

ClientAlert

Capital Markets/Mergers and Acquisitions

June 2009

SEC Proposes Rules on Shareholder Proxy Access: Analysis and Commentary

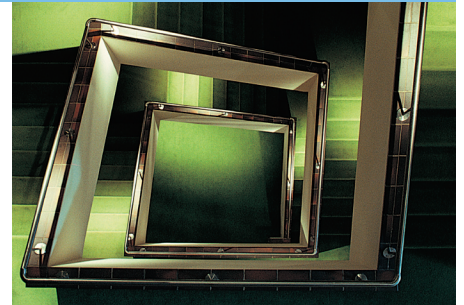
On June 10, 2009, the Securities and Exchange Commission (the "SEC") published proposed amendments to its proxy rules to permit shareholders to include director nominees in a company's proxy materials.¹ The SEC Commissioners had approved the long-awaited proposals three weeks earlier in a three-to-two vote along party lines. The 250-page proposing release reflects the significant ongoing debate over what the SEC has acknowledged is a "novel" and "significant" change in corporate governance.

The proposed rules would require companies to include in their proxy materials:

- directors nominated by certain shareholders or groups of shareholders; and
- shareholder proposals seeking to amend a company's governing documents as they relate to director nomination procedures or disclosures related to shareholder nominations.²

The proposed rules would apply to all companies that are subject to US proxy solicitation rules, including registered investment companies.³ The proposed rules would not apply to foreign private issuers. Comments on the proposed rules are due before August 17, 2009. Assuming final rules are adopted, it is not clear if the final rules will be effective before the 2010 proxy season.

This is the SEC's third attempt in the last six years to address the issue of shareholder access to company proxy statements. We believe that it is a positive step to open proxy statements to shareholder proposals regarding director nomination procedures and disclosures related to shareholder nominations. However, we believe that some of the points raised by the dissenting Commissioners, particularly with respect to shareholder access to company proxy statements for director nominations, merit consideration.



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1 Securities Release Nos. 33-9046; 34-60089, June 10, 2009, "Facilitating Shareholders Director Nominations," available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

2 *Id.* at 122.

3 They would not apply to companies that are subject to proxy rules only because they have a class of debt registered under Section 12 of the Exchange Act.

4 These campaigns include formal proxy fights as well as other solicitations and activist campaigns typically calling for action to enhance value or corporate governance practices. See https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20090122.html&rnd=635192.

Boards of directors have traditionally experienced a significant degree of entrenchment. However, the ability of shareholders to effect change has increased significantly in recent years. For example, recent proxy seasons have seen record numbers of activist campaigns by investors—506 in 2007 and 479 in 2008.⁴ These proxy fights and other campaigns resulted in activists gaining board seats at 84 companies in 2008, more than any other recent year. Also, the corporate law marketplace has started to offer new possibilities for activist shareholders. In 2007, North Dakota became the first and, to date, only state to adopt a mandatory proxy access law. In June 2009, the first US public company voted to reincorporate in North Dakota.⁵ At the same time, Delaware recently amended its corporate law to explicitly permit companies to include provisions in their certificates of incorporation or bylaws permitting reimbursement of the expenses incurred by shareholders in conducting director election contests.⁶ Delaware also recently amended its corporate law to explicitly permit (but not require) companies to amend their bylaws to permit shareholders to include director nominees in the company's proxy materials.⁷ Subsequently, the Corporate Laws Committee of the American Bar Association approved the first reading of amendments to the Model Business Corporation Act (the "MCBA") that include provisions similar to the Delaware amendments. The MCBA has been adopted in whole or in part by more than 30 states. Finally, there has been a significant shift away from plurality voting toward majority voting in director elections. This has given teeth to a withhold vote and enhanced shareholders' ability to hold directors accountable.

We believe these events are evidence of the increasing ability of shareholders to influence boards and nominate directors on a cost-effective basis. This calls into question the need for a single, federally mandated proxy access solution for all US public companies. We believe it would be preferable simply to open up company proxy statements to shareholder proposals regarding the director election process, as the proposed amendment to Rule 14a-8(i)(8) seeks to do. Shareholders could then propose amendments to a company's governing documents to permit shareholder access for that particular company. Acknowledging, however, that Rule 14a-11 regarding director nominations seems likely to be adopted in one form or another, we offer comment below on both it and the proposed amendment to Rule 14a-8(i)(8).

