DAVIS POLK & WARDWELL

Corporate Regulatory Report

A Summary of Current Regulatory Developments Affecting Publicly Listed Companies

Contents

NYSE Developments

NYSE Working Group Recommends Elimination of Broker Non-Votes for Director Elections

The NYSE's Proxy Working Group has unanimously adopted and published six recommendations with respect to NYSE rules on broker non-votes and other proxy voting matters. The most important of these recommendations is a change to make the election of directors a non-routine matter, such that brokers would no longer be able to vote in the election of directors when they do not receive instructions from the beneficial owners, even in uncontested elections of directors.

This recommendation must still be approved by the board of the NYSE before filing with the SEC. Once filed, the proposed rule changes must be published for further comment before approval by the SEC. However, reports indicate that the NYSE Staff would like comments to be submitted by the end of June 2006, with an eye towards finalization of the proposed rule change in time for next proxy season. For a copy of the final report, see http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf.

NYSE Proposal to Eliminate Annual Report Delivery Requirement Published by SEC

The SEC has published the proposed rule change filed by the NYSE last fall which would eliminate the NYSE's annual report delivery requirement provided the listed company makes its Form 10-K or 20-F available on its website and agrees to provide hard copies upon request. Listed companies would also be required to issue a press release simultaneously with their filing of the annual report with the SEC stating that their annual report has been so filed. This proposed rule change is still subject to SEC approval. The comment period ends on July 20, 2006.

Exchange Act Rule 14a-3(b) still requires that each proxy statement related to an annual meeting be accompanied or preceded by delivery of an annual report meeting the requirements of Rule 14a-3. As a result, U.S. issuers would still be required to deliver an annual report in conjunction with their annual proxy statement and therefore the NYSE's proposal will not have much meaning for U.S. issuers unless and until the SEC adopts its e-proxy proposal. Foreign private issuers are exempt from the proxy rules.

NYSE Developments (cont.)

The proposed rule change also:

- eliminates the requirement that a company inform the NYSE if it is unable to file its annual report with the SEC in a timely manner;
- adds a new section to the NYSE Listed Company Manual that specifically requires companies to have and maintain a website;
- eliminates the requirement that FPIs distribute to shareholders at least a summary annual report that includes summary financial information reconciled to U.S. GAAP but requires FPIs to post their Form 20-F or 40-F on their websites and provide hard copies of audited, U.S. GAAP reconciled, financial statements upon request;
- consolidates and streamlines the requirements for companies to provide notice to and file certain documents with the NYSE if such information is available via EDGAR;
- eliminates Section 401.04 of the NYSE Listed Company Manual which provides guidance regarding the interval between the end of the fiscal year and the annual meeting of shareholders (although the proposed rule change notes that the NYSE is not disavowing this "best practice"); and
- proposes a "cleanup" of Section 703.09 of the NYSE Listed Company Manual regarding disclosure of options, stock purchase and other remuneration plans because Reg. S-K's requirements in this area subsume the NYSE's disclosure requirements.

The text of the proposed rule change is available at http://www.sec.gov/rules/sro/nyse/2006/34-54029.pdf.

SEC Developments

SEC Announces Settlement with Raytheon for Improper Accounting and Disclosure

The SEC announced on June 29, 2006, that it has settled enforcement proceedings against Raytheon, two executive officers related to its improper accounting practices and failure to disclose (in both periodic reports and registration statements) the declining financial results and deteriorating business of Raytheon's commercial aircraft manufacturing subsidiary, Raytheon Aircraft Company (RAC), during the period from 1997 to 2001.

While a significant part of the Administrative Proceeding relates to the existence, and Raytheon senior management's knowledge, of several improper accounting practices at RAC as well as Raytheon's failure to disclose these improper accounting practices, it is noteworthy that the SEC also focuses on Raytheon's failure to accurately and fully disclose known risks, trends and uncertainties regarding RAC's commuter airline business, which were the subject of various internal business updates during the time period at issue. The Administrative Proceeding serves as a reminder that the disclosure of the impact of any known trends or uncertainties on a company's results of operations, liquidity or capital resources is a critical part of a company's MD&A disclosure.

