DAVIS POLK & WARDWELL

Corporate Regulatory Report

A Summary of Current Regulatory Developments Affecting Publicly Listed Companies

Contents

SEC Developments

SEC Issues Executive Compensation and Related Party Transition Q&As

On September 22, 2006, the SEC issued a series of Transition Questions and Answers ("Q&As"), which represent the views of the staff of the Division of Corporation Finance with respect to questions the staff has received regarding issuers' transition to compliance with the new Executive Compensation and Related Person Disclosure. Although the questions and answers are not rules, regulations, or statements of the SEC, the Q&As contain important information regarding the required compliance dates for the new Executive Compensation and Related Party disclosure rules for Registration Statements, Form 10-Ks and Form 8-Ks as well as information regarding early compliance with the rules once effective.

The new executive compensation rules become effective November 7, 2006, and Q&A #1 provides that compliance with the new rules is *not* permitted prior to November 7, 2006. The adopting release for the new executive compensation rules provides a transition period in Section VII for required compliance with the new rules such that registrants must comply with the new rules in:

- Registration statements that are filed with the SEC on or after December 15, 2006, that are required to include Regulation S-K Items 402 and 404 disclosure for fiscal years ending on or after December 15, 2006;
- Form 10-Ks for fiscal years ending on or after December 15, 2006;
- Form 8-Ks relating to triggering events that occur on or after November 7, 2006; and
- Proxy statements filed on or after December 15, 2006, that are required to include Items 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

The Q&As make it clear that an issuer that chooses to comply with *some* of the new rules early (for example, an issuer that files a registration statement or Form 10-K on December 14, 2006, with respect to its fiscal year ending September 30, 2006) must comply with *all* of the new rules (Q&As 3 and 6). In addition, the Q&As provide that because registration statements for IPOs are required to contain only one year of compensation disclosure *unless* the information for prior periods has been previously disclosed, a calendar year end IPO company that chooses to comply

with the new rules early with respect to its 2005 fiscal year-end will be required to include two years of compensation disclosure (2005 and 2006) in any subsequent amendment in which it is required to include compensation disclosure for its 2006 fiscal year (Q&A 8). The Q&As also provide that a calendar year-end issuer that amends a registration statement after its 2006 fiscal year-end must comply with the new rules in the amendment even if the original registration statement did not comply with the new rules because it was filed before December 14, 2006 (see Q&A 7).

The Q&As are available at http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf.

SEC Chief Accountant Issues Letter Regarding Accounting for Stock Options

On September 19, 2006, the SEC Office of the Chief Accountant issued a letter summarizing the staff's views regarding the accounting for stock options in the historical financial statements of public companies. The letter discusses the accounting consequences under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25) of dating an option award to predate the actual award date, option grants with administrative delays, uncertainty as to the validity of prior grants, and other related circumstances. Prior to the adoption of the Financial Accounting Standards Board's Statement No. 123 (revised 2004), "Share-Based Payment," many public companies accounted for stock options under APB 25.

The letter is available at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm.

SEC Issues SAB 108 Regarding the Process of Quantifying Financial Statement Misstatements

On September 13, 2006, the SEC issued Staff Accounting Bulletin 108 ("SAB 108") to provide interpretative guidance on how the effects of the carryover or reversal of prior year financial statement misstatements should be considered in quantifying a current year misstatement. According to the SEC staff, there have been two common approaches used to quantify these types of errors. Under one approach, called the "rollover approach," the error is quantified as the amount by which the current year income statement is misstated. The other common approach, called the "iron curtain approach," quantifies the error as the cumulative amount by which the current year balance sheet is misstated. The SEC staff has found that exclusive reliance on the income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but which nonetheless, may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

SAB 108 provides that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material.

The SEC's press release describing SAB 108 is available at http://www.sec.gov/news/press/2006/2006-153.htm. The full text of SAB 108 is available at http://www.sec.gov/interps/account/sab108.pdf.

SEC to Propose Amendment to Exchange Act Rule 14a-8 Governing Director Nominations by Shareholders

On September 7, 2006, the SEC announced that the SEC Division of Corporation Finance will recommend an amendment to Exchange Act Rule 14a-8 concerning director nominations by shareholders. According to the SEC's press release on this subject, the staff proposal, still to be developed, will address issues raised by a decision of the U.S. Court of Appeals for the Second Circuit on September 5, 2006, in a case entitled *American Federation of State, County & Municipal Employees Pension Plan, Appellant, v. American International Group, Inc.* ("**AIG**") (the "**AFSCME Case**"). In the AFSCME case, the Second Circuit held that a shareholder proposal to amend the corporate bylaws of AIG to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot does not relate to an election within the meaning of Rule 14a-8 of the Exchange Act and therefore could not be excluded from AIG's corporate proxy materials under that regulation. According to the SEC, this decision is contrary to the SEC's longstanding interpretation of Rule 14a-8.

The SEC will first consider this issue at an open meeting to be held on Oct. 18, 2006. According to SEC Chairman Cox, "following the publication of a proposed amendment and the opportunity for public comment, a final proposal will be considered at an open meeting of the Commission that will be scheduled to allow a final rule to go into effect in time for the 2007 proxy season."

For a copy of the SEC's press release announcing its intent to propose an amendment to Exchange Act Rule 14a-8, see http://www.sec.gov/news/press/2006/2006-150.htm. For a copy of the Second Circuit decision in the AFSCME case, click here.

SEC Issues Fee Rate Advisory #3 for FY 2007

On September 29, 2006, the SEC issued Fee Rate Advisory #3 for FY 2007 to inform issuers that it will not receive its 2007 annual appropriation before October 1, 2006 (the first day of the SEC's 2007 fiscal year), and therefore the current fee rate ($107.00 per $1,000,000 of securities registered) will continue in effect under a continuing resolution, which will extend through November 17, 2006.

In May, the SEC announced that effective Oct. 1, 2006, or 5 days after the date on which the SEC receives its fiscal year 2007 regular appropriation, *whichever date comes later*, the Section 6(b) fee rate applicable to the registration of securities, the Section 13(e) fee rate applicable to the repurchase of securities, and the Section 14(g) fee rate applicable to proxy solicitations and statements in corporate control transactions will decrease to $30.70 per million from the current rate of $107.00 per million.

The SEC will issue additional notices to inform issuers as to when the 2007 fee rate change will occur.

SEC Fee rate advisory #3 for 2007 is available at http://www.sec.gov/news/press/2006/2006-168.htm.

SEC Speaks

John White Makes it Clear that "Principles Matter"

John White, Director of the SEC Division of Corporation Finance, made several speeches in September in which he reiterated his belief that "principles matter" when it comes to all disclosure, particularly the disclosure required under the new executive compensation rules. In a speech given by Mr. White on September 6, 2006, at a Practising Law Institute Conference related to the new executive compensation rules, Mr. White referred to a description of principles-based reporting provided by FASB Chairman Robert Herz in 2002 as a good explanation of the term "principles-based." According to Mr. Herz:

> "under a principle-based approach, one starts with laying out the key objectives of good reporting in the subject area and then provides guidance explaining the objective and relating it to some common examples. While rules are sometime unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles."

Mr. White went on to discuss how the concept of principles-based disclosure should be applied in drafting the Compensation Discussion & Analysis (CD&A) required under the new executive compensation rules. According to Mr. White, a principles-based approach should be used to determine whether to discuss matters that occurred after the fiscal year end being reported on or in years prior to it. According to Mr. White, if such information is "relevant or necessary to a fair understanding of the year in question, then you do need to talk about it" and "the same could be true with regard to something that everyone expects to happen next year." With regards to perquisite disclosure, Mr. White assured people that while he could not provide hard and fast rules "if you let the principles guide you, you will not run astray." Mr. White further noted that the perquisite disclosure objective is to provide investors with the material information they need in order to understand the incremental costs of the perquisites, "that valuation, its context and the particular facts and circumstances of those perquisites."

In another speech at the Corporate Counsel Conference on September 11, 2006, Mr. White discussed how principles work in the disclosure of option grants. Noting that the adopting release for the new executive compensation rules "contains several questions and examples in order to help companies craft the right disclosure in their CD&A specifically about option grants," Mr. White stated that while the question which asks a company to consider whether it has any program, plan or practice to time option grants to its executives in coordination with the release of material non-public information is not "mandatory or exhaustive," it does "deserve careful consideration." Mr. White also urged issuers to "think in principle about what it means to "time an option grant in coordination with the release of material non-public information." Mr. White also suggested that investors apply the lessons learned from following a principles-based approach in drafting their Management's Discussion & Analysis in prior years to the preparation of their new CD&A.

For a copy of Mr. White's speech on September 6, 2006, regarding a principles-based approach to executive compensation disclosure, particularly CD&A disclosure, see http://www.sec.gov/news/speech/2006/spch090606jww.htm. For a copy of Mr. White's speech on September 11, 2006, regarding a principles-based approach to option grant disclosure, see http://www.sec.gov/news/speech/2006/spch091106jww.htm.