Background

Eligible shareholders are currently allowed under Rule 14a-8 to include a limited range of proposals in a company's proxy statement. The inclusion of director nominees is currently not permitted. Shareholders seeking to elect their nominees to a company's board of directors must therefore prepare and distribute their own proxy statement, and wage a proxy battle that can be costly and time-consuming. Under current rules, companies may also exclude shareholder proposals relating to the processes by which directors are nominated and elected—such as proposals to amend a company's bylaws to grant shareholders access to the company's proxy statement.

Shareholder Right to Include Nominees in Company Proxy Statements—Proposed Rule 14a-11

Eligibility of Nominating Shareholder

Under the proposed proxy access rule, a shareholder must hold the following percentage of a company's voting securities in order to include one or more director nominees in the company's proxy materials:

- one percent in the case of a "large accelerated filer" (a company with a worldwide market capitalization held by non-affiliates of at least US\$700 million) or a registered investment company with net assets of at least US\$700 million;
- three percent in the case of an "accelerated filer" (companies with a worldwide market capitalization held by non-affiliates of at least US\$75 million but less than US\$700 million) or registered investment company with net assets of at least US\$75 million but less than US\$700 million; and
- five percent in the case of a "non-accelerated filer" (a company with a worldwide market capitalization held by non-affiliates of less than US\$75 million), or a registered investment company with net assets of less than US\$75 million.

The proposed rule would allow multiple shareholders to aggregate their holdings in order to meet these thresholds. The nominating shareholder or each member of a group of nominating shareholders must have beneficially owned its securities for at least one year before the date it provides notice to the company of its nominees. The shareholder or group must intend to own its securities through the date of the shareholder meeting.

⁵ The company, American Railcar Industries, Inc., is 54 percent owned by Carl Icahn and his affiliates. It remains to be seen if any widely controlled companies reincorporate in North Dakota in the future.

⁶ The SEC acknowledged this development in the proxy access proposing release and is seeking comment on whether companies that provide for reimbursement should be required to comply with the proposed proxy access rules.

⁷ Section 112, General Corporation Law of the State of Delaware.

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Comment:

The SEC indicates that 99 percent of large accelerated filers have at least one shareholder that beneficially owns at least one percent of the company's securities. This number drops to 85 percent for accelerated filers and 59 percent for non-accelerated filers. Based on these statistics, the threshold is arguably too low, especially with respect to large accelerated filers.

Schedule 14N

The SEC proposes to designate a new Schedule 14N, which would contain information about each director nominee and nominating shareholder or group. Schedule 14N would contain the information set forth on Schedule 1 hereto. It would also need to contain a certification that the nominating shareholder is not holding its shares for the purpose, or with the effect of, changing the control of the subject company. Schedule 14N must be delivered to the company and filed with the SEC on the same date. An amendment to the Schedule 14N must be filed if a material change occurs in the facts contained therein. An amendment must also be filed within 10 days after the announcement of the election results stating the intention of the nominating shareholder or group with regard to continued ownership of their shares. The information contained in Schedule 14N may not be false or misleading in any material respect.

Comment:

A shareholder could change its control intent immediately after a shareholder meeting. This leaves a significant gray area both for companies and shareholders since it is difficult to determine when, and prove that, a person's intent changed. It would be preferable to consider some sort of standstill for a minimum period of time following the successful election of a shareholder nominee.

The share ownership required to be disclosed on Schedule 14N is limited to "beneficial" ownership. A large number of companies have recently amended their bylaws to require shareholders that propose director nominees to disclose derivative and synthetic positions that may fall short of beneficial ownership. In order to ensure equal treatment, the SEC should permit companies to require shareholders nominating directors pursuant to Rule 14a-11 to follow the same disclosure requirements regarding share ownership as the company applies under its bylaws.

Eligibility

The candidacy of any nominee, and his or her membership on the board if elected, must not violate applicable federal and state laws, the rules of the relevant national securities exchange or association, or the company's governing documents. The nominee must also consent to being named in the proxy statement and, if the company's securities are listed on a national securities exchange, meet the "objective" independence standards of that exchange.