SEC Developments (cont.)

The SEC's press release regarding this matter is available at http://www.sec.gov/news/press/2006/ 2006-104.htm. The SEC Administrative Proceeding with respect to this matter is available at http://www.sec.gov/litigation/admin/2006/33-8715.pdf.

We will be providing a more detailed memo on this development to be distributed separately.

SEC Issues Fact Sheet to Address Impact of Potential Cross-Border Stock Exchange Mergers

On June 16, 2006, the SEC issued a fact sheet to address the impact of potential mergers of U.S. and non-U.S. stock exchanges. The fact sheet notes the following:

» The cross-border exchange mergers would not result in the mandatory registration of a non-U.S. exchange's listed companies with the SEC or the mandatory compliance with the provisions of U.S. federal securities laws, including the Sarbanes-Oxley Act.

» Joint ownership of a U.S. exchange and a non-U.S. exchange would not result in automatic application of U.S. securities regulation to the listing or trading activities of the non-U.S. exchange.

» Whether a non-U.S. exchange, and thereby its listed companies, would be subject to U.S. registration depends on a careful analysis of the U.S. activities of the non-U.S. exchange.

» The non-U.S. exchange would only become subject to U.S. securities laws if that exchange is operating within the United States, not merely because it is affiliated with a U.S. exchange.

For a copy of the fact sheet, see http://www.sec.gov/news/press/2006/2006-96.htm.

SEC Publishes NYSE and NASDAQ Proposals to Facilitate Book-Entry Transactions

The SEC has published NYSE and NASDAQ proposals to require listed companies to become eligible to participate in the direct registration system of a registered clearing agency. Once a company is eligible for participation, shareholders will be able to register securities in their name without having a certificate issued and to transfer securities electronically without the risk and delay associated with the use of paper certificates. Under the proposals, generally, this requirement would apply to new listings starting on January 1, 2007, and to existing listings starting on January 1, 2008. For a copy of the NYSE proposal, see http://www.sec.gov/rules/sro/nyse/2006/34-53912.pdf. For a copy of the NASD proposal, see http://www.sec.gov/rules/sro/nasdaq/2006/34-53913.pdf.

SEC and Korean Financial Supervisory Commission Announces New Regulatory Dialogue

In a continuation of efforts to increase cooperation with non-U.S. securities regulatory authorities, which has been punctuated by previously announced agreements to cooperate with the U.K. and Chinese regulatory authorities, the SEC and the Korea Financial Supervisory Commission has announced terms for a dialogue between the two agencies. The agencies' objectives are to improve cooperation and the exchange

SEC Developments *(cont.)*

of information in cross-border securities enforcement matters; and identify and discuss regulatory issues of common concern. To this end, the following topics have been identified for discussion over the next year: (i) cross-border cooperation and information sharing on enforcement matters; (ii) accounting and auditing standards; (iii) corporate governance and internal controls; and (iv) approaches to regulated entities and market intermediaries. For a copy of the SEC press release on this development, see http://www.sec.gov/news/press/2006/2006-102.htm.

SEC Speaks

Acting Chief Accountant Provides Five Suggestions For Improving Financial Reporting

On June 8, 2006, in remarks before the Leventhal School of Accounting SEC and Financial Reporting Institute, Scott Taub, SEC Acting Chief Accountant, had five suggestions on how to think about and approach financial reporting. According to Mr. Taub, these suggestions will "drive down errors and the costs of reporting, while making things easier for investors to understand."

» *Allow accounting standards to focus on transparency of information.* According to Mr. Taub, for financial reporting to improve, "we all need to be committed to accepting standards that choose transparency over predictability, relevance of information over precision of calculation, and investor needs over those of management, regulators or others."

