

DAVIS POLK & WARDWELL
Corporate Regulatory Report

A Summary of
Current Regulatory
Developments Affecting
Publicly Listed Companies

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SEC Developments

SEC Publishes Proposal to Revamp Executive Compensation Disclosure; Provides Current Guidance on Perk Disclosure

On January 27, 2006, the SEC issued its proposal to modify disclosure rules regarding executive compensation, director independence, related party transactions and other corporate governance matters. Generally, for calendar-year companies, the proposed proxy statement disclosure changes would not apply until the 2007 proxy season. However, the proposal includes interpretative guidance that applies immediately to current disclosure. Among other things, the guidance reiterates that the standard for valuation of perks is “aggregate incremental cost” to the issuer and sets forth factors in determining what constitutes a perk or personal benefit (see p. 46 of the proposal). Comments are due on or before April 10, 2006. We will provide more detail on this proposal in a subsequent client memorandum. For a copy of the rule proposal, see <http://www.sec.gov/rules/proposed/33-8655.pdf>.

SEC Announces Objective Standards for Corporate Fines

On January 4, 2006, in conjunction with the filing of settled actions alleging financial fraud against McAfee and Applix, the SEC announced the unanimous adoption of objective standards for the imposition of corporate fines. The standards turn on two main considerations:

- » Whether there was a direct benefit to the corporation as a result of the violation (if shareholders have benefited from the violation, then that is the strongest case for the imposition of a corporate fine); and
- » The degree to which the fine will recompense or further harm the injured shareholders.

In addition, the SEC will consider the following factors in determining whether to impose a fine and the amount thereof: the need to deter the particular type of offense; the extent of injury to innocent parties; whether complicity in the violation is widespread throughout the corporation; the level of intent on the part of the perpetrators; the degree of difficulty in detecting the particular type of offense; the presence or lack of remedial steps by the corporation; and the extent of cooperation with the SEC and other law enforcement. See <http://www.sec.gov/news/press/2006-4.htm> for a copy of the SEC statement.

SEC Developments (cont.)

SEC Offers Incentive for Companies to Use XBRL

On January 11, 2006, the SEC announced that companies volunteering for the XBRL test group will be offered expedited reviews of their registration statements and annual reports. Among other things, the Staff will inform well known seasoned issuer volunteers as to whether or not their annual reports on Form 10-K will be selected for review within 30 days after filing and will undertake to provide any comments on that filing within 45-60 days of filing. For a copy of the SEC press release, see <http://www.sec.gov/news/press/2006-7.htm>.

SEC Speaks

SEC Commissioners Urge Continued Examination of Section 404

In separate speeches, Commissioners Atkins and Glassman both urged continued examination by the SEC and PCAOB of the implementation of Section 404 (internal control over financial reporting requirements) so as to increase efficiency and effectiveness. According to Commissioner Atkins, survey results indicate that actual costs incurred for compliance were twenty times higher than what the SEC estimated. Both Commissioners acknowledged that compliance costs have declined in year two of these requirements, but noted that the declines are not as significant as hoped. Commissioner Glassman is concerned that the PCAOB's Auditing Standard No. 2 (regarding the conduct of an audit of internal control over financial reporting) may still have missed "the forest for the trees", and may need to be revisited in the future. For Commissioner Atkins' speech, see <http://www.sec.gov/news/speech/spch011906psa.htm>. For Commissioner Glassman's speech, see <http://www.sec.gov/news/speech/spch020306cag.htm>.

PCAOB Developments

SEC Publishes PCAOB Proposal Regarding the Continued Existence of a Material Weakness in Internal Controls

At the end of 2005, the SEC published for comment the PCAOB's proposed Auditing Standard No. 4, which was first issued by the PCAOB in July 2005. Standard No. 4 would establish requirements and provide direction for when an auditor is engaged to report on whether a company's previously reported material weakness in its internal control over financial reporting continues to exist. Among other things, the proposed rule provides that auditors would use materiality at the financial statement level, rather than at the individual account balance level, in evaluating whether a material weakness exists. For a copy of the rule proposal, see <http://www.sec.gov/rules/pcaob/34-52990.pdf>.

NYSE Developments

SEC Approves Changes to NYSE Procedures Regarding Late Filers of Annual Reports

On January 19, 2006, the SEC approved the NYSE's changes to its procedures for companies that fail to file their annual reports in a timely manner. Among other things, the NYSE is (i) providing that in very rare circumstances involving companies with a "position in the market" (due either to the nature of their business or the depth of their public shareholder base), the NYSE may permit the delay in annual report filing to extend beyond a year, and (ii) otherwise maintaining that one year be the maximum period that a company may be delinquent in its filings before the NYSE begins delisting procedures but shortening the initial monitoring period for such late filers to six months from nine months and lengthening from three months to six months the additional grace period that the NYSE may give to companies before beginning delisting procedures. For a copy of the SEC's approving release, see <http://www.sec.gov/rules/sro/nyse/34-53152.pdf>.

NASD Developments

NASDAQ Approved as Registered National Securities Exchange

On January 13, 2006, the SEC approved the registration of The Nasdaq Stock Market as a national securities exchange. This will allow the full separation of Nasdaq from the National Association of Securities Dealers. The commencement of operation of Nasdaq as a national securities exchange is subject to the satisfaction of certain conditions by Nasdaq and the NASD, including the filing, amendment and approval of certain national market system plans and the making of arrangements by Nasdaq and the NASD to satisfy certain regulatory requirements. Nasdaq has stated that it hopes that it will satisfy the conditions imposed by the SEC and begin operating as a national securities exchange on or about April 1, 2006. For a copy of the SEC's findings, opinion and order granting Nasdaq's application, see <http://www.sec.gov/litigation/opinions/34-53128.pdf>. For a copy of the DPW memorandum on this development, click [\[here\]](#).

Other Developments

Third Circuit Affirms Dismissal of Class Action Securities Fraud Claims Against Merck

In January 2005, the Third Circuit Court of Appeals dismissed securities fraud claims against Merck stemming from the failed IPO in 2002 of Merck's subsidiary, Medco Health Solutions. At issue were Medco's revenue recognition policies for co-payments made by consumers directly to dispensing pharmacies. Certain disclosures regarding Medco's revenue recognition policy were made in pre-effective amendments to Medco's IPO registration statement. Two months following Medco's initial disclosure of the policy in its registration statement, the Wall Street Journal publicly estimated the magnitude of such policy to be in

Other Developments (cont.)

the billions of dollars. The Third Circuit held that although the disclosure in question was “opaque,” “delayed,” and “piecemeal,” it did not rise to the level of a material misstatement for purposes of Section 11 of the Securities Act or Section 10(b) of the Exchange Act. According to the Third Circuit, based on the efficient market hypothesis, the market made the same calculations at the time of Medco’s initial disclosure of its revenue recognition policy as those later made by the Wall Street Journal, without any adverse impact on Merck’s stock price. The Third Circuit reasoned that, as a result, the alleged misstatements were immaterial. The Third Circuit’s opinion is available at: <http://www.ca3.uscourts.gov/opinarch/043298p.pdf>.

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It is not a full analysis of the matters presented and should not be relied upon as legal advice.*