SEC Speaks *(cont.)*

John White Urges Directors to View SEC Comments as a "Valuable Resource"

In a speech before the Practising Law Institute Fourth Annual Directors' Institute on Corporate Governance on September 25, 2006, John White told the director attendees that he believes that members of a company's board of directors should be familiar with the SEC comments issued to the company and should view these comments as "a valuable resource." According to Mr. White, the SEC staff's comments "often go directly to the heart of key issues (particularly on the accounting side)" because the SEC is often familiar with "a cross-section of companies that often have similar businesses and similar disclosure issues." Mr. White went on to note that the SEC comments "warrant the attention of a careful and conscientious board member" and urged directors to "keep an open mind and think about how the staff's comments might advance the needs and interests of your team to the benefit of investors."

For a copy of Mr. White's speech urging director's to utilize SEC comments, see http://www.sec.gov/news/speech/2006/spch092506jww.htm.

NYSE and NASD Developments

NYSE AND NASD Propose Changes to Research Analyst Conflict of Interest Rules

On September 27, 2006, the NYSE made two separate proposed rule change filings with the SEC with respect to Rule 472 regarding research analyst conflicts of interest. The first rule filing is meant to codify existing interpretations of the NYSE rules regarding research analyst conflicts of interest and is therefore effective immediately (although it can be abrogated by the SEC within 60 days). This rule filing is available at http://apps.nyse.com/commdata/pub19b4.nsf/docs/729A630785C882E0852571F600716DF0/$FILE/NYSE-2006-77.pdf.

The second rule filing contains proposed substantive changes to Rule 472 and will therefore be subject to SEC publication and approval as well as a comment period prior to effectiveness. The proposed substantive amendments to Rule 472 eliminate the pre-publication factual verification review of research reports by non-research personnel; change the quiet periods surrounding securities offerings and the release of lock-up agreements; allow member organizations to develop policies and procedures if they choose to prohibit research analysts from holding securities for companies they cover; alter the format for certain disclosures in research reports; and extend the anti-retaliation prohibitions to all employees of a member organization, not just investment banking. This rule filing is available at http://apps.nyse.com/commdata/pub19b4.nsf/docs/790CA663E8440738852571F600716E07/$FILE/NYSE-2006-78.pdf.

On September 27, 2006, the NASD also filed with the SEC substantively similar amendments to its research analyst conflict of interest rules (NASD Rule 2711 and NASD Rule 1050). The NASD rule filings are available at http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_017550.pdf and http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_017553.pdf.

NYSE and NASD Developments (cont.)

NASD Proposes Amendments to Conflict of Interest Rule

The NASD has proposed significant amendments to Rule 2720, which applies to, among other things, offerings by an NASD member of (i) securities of an affiliate and (ii) securities of an issuer with which the member has a conflict of interest.* Offerings subject to Rule 2720 must be filed for review under the Corporate Financing Rule (Rule 2710) and are subject to certain substantive requirements, the most significant of which is the requirement that a qualified independent underwriter (a "QIU") participate in due diligence and issue a pricing opinion with respect to the offering. The proposed amendments have been published for comment in Notice to Members 06-52, which is available at http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW_017396.

There is a fair amount of good news in the proposal. For example, no filing and no QIU will be required for (i) offerings of investment-grade-rated securities and (ii) offerings of equity securities that meet (x) the Regulation M actively traded security definition and (y) the exemption from filing requirements under Rule 2710. Other good news is the proposal to eliminate the requirement that a QIU issue a pricing opinion. More controversial is the proposal to expand the definition of "conflict of interest," and thereby extend the filing requirements, to offerings in which five percent or more of the offering proceeds will be directed to a member participating in the distribution of the offering, its affiliates or associated persons.

Before becoming effective, the rule change must be reviewed by the NASD Regulation Board of Governors and approved by the SEC. Accordingly, it may be some time before the rule change becomes effective and it is likely that the final rule will differ from this proposal.