» *Apply the standards; don't abuse them.* Mr. Taub noted that there are currently "numerous instances of standards being applied to situations they clearly weren't written for, in ways that clearly weren't intended" and a mindset that "it's the FASB's fault for not writing foolproof standards; or that until and unless the SEC catches it and stops it, it's OK." According to Mr. Taub, "that's not the framework in which the standards were written" and these types of abusive situations should stop.

» *Professional judgment is necessary to high-quality reporting.* Mr. Taub noted that while "bright-lines exist in many areas," professional judgment is required for much of financial reporting. Preparers of financial reports and auditors should be comfortable using their judgment on what type of treatment provides high-quality transparent reporting rather than twisting the facts to find the "safest" answer. Mr. Taub strongly supports the use of such professional judgment and stated that as "long as those judgments result in transparent reporting" the SEC is not likely to object.

» *Go beyond the minimum disclosure requirements if it helps users.* Mr. Taub emphasized that companies should disclose key information whether a specific requirement to disclose it exists or not.

» *Accept diversity in practice and deal with it transparently.* Mr. Taub acknowledged that the use of professional judgment in reporting may sometimes result in different companies accounting for a similar transaction differently. According to Mr. Taub, he is "comfortable accepting two reasonable interpretations of [accounting] literature" provided the companies "explain to investors the practices they have chosen and why they chose those practices."

SEC Speaks (cont.)

Mr. Taub also encouraged companies to contact the SEC to seek advice or help with respect to their financial reporting.

Mr. Taub's speech is available at http://www.sec.gov/news/speech/2006/spch060806sat.htm.

Commissioner Atkins on Whether U.S. Regulations Are Affecting the Competitiveness of U.S. Markets

In separate speeches on June 7, 2006, and June 15, 2006, SEC Commissioner Paul Atkins discussed whether increased regulation in the United States is hurting its competitiveness. Commissioner Atkins acknowledged that he is "worried" by statistics presented in the *Wall Street Journal* that in 2000, 9 out of every 10 dollars raised by foreign companies through new stock listings were done in New York but in 2005, 9 out of every 10 dollars were raised outside of the United States. Notwithstanding his concern, Commissioner Atkins is still confident that SOX "offers considerable benefits to shareholders." Commissioner Atkins further stated that he finds SOX's emphasis on good internal controls "laudable," but that the implementation of SOX 404 has been a "train wreck." Commissioner Atkins hoped that the recent SEC and PCAOB efforts will make compliance with SOX 404 more efficient and suggested that the anticipated SEC Concept Release, in which the SEC intends to solicit views on the SOX 404 management assessment process, will be issued within the next few weeks.

For a copy of Commissioner Atkins' remarks on June 7, 2006, before the International Law Association's 72nd Biannual Conference, see http://www.sec.gov/news/speech/2006/ spch060706psa.htm.

For a copy of Commissioner Atkins' remarks on June 15, 2006, before the French Association of Corporate Governance, see http://www.sec.gov/news/speech/2006/spch061506psa_eng.htm.

Commissioner Campos Speaks on Hedge Fund Activity and Regulation

In what was often a repeat of similar statements in past speeches, on June 14, 2006, in a speech before the SIA Hedge Funds & Alternative Investments Conference, Commissioner Roel Campos reiterated the SEC's awareness of the growing power of hedge funds as players in both the financial and corporate governance arenas of Corporate America. Noting that many people believe that the market is the best force to discipline hedge fund activity, he discussed the steps that the SEC is taking to monitor the market's ability to provide such discipline, including focusing attention on broker-dealers' exposure to hedge fund risks; meeting regularly with members of the President's Working Group on Financial Markets and the Counterparty Risk Management Policy Group and continuing the inspections of hedge funds by the SEC Office of Compliance Inspections and Examinations. Commissioner Campos recognizes that there have been complaints about the length of the OCIE examinations and the related document requests, but believes that these examinations merely need to be tailored, a task on which the SEC Staff is focused.