Comment:

It is not clear what happens if a director nominee meets an exchange's "objective" independence standards, but does not meet the "subjective" independence standards (e.g. the requirement, in the case of the New York Stock Exchange ("NYSE"), that the board determines that the director has no material relationship with the listed company and, in the case of Nasdaq, that the director has no relationship that would interfere with the exercise of independent judgment). It is also not clear what happens if a director nominee does not meet the categorical standards for independence adopted by an NYSE-listed company even if the nominee technically meets the exchange's "objective" independence standards. Under these circumstances, if such a nominee were elected, it appears as if the board would need to be expanded in size or the resignation of another director would need to be obtained if necessary to satisfy the exchange's majority independence requirements. Companies will need to consider addressing this circumstance in their bylaws or corporate governance guidelines.

Procedures

The Schedule 14N must be filed within the period specified in a company's advance bylaw provision or, if there is no such provision, no later than 120 days before the date that the company mailed its proxy materials for the prior year's annual meeting. If the date of the meeting has changed more than 30 days from the prior year, or if the company did not hold a meeting in the prior year, the company must specify the date by which shareholders must submit director nominees, which date must be a reasonable time before the company mails proxy materials to its shareholders. This disclosure must be made pursuant to new Item 5.07 of Form 8-K.

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If the company intends to include the nominee in its proxy statement, the company must notify the nominating shareholder no later than 30 days before it files its definitive proxy statement with the SEC. The company must notify the nominating shareholder no later than 14 days after receiving the Schedule 14N if it determines that the nominee is not eligible for inclusion. The nominating shareholder then has a further 14 days from receipt of the company's notice to correct any ineligibility. Neither the composition of a nominating group nor the identity of the nominee may be changed in order to cure ineligibility.

A company that determines that it is entitled to exclude a nominee must provide notice to the SEC (with a copy to the nominating shareholder or group) of its determination and the basis for that determination no later than 80 days before it files its definitive proxy statement. The nominating shareholder or group may then submit a response to the company's notice to the SEC (with a copy to the company) within 14 days after its receipt of that notice.

The SEC may provide an informal statement to the company and the nominating shareholder or group regarding its views on the exclusion. One would expect that the SEC's informal views will hold considerable sway. Ultimately, an impermissible exclusion is a violation of Rule 14a-11.

Twenty-Five Percent Limit

A company does not have to include in its proxy materials more than one shareholder nominee if those nominees would represent more than 25 percent of the company's board of directors (or the closest whole number below 25 percent). If the company has existing shareholder-nominated directors serving on its board of directors and those directors' terms extend beyond the annual meeting, the company can exclude shareholder-nominated that would result in more than 25 percent of the board (or the closest whole number below 25 percent) being shareholder nominees. If a nominee or a nominating shareholder or group has an agreement with the company or an affiliate of the company regarding the election of a director, that director will not be included in the 25 percent limit.

Comment:

The proposed rule means that a company with a classified board might be required to permit shareholder nominees for all or a significant portion of the directors being elected at a particular annual meeting. This is because typically each annual election would be for approximately one-third of the board, and the 25 percent limit is based on the size of the board, not the number of directors elected at a particular meeting.

The exclusion from the 25 percent cap of any director who is appointed pursuant to an agreement with a shareholder creates something of a dilemma for companies with such agreements. A number of companies have reached agreements with shareholders to appoint one or more of their nominees to the company's board of directors in order to avoid a proxy fight. Those companies may now regret that action if those agreements extend beyond the subsequent shareholders meeting and do not count towards the 25 percent cap. In addition, the effect of this exclusion is to create incentives for companies not to reach agreement with shareholders for fear that other shareholders will simply propose additional nominees up to the 25 percent cap.

Priority of Nominees

If the above limits are met due to more than one shareholder or group of shareholders designating a director nominee, the first shareholder or group to notify the company of its intent by submitting a Schedule 14N would prevail. If that shareholder does not nominate the maximum number of directors, then the nominee or nominees of the second shareholder to file notice would be included, and so forth until the maximum number is reached.

Comment:

The proposed rules create a situation where a smaller shareholder can capture all available nominee slots from a larger shareholder where, for example, the larger shareholder submits a notice one day (or one hour) after the smaller shareholder. A different method of apportionment may be preferable; for example, one based on size of shareholding.

Disclosure

The company must include in its proxy materials information regarding the nominating shareholder or group and the nominee(s) similar to the disclosure currently required in contested elections. The company is not responsible for any false or misleading statements that are based on information provided by the nominating stockholder unless the company had reason to know it was misleading.

Opt-Out Possibilities

Shareholders may nominate directors pursuant to the SEC's proposed procedures unless state law or the company's governing documents prohibit the nomination of directors.

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Comment:

The SEC notes that it is not aware of any state whose laws currently prohibit shareholders from nominating directors. Individual companies could amend their governing documents to prohibit shareholders from nominating directors; however, such a step seems unlikely for most public companies. As a result, the proposed rules would effectively set a minimum federal standard for shareholder nomination of directors. The best example of the interaction with state law appears to be the fact that the proposed rules would override the five percent threshold for proxy access mandated by North Dakota for all companies incorporated there and impose one percent and three percent thresholds for large accelerated and accelerated filers, respectively.

Affiliate Status

The mere nomination of a candidate for a company's board of directors will not result in the nominating shareholder being considered an affiliate of the company. Furthermore, the nominating shareholder will not be considered an affiliate of the company solely by virtue of the election of its director nominee if the director does not have an agreement or relationship with the nominating shareholder other than the nomination and activities related to it.

Exemption from Proxy Rules Reporting for Activities Related to Director Nominees

In order to facilitate the formation of nominating groups, the SEC is proposing a new exemption from the proxy solicitation rules for written communications that include no more than: (1) a shareholder's statement of intent to form a nominating shareholder group; (2) a brief statement about the proposed nominee or the characteristics of such a nominee that the shareholder intends to nominate; (3) the percentage of shares beneficially owned by the nominating shareholder or group; and (4) the means by which the shareholder may contact the soliciting party. The written communication would need to be filed with the SEC no later than the date of its first publication.

The SEC is proposing another new exemption from the proxy solicitation rules for solicitations by or on behalf of a nominating shareholder or group provided that: (1) the soliciting party does not seek to act as a proxy; and (2) any communications contain a description of the nominating party or group, and a legend directing shareholders to the company's proxy statement. Any such soliciting material would need to be filed with the SEC no later than the first date of its publication.

Comment:

In addition to the proposed new exemptions, shareholders can continue to use the exemption for solicitation of no more than ten shareholders and the exemption for communications in an electronic shareholder forum (though the latter of these two exemptions has been little used to date).

Exemption from Schedule 13D Requirements for Activities Related to Director Nominees

The SEC is proposing that a nominating group that is formed as a result of activities in connection with Rule 14a-11, and that holds more than five percent of the shares of a company, would be eligible to use, or continue using, Schedule 13G to report its beneficial ownership provided that its activities are limited to those contemplated by Rule 14a-11.

No Exemption from Section 16 for a Nominating Group

The SEC has decided not to propose any exemption from Section 16 for a nominating group that beneficially owns in excess of ten percent of a company's equity securities. The SEC notes that the eligibility thresholds for Rule 14a-11 are considerably lower than ten percent, and believes that the formation of a group can be addressed under existing principles.

Shareholder Right to Proposals Relating to Director Nomination and Election

The SEC is also proposing an amendment to Rule 14a-8(i)(8). Currently, pursuant to the “election exclusion” adopted by the SEC in 2007, a company may exclude from its proxy materials any proposal that “relates to a nomination or an election for membership on the company’s board of directors...or a procedure for such nomination or election.”⁸ The proposed amendment would reverse this and require a company, under certain circumstances, to include in its materials shareholder proposals that would amend, or request amendments to, the company’s governing documents regarding both shareholder nomination disclosures and director nomination procedures.⁹

Under the amended rule, the proposal must satisfy current procedural requirements and not fall under the other bases for exclusion of shareholder proposals contained in Rule 14a-8.¹⁰ In addition, the eligibility requirements of Rule 14a-8 would continue to apply, meaning that a proposing shareholder must have continuously held, for a period of at least one year prior to submitting the proposal, at least US\$2,000 in market value, or one percent, of the company’s shares. The rule would not allow amendments that would contravene Rule 14a-11, such as any that would attempt to exclude shareholder nominees that are otherwise eligible. It would, however, allow shareholders to propose means for disclosure of shareholder nominees in proxy materials in addition to those provided for in Rule 14a-11.

To accommodate the possibility that state law or the governing documents of a particular company might propose eligibility standards that are less stringent than the standards proposed under Rule 14a-11, the SEC has proposed that Schedule 14N would also be used in connection with director nominations made other than pursuant to Section 14a-11. Whereas Rule 14a-8 sets forth disclosure requirements for director nominees pursuant to Section 14a-11, Rule 14a-9 would apply to other director nominations.