* *Under the proposal, a conflict of interest exists when (i) a participating member, its affiliates or associated persons owns 10% or more of the common or preferred stock of the issuer or (ii) 5% or more of offering proceeds will be directed to a participating member, its affiliates or associated persons.*

NASDAQ Developments

SEC Approves NASDAQ Change to Cure Period for Independent Directors and Audit Committee Members

The SEC has approved the NASDAQ's proposed rule change which amends its cure period for violations of its independent director and independent audit committee member requirements. 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. Historically, issuers who lost an independent board or audit committee member, either because the member ceased to be independent for reasons outside the member's reasonable control or because a vacancy arose, have had 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. This cure period remains intact but now, as a result of the rule change, which is now in effect, if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with the majority independent board requirement or the audit committee composition requirement, the issuer will instead have 180 days from the event to regain compliance.

NASDAQ Developments *(cont.)*

According to NASDAQ, the addition of the 180-day minimum cure period is intended to address the anomalous results that occurred under the pre-amended rule when a board's independence status changed shortly before the issuer's annual meeting. Under the pre-amended rule, if a board member resigned 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 occurred just before the company's annual meeting, the company would have had only days or weeks to recruit a new director.

The SEC order approving the change to the independent director cure period is available at http://www.sec.gov/rules/sro/nasdaq/2006/34-54421.pdf.

NASDAQ Proposes Changes to Certain NASDAQ Capital Market Listing Requirements

On August 28, 2006, the SEC published a proposal by the NASDAQ to revise certain listing requirements applicable to the NASDAQ Capital Market. Under the current NASDAQ Capital Market primary listing standards, a company can list on the NASDAQ Capital Market by meeting a stockholders' equity, income or market value of listed securities requirement, along with other applicable listing standards. The proposed rule change would modify the income and market value of listed securities components of these listing standards to also require a minimum of $4 million in equity in each case. In addition, for companies listing under the equity alternative, NASDAQ proposes to require a two-year operating history, instead of the one-year history currently required. Further, for companies listing under the market value of listed securities and equity alternatives, NASDAQ proposes to increase the market value of publicly held shares requirement for initial listing from $5 million to $15 million. Finally, NASDAQ proposes to clarify that all companies must have 300 round lot shareholders for continued listing of a primary class of common stock. The NASDAQ proposal also modifies the listing standards applicable to secondary classes of common and preferred stock, rights and warrants, options and other issues.

In the rule filing, NASDAQ states that it recognizes that the proposed changes could result in a security that currently meets all the listing requirements becoming non-compliant. Therefore, NASDAQ proposes that the changes to the continued listing requirements be made effective 30 days after the proposed rule change is approved by the SEC. In the case of companies applying for initial listing, NASDAQ proposes that the new requirements be effective upon approval for companies that apply after August 28, 2006, the date this proposed rule change was submitted to the SEC. Companies that had applied for listing prior to August 28, 2006, would be able to continue to qualify under the prior standards, provided that they complete the listing process not later than 30 days after the proposed rule change is approved by the SEC. Companies applying for listing after August 28, 2006, would be approved for listing based on the rules in effect at the time of the approval. According to the NASDAQ, this implementation approach would provide notice to companies applying for listing that they would be subject to higher standards upon approval of the rule, so such companies would not be prejudiced, but would recognize that companies that have previously applied did so in reliance on the prior listing standards, and therefore provide them a reasonable period of time to complete the listing process on that basis.

NASDAQ Developments (cont.)

The proposed rule change, which was subject to a comment period that ended September 26, 2006, has not yet been approved by the SEC. The full text of the proposed rule change as published by the SEC is available at http://www.sec.gov/rules/sro/nasdaq/2006/34-54378.pdf.

FASB Developments

FASB Issues Statement No. 157, Fair Value Measurements

On September 15, 2006, the FASB issued Statement No. 157, Fair Value Measurements. According to the FASB, the Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. According to the FASB, however, for some entities, the application of this Statement will change current practice.

The standard is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted.

A summary of the statement is available at http://www.fasb.org/st/summary/stsum157.shtml. The full text of the statement is available at http://www.fasb.org/pdf/fas157.pdf.

Other Developments and DPW Memos

NY State Court Decides That Failure to File Exchange Act Reports with SEC and Trustee Constitutes Default under Indenture

On September 18, 2006, the Supreme Court of New York, New York County (New York State's trial level court) issued an opinion in *The Bank of New York v. BearingPoint, Inc.*, in which it found that a company's failure to file, within the time periods required by the SEC, its Exchange Act reports with the SEC and therefore its indenture Trustee, could constitute a default under the indenture when coupled with the notice and passage of time required for such a default under the indenture. For a copy of the DPW Newsflash on this decision, click here. A copy of the court's decision is available at http://www.courts.state.ny.us/reporter/3dseries/2006/2006_51739.htm.

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**