements of pension and nonqualified deferred compensation benefits,
            - Perquisites and other personal benefits and health and welfare benefits, including nondiscriminatory, broad-based programs,
            - tax reimbursements,
            - "other" payments or benefits not otherwise picked up, and
            - the total amount of payments.

- Footnote disclosure be included indicating each form of compensation reported (with perquisites identified and quantified in accordance with the existing compensation disclosure rules and health benefits quantified using GAAP financial reporting assumptions).

- Footnote disclosure be included identifying amounts attributable to single trigger and double trigger arrangements and, in the latter case, specifying the time range in which termination of employment must occur.

- Tabular quantification of amounts payable be determined assuming a triggering event and closing price per share as of the latest practicable date and disclosure of other material assumptions used in the estimating amounts.[6]

- Narrative be included disclosing any material factors necessary to understand the Golden Parachutes and the Golden Parachute Table, including but not limited to triggering circumstances, time of payment (e.g., lump sum or over specified period), payor of compensation and the details of any material conditions or obligations to which payment is subject (e.g., a noncompete covenant and its extent, duration and waiver provisions).

- The SEC has requested comment on the scope and nature of this disclosure.

- What Disclosure is Not Required

  - The proposed regulations state that no disclosure is required with respect to:

    - Previously vested equity awards.

    - Compensation to be paid under a bona fide post-transaction employment agreement to be entered into in connection with the transaction.

    - Agreements and understandings with senior management of foreign private issuers where the target or acquirer company is a foreign private issuer.

[6] As discussed below, Item 402(t) disclosure included in an annual meeting proxy statement should be calculated consistent with current Item 402(j) (i.e., a trigger event and closing market price per share as of the last business day of the company's last completed fiscal year).

- When and Where is the Disclosure Required

    - In addition to proxy or consent solicitation materials seeking shareholder approval for any acquisition, merger, consolidation or sale of substantially all of a company's assets, the proposed regulations require the disclosure of Golden Parachutes to be included in any:

        - Information statement filed pursuant to Regulation 14C.

        - Proxy or consent solicitation statement not containing merger proposals but requiring disclosure of information under Item 14 of Schedule 14A pursuant to Note A (e.g., seeking approval for issuance of shares to conduct a merger transaction).

        - Registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions.

        - Going private transaction on Schedule 13E-3 (except where the target or subject company is a foreign private issuer).

        - Third-party tender offers on Schedule TO (except where the bidder or target company is a foreign private issuer and only to the extent the bidder has made a reasonable inquiry regarding the Golden Parachutes and has knowledge of such arrangements).

        - Schedule 14D-9 solicitation/recommendation statements.

B. <u>Vote Requirements – Proposed Rule 14a-21(c)</u>

Section 14A(b) also requires that in any proxy or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets occurring after January 21, 2011, the company must provide shareholders a separate advisory vote on the Golden Parachutes disclosed, unless they were previously the subject of a Say on Pay vote.

- What Golden Parachutes Must be Subject to Shareholder Vote

    - The proposed regulations specify that a separate shareholder vote on golden parachute arrangements is required <u>only</u> in the circumstances set forth in the Dodd-Frank Act.

        - As a result, although required to be disclosed under proposed Item 402(t), when a target company conducts a proxy or consent solicitation, Golden Parachutes between the acquiring company and the NEOs of the target company need <u>not</u> be subject to a shareholder vote.

        - Similarly, although disclosure of Golden Parachutes must be included in a variety of forms in connection with corporate transactions (as discussed above), a shareholder vote will be required only in any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets.

    - The proposed regulations clarify that in order to benefit from the exception from a Say on Golden Parachutes vote for Golden Parachutes previously the subject of a Say on Pay vote:

        - The Golden Parachutes need only to have been subject to a Say on Pay vote, not approved by shareholders.

        - The annual meeting proxy statement included the disclosure required under new Item 402(t), using the last business day of the issuer's last completed fiscal year for triggering event date and stock price determination.

            - If a company includes disclosure under Item 402(t) in its annual meeting proxy statement, it need not provide disclosure regarding the possible payments to NEOs upon change in control under Item 402(j). However, the company must still provide the disclosure required by Item 402(j) with respect to potential payments to NEOs upon termination of employment other than in a change in control context.

        - The Golden Parachutes have remained in effect and their terms have not been modified.

            - Any new arrangements or revisions would be subject to a separate shareholder vote, but not the existing arrangements and unchanged provisions.

                - In this case, the company should have two Golden Parachute Compensation tables, one with complete information and one with only the new arrangements or revised terms, to make clear what is subject to the vote.

                - Similarly, if the Golden Parachute Compensation table includes Golden Parachutes between an acquiring company and the NEOs of the soliciting target company, the company should make clear whether or not these arrangements are subject to the vote and, if not, provide a separate table disclosing only Golden Parachutes subject to the vote.

- Updates based upon the value of items reflecting stock price movement would not count as revisions; however, the addition of a new NEO or new equity grants (even with the same terms as awards previously subject to a Say on Pay vote) would require a shareholder vote. The SEC requested comment on these points.