Finally, the proposed amendment to Rule 14a-8(i)(8) codifies certain existing SEC interpretations regarding proposals that will continue to be excludable. These consist of proposals that (1) would disqualify a nominee who is standing for election; (2) remove a director from office before his or her term expired; (3) question the competence, business judgment or character of one or more nominees for director; (4) nominate a specific individual for election to the board of directors; or (5) otherwise affect the outcome of the upcoming election of directors.

Conclusion

Recent years have seen a significant shift in the balance of power between shareholders and boards of directors. We believe that there is much that is meritorious in the SEC’s proposed amendments to Rule 14a-8(i)(8), which would build on this shift by allowing the shareholders of each company to submit proposals regarding the elections of directors, including proxy access, tailored to the needs of their particular company.

However, there is considerable pressure for the SEC to go further and adopt a mandatory proxy access rule for all US public companies, as Rule 14a-11 proposes to do. We believe there is a legitimate concern that mandatory proxy access would lower the cost of contesting a board seat to a point whereby it could result in large numbers of annual shareholder meetings being contested on a routine basis, possibly for reasons not even directly related to board performance. Ironically, this could cause boards to take a more short-term view, given that each director would not know whether he or she might be forced out at the subsequent year’s annual meeting. Some form of proxy access might be appropriate for particular companies, but it might not be appropriate at others. We believe that individual states and companies should be left to determine what level of access is most appropriate.

Nevertheless, as outlined above, we believe there are improvements that can be made to proposed Rule 14a-11 if the SEC decides to move forward with mandatory proxy access.

⁸ 17 C.F.R. 240.14a-8(i)(8).

⁹ It is worth noting the case of *Bebchuk v. Electronic Arts, Inc.*, No. 08-cv-3716, which arose, in part, out of the fact that current Rule 14a-8(i)(8) prohibits any proposal that “relates to a nomination or an election for membership on the company’s board of directors ... or a procedure for such nomination or election.” Prof. Lucian Bebchuk submitted a shareholder proposal pursuant to Rule 14a-8 seeking an amendment to the bylaws of Electronic Arts, Inc. (“EA”) to require the company to include in its proxy materials any proposal permitted under Delaware law and made by a shareholder or group of shareholders who owned five percent of EA’s shares or at least \$2,000 worth of shares, and intended to own those shares through the date of the meeting. If approved by shareholders, the bylaw amendment seeks to bypass Rule 14a-8 completely. The case is currently on appeal to the Second Circuit.

¹⁰ For example, a proposal could be excluded if it had already been substantially implemented by the company or if the shareholder did not meet the ownership requirements of Rule 14a-8.

Schedule 1

Contents of Schedule 14N

The following information is required to be included in a Schedule 14N filed by a nominating shareholder or group:

- the amount and percentage of shares held by the nominating shareholder or group and entitled to be voted at the shareholders meeting, and the length of ownership;
- a statement that the nominating shareholder or group is the registered owner of the shares, or a written statement from the record holder (such as a broker or bank) confirming that the nominating shareholder or group has held the shares for the required period;
- a representation that the election of the nominee would not violate state law, federal law, or the rules of a national securities exchange;
- a representation that the nominating shareholder or group holds the requisite percentage of shares and has done so for the required time period;
- a representation that the nominee meets the “objective” requirements for independence under the rules of any national securities exchange that are applicable to the company;
- a representation that neither the nominee, nor the nominating shareholder, nor member of a nominating shareholder group, has an agreement with the company regarding the nomination of the nominee;
- a statement that the nominee agrees to be named in the proxy statement and to serve on the board of directors, if elected;
- a statement that the nominating shareholder or group intends to hold the requisite percentage of shares through the date of the shareholder meeting, and disclosure regarding whether the nominating shareholder intends to continue holding its securities after the election;
- disclosure about the nominee to the same extent as required under Items 4(b), 5(b), 7(a) – (c) of Schedule 14A, and about the nominating shareholder or group to the same extent as required under Items 4(b) and 5(b) of Schedule 14A;
- disclosure of any legal proceedings involving the nominating shareholder or members of the nominating group pursuant to Item 401(f) of Regulation S-K;
- disclosure regarding the extent and nature of certain designated relationships between the nominee, or the nominating shareholder or nominating group, and the company;
- the website address on which the nominating shareholder or group may publish soliciting materials;
- a statement of support not in excess of 500 words; and
- a certification that the nominating shareholder or group is not holding shares in order to affect a change in control of the company or gain more than a minority representation on the board.

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