For a copy of Commissioner Campos' speech, see http://www.sec.gov/news/speech/2006/spch061406rcc.htm.

SEC Speaks *(cont.)*

Chairman Cox and Commissioner Glassman Speak About the Need to Reduce Complexity in Disclosure and Financial Reporting

On June 8, 2006, in an address to the New York Financial Writers Association, SEC Chairman Christopher Cox reiterated his commitment to plain English disclosure stating that the SEC is "mounting an all out war on needless complexity." Commissioner Cox referred to the SEC's executive compensation proposals as one example of what the SEC is striving for with respect to plain English disclosure noting that the proposals will require clear disclosure of current executive compensation as well as any future benefits that executives may be entitled to upon leaving the company. Commissioner Cox also stated that the final executive compensation rules will likely be modified from the proposals to address the issues surrounding the back-dating of stock options. According to Commissioner Cox, the Staff will make a recommendation regarding these issues at an opening meeting soon and he expects the matter will be settled in time for next year's proxy season.

In a speech before the 25th Annual USC Leventhal School of Accounting SEC and Financial Reporting Institute Conference on June 8, 2006, Commissioner Cynthia Glassman also spoke about the need to reduce complexity in financial reporting and disclosure. Commissioner Glassman noted that the vast array of accounting standard setters, regulators and other sources contributes to the complexity of financial reporting. Commissioner Glassman also believes that accounting standards have become overly prescriptive which can create legal problems for preparers and issuers that either do not understand the standards or "take advantage of complexity to provide misleading disclosure." In order to solve these problems, Commissioner Glassman suggested that the various accounting pronouncements should be "reconciled, organized and rationalized and standard setters should work to ensure that accounting standards are principles-based and objectives-oriented." Commissioner Glassman also suggested that similar reforms are needed to simplify and streamline SEC disclosure rules.

Chairman Cox's speech is available at http://www.sec.gov/news/speech/2006/spch060806cc.htm. Commissioner Glassman's speech is available at http://www.sec.gov/news/speech/2006/spch060806cag.htm.

Commissioner Nazareth Provides an Overview of Developments in International Regulatory Cooperation

On June 20, 2006, in a speech before the NYSE Regulation Second Annual Securities Conference, Commissioner Annette Nazareth provided an overview of developments in international regulatory cooperation. Commissioner Nazareth noted that there is a long and positive history of cooperation in the enforcement area and this cooperation has greatly enhanced the SEC's enforcement program by increasing its ability to obtain information from a growing number of jurisdictions. Commissioner Nazareth also summarized the steps taken by the SEC to facilitate the transition to International Financial Reporting Standards (IFRS) and noted that Chairman Cox has reaffirmed the SEC's commitment to eliminate, by 2009 at the latest, the U.S. GAAP reconciliation requirement.

A copy of Commissioner Nazareth's speech is available at http://www.sec.gov/news/speech/2006/spch062006aln.htm.

PCAOB Developments

Mark W. Olson Appointed PCAOB Chairman

On June 19, 2006, the SEC announced the appointment of Federal Reserve Board Governor Mark W. Olson as Chairman of the PCAOB. On the same day, the SEC also announced that founding PCAOB member Kayla Gillan has been re-appointed to the Board. A copy of the SEC's press release announcing Mr. Olson's appointment is available at http://www.sec.gov/news/press/2006/2006-97.htm. A copy of the SEC's press release announcing Ms. Gillan's reappointment is available at http://www.sec.gov/news/press/2006/2006-98.htm.

PCAOB Issues Q&As on Adjustments to Prior Period Financial Statements Audited by a Predecessor Auditor

On June 9, 2006, the PCAOB issued Q&As on adjustments to prior period financial statements audited by a predecessor auditor. The Q&As provide, among other things, that companies that change auditors and then have to restate or otherwise adjust prior financial statements may use either their current audit firm or their prior audit firm to perform the work. The Q&As are available at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/QA_Adjustments.pdf.

PCAOB Chief Auditor and Director of Professional Standards Discusses Auditing Standard No. 2

On June 8, 2006, Thomas Ray, PCAOB Chief Auditor and Director of Professional Standards, discussed Auditing Standard No. 2 in a speech to the 25th Annual SEC and Financial Reporting Institute Conference in Pasadena. In his speech, Mr. Ray discussed his views on areas in which he believes "significant opportunities for increased efficiency currently exist." First, Mr. Ray believes that a misunderstanding exists with regards to the auditors' opinion on whether management's assessment of the company's internal control over financial reporting is fairly stated, in all material respects. Mr. Ray noted that "some believe that the auditor is expressing an opinion on management's assessment process" and this is resulting in unnecessary work to evaluate the adequacy of management's process. According to Mr. Ray, "while Auditing Standard No. 2 does require the auditor to obtain an understanding of and evaluate management's assessment process . . . the extent of the auditor's work is only that which is necessary for the auditor to form a conclusion as to whether management's process was sufficiently complete to provide management with a basis to support its reporting, and whether the results of management's testing support management's conclusion about internal control effectiveness." Mr. Ray also believes that there is a significant opportunity for auditors to reduce the amount of testing by adjusting the nature, timing and extent of testing based on risk. For example, auditors should reduce the amount of testing performed with respect to low-risk transaction controls and eliminate testing of redundant controls.

For a copy of Mr. Ray's speech see http://www.pcaobus.org/News_and_Events/Events/2006/Speech/ 06-08_Thomas_Ray.aspx.

NASDAQ Developments

NASDAQ Proposes Minimum Cure Period for Independent Directors and Audit Committee Members

The SEC has published NASDAQ's proposal to amend its cure period for violations of its independent director and independent audit committee member requirements. The proposal allows for a minimum 180-day cure period in cases where within 180 days before the company's annual meeting:

» a vacancy arises on the audit committee or board, or

» the company ceases to have a majority of independent directors on its board because a director loses his or her independence through no fault of the director.

NASDAQ Rule 4350 requires each listed issuer to have a majority of independent board members and an audit committee that consists of at least three independent members. Currently, issuers who lose an independent board or audit committee member, either because the member ceases to be independent for reasons outside the member's reasonable control or because a vacancy arises, have until the earlier of the company's next annual shareholders' meeting or one year from the date of the event to cure any non-compliance with these NASDAQ independence requirements. According to NASDAQ, the current cure period has caused anomalous results because if a board member resigns just after the company's annual meeting, the company would have almost a year to recruit a new director and regain compliance, but if the same situation occurs just before the company's annual meeting, the company would have only days or weeks to recruit a new director.

The comment period ends July 5, 2006. Upon approval of this proposed rule change, NASDAQ will allow any company then eligible to utilize the new 180-day minimum period from the date of the vacancy or the event that caused non-compliance, even if the vacancy or non-compliance arose before the date of approval, provided that such company has not exceeded the cure period provided for in the rule as in effect prior to the proposed rule change.

The proposed rule change is available at www.sec.gov/rules/sro/nasdaq/2006/34-53941.pdf.

FASB Developments

FASB Issues Proposed Staff Guidance on Classification of Stock-Based Compensation

The FASB has issued proposed staff guidance, FAS 123(r)-e, on how to classify financial instruments that were first issued as stock-based compensation to employees. The FASB stated in its press release for the guidance that it is seeking to clarify the circumstances surrounding changes to a stock-based award that would not necessarily lead to a modified award being booked as a liability. Such changes might stem from an equity restructuring or a business combination, according to examples cited by FASB's chairman when the board cleared the proposal for final drafting and issuance. The proposed staff guidance is available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas123r-e.pdf.

FASB Developments (cont.)

FASB and AICPA Issue Proposal Regarding Different Accounting Standards for Private Companies

On June 8, 2006, the FASB and the AICPA issued a proposal which seeks feedback on whether the FASB should consider differences in GAAP accounting standards for private companies. Under the proposal, the FASB would implement certain improvements to enhance the transparency of its standard setting process for private companies and consider input from private company constituents. To that end, the FASB and the AICPA would also sponsor and fund a joint committee to serve as an additional resource to the FASB to further ensure that the views of private company constituents are incorporated into the standard-setting process.

The FASB and the AICPA are encouraging everyone who plays a role in private company financial reporting to comment by August 16, 2006. A copy of the proposal is available at www.pcfr.org.

NASD Developments

Director Gives Update on Proposed NASD Rule Changes

At an ABA subcommittee meeting on June 21, 2006, Joe Price, Director of the NASD Corporate Financing Department, provided news regarding proposed changes to the following rules:

» *Rule 2720.* Rule 2720 imposes certain requirements to resolve the conflicts of interest that arise when an NASD member participates in the distribution of an offering of an issuer with which it is affiliated or with which it has other specified relationships. Mr. Price advised that the NASD will file a rule change with the SEC (i) to exempt from both the filing and substantive requirements of the rule, offerings of investment-grade-rated debt securities and securities of the same class that have not been rated as well as offerings of securities for which there is a bona fide independent market, (ii) to eliminate the requirement that qualified independent underwriters (QIUs) issue a pricing opinion, (iii) to limit the requirement for a QIU to situations in which a conflict exists between the issuer and either the sole underwriter, book-running lead manager or dealer manager (as opposed to all distribution participants), (iv) to modify the "proceeds directed to a member" provision of Rule 2710 so that any offering in which 5 percent or more of the net offering proceeds are proposed to be paid to a member or affiliate or associated person of a member participating in the distribution of the offering would be subject to the filing requirements of Rule 2710 and (v) to require more prominent disclosure in offering documents of the participation of a QIU. Once the rule change is filed with and published by the SEC, there will be an opportunity to comment.

» *Rules 2710 and 2810.* The proposal to revise provisions of Rule 2710 that relate primarily to shelf offerings and proposal to amend Rule 2810 are expected to be published for comment shortly.

» *Rule 2790.* The NASD has filed the proposal to prohibit sales to broker-dealers in issuer directed programs and exempt all issuer directed sales from the new issue restrictions in offerings where no broker-dealer underwrites or sells any new issue securities or influences the allocation of such securities.

Other Developments and DPW Memos

FTC and DOJ Unveil Electronic HSR Filing System

On June 20, 2006, the FTC and DOJ announced the implementation of an Internet filing system for parties to submit electronically premerger notification filings required by the Hart-Scott-Rodino Act. Companies will now have the option of continuing to submit the premerger notification form and attachments in hard copy or submitting the premerger notification form electronically and submitting the attachments in hard copy or electronically. The FTC and DOJ hope that the electronic filing option will eliminate the time and expense of duplicating and delivering hard copy documents. For more information on this development, see https://www.hsr.gov.

2nd Circuit Upholds SEC's Authority to Exempt Foreign Private Issuers from U.S. Proxy Rules

In a recent decision (*Schiller v. Tower Semiconductor Ltd.*), the Second Circuit Court of Appeals affirmed that the SEC did not exceed its authority in adopting Rule 3a12-3 of the Securities Exchange Act, pursuant to which foreign private issuers are exempted from the application of U.S. proxy requirements under Section 14(a) and related SEC rules. For a copy of this decision, click [here].

U.S. Court of Appeals for the District of Columbia Circuit Vacates SEC Rule Requiring Registration of Hedge Fund Advisors

On June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the SEC's controversial rule regarding the registration of hedge fund advisers promulgated under the Investment Advisers Act of 1940. For a copy of the DPW Newsflash on this decision, click [here].

Contacts

If you have questions about any of the developments covered in this report, please call your regular Davis Polk contact or:

Janice Brunner
212-450-4211
janice.brunner@dpw.com

Frances Mi
212-450-4048
frances.mi@dpw.com