- Steps to Consider
  - Consider whether any supermajority voting requirement otherwise applicable to shareholder approval of the transaction triggering a Say on Golden Parachutes vote could inadvertently apply to the Say on Golden Parachutes vote itself. While the vote is advisory only, the failure to achieve a favorable outcome – made more difficult by the higher voting standard – could attract adverse press.
  - We expect that many companies will conclude that the Say on Golden Parachutes vote is unlikely to have practical impact and, therefore, changes to parachute arrangements or practices should not be needed at this time in light of the new voting requirement. Management should nonetheless review this issue with the compensation committee.[7]
  - Companies should consider the benefit offered (versus the burden undertaken) by including the Golden Parachutes disclosure under Item 402(t) in its annual proxy statement for shareholder approval.

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[7] Most companies have recently reviewed their golden parachute arrangements in light of the scrutiny given to these arrangements by institutional investors. For those companies, the new voting requirement may not be enough to motivate further change. However, a review of the voting guidelines of significant shareholders may nevertheless be worthwhile. For example, in its February 2010 proxy voting guidelines summary, ISS stated that an acceptable golden parachute has, at a minimum: (x) a triggering mechanism beyond the control of management; (y) a payment of no more than three times the executive's average annual W-2 compensation during the five years prior to the year in which the change of control occurs; and (z) a double-trigger payment structure.

**Institutional Investment Manager Executive Compensation Vote Reporting**

The Dodd-Frank Act also added Section 14A(d) of the Exchange Act requiring every institutional investment manager subject to Exchange Act Section 13(f) ("Covered Managers")[8] to report at least annually how it voted on any Say on Pay, Say When on Pay or Say on Golden Parachutes vote ("Section 14A Votes"). The SEC has proposed new Rule 14Ad-1 under the Exchange Act as well as amendments to Form N-PX, now used by management investment companies registered under the Investment Company Act of 1940 ("RICs") to satisfy requirements to file complete proxy voting records with the SEC, to accommodate the new Rule's requirements. The proposed changes to Form N-PX also affect the way in which RICs report all their proxy votes, not just Section 14A Votes.

- The proposed regulations clarify that Covered Managers must:
  - File an annual report on Form N-PX,
  - Not later than August 31 of each year for the most recent 12-month period ended June 30 (with special transition rules for Covered Managers making either their initial filing or final filing under Section 13(f)),
  - Setting forth its proxy voting record for each Section 14A Vote with respect to which it, whether director or indirectly, through any contract arrangement, understanding, relationship, or otherwise, had or shared the power to vote, or to direct the voting of, any security.
    - The SEC requested comment regarding the "voting power" basis for determining which Section 14 Votes must be reported, especially in light of the current reporting basis under Section 13(f), which is "investment discretion."

[8] Section 13(f) applies to institutional investment managers with more than $100 million of registered equity securities under management. Under Section 13(f), such managers are required to file reports with the SEC on Form 13F disclosing holdings of registered equity securities at the end of each quarter, subject to a de minimis exception (generally, holdings of fewer than 10,000 shares and less than $200,000 aggregate fair market value).

Under the proposed regulations, consistent with the statutory provisions of the Dodd-Frank Act, an institutional investment manager (including an institutional investor as principal) that does not exercise investment discretion over the requisite securities to be deemed a Covered Manager, but that has voting power over securities, is not subject to the voting requirements. Under the proposed regulations, a Covered Manager with voting power over securities as to which it does not have investment discretion is required to report as to its votes in respect of all securities covered by the rules, whether or not it also has investment discretion as to those securities.

        - As proposed, the requirement applies to any security voted regardless of whether it has been or must be reported by the Covered Manager on a Form 13F, although the SEC requested comment on this point.

- The proposed regulations modify current Form N-PX:

    - To accommodate its use by institutional investment managers to report Section 14A Votes.

    - To permit joint reporting of proxy votes in the case where one or more Covered Managers share voting power or the Form N-PX filed by a RIC includes the Covered Manager's Section 14A Votes.

        - However, any Covered Manager not reporting a Section 14A Vote must still file a Form N-PX identifying each other Covered Manager or RIC reporting on its behalf (which entities must also disclose in their Forms N-PX any Covered Managers on behalf of which they are reporting Section 14A Votes).

    - To require greater detail on the number of shares the reporting person is entitled to vote (RICs) or has or shares voting power (Covered Managers), the number of shares voted and how the shares were voted (including the number voted in each manner if more than one).

        - As proposed, this would apply to the reporting by RICs on votes other than Section 14A Votes.

- If adopted, the proposed regulations would require Covered Managers to file their first reports on Form N-PX no later than August 31, 2011, reporting Section 14A Votes at meetings that occur on or after January 21, 2011 through June 30, 2011. RICs must comply with the amendments to Form N-PX in their Forms filed for the period July 1, 2010 through June 30, 2011, except that for votes occurring at meetings prior to January 21, 2011, only the information currently required by Form N-PX need be included.

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Please feel free to call any of your regular contacts at the firm or any of the partners and counsel listed under Employee Benefits or Corporate Governance in the Practices section of our website (www.cgsh.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

# Office Locations

**NEW YORK**
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

**WASHINGTON**
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

**PARIS**
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

**BRUSSELS**
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

**LONDON**
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

**MOSCOW**
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

**FRANKFURT**
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

**COLOGNE**
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

**ROME**
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

**MILAN**
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

**HONG KONG**
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

**BEIJING**
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax