DAVIS POLK & WARDWELL
Corporate Regulatory Report

A Summary of Current Regulatory Developments Affecting Publicly Listed Companies

Contents

SEC and PCAOB Speak at Annual PLI Conference

On November 3-5, 2005, various SEC staff members and practitioners spoke at the PLI 37th Annual Institute on Securities Regulation. Among other things, they discussed:

» *Segment Disclosure.* The SEC staff noted that it continues to issue a lot of comments regarding segment disclosure. When reviewing a company's segment disclosure, the staff indicated that it will often look outside of the registration statement or Exchange Act report under review to an issuer's website, analyst reports or other sources to see if the issuer's segment disclosure is consistent with the way that the issuer manages and portrays its business. The staff may also request that an issuer provide excerpts from board books or other internal documents to see whether the format of information provided to management is consistent with a company's segment disclosure.

» *Enforcement of Regulation FD and the Siebel Systems Case.* Both Alan Beller, Director, Division of Corporation Finance, and Linda Chatman Thomsen, Director, Division of Enforcement, noted that although disappointed by the outcome, the SEC will not appeal the dismissal by the U.S. District Court for the Southern District of New York of the SEC'S complaint against Siebel Systems, Inc. and two of its officers for violations of Regulation FD. They further noted that the SEC will continue to bring Regulation FD enforcement actions, with Ms. Thomsen noting that there are about a dozen Regulation FD investigations in process although not all of these investigations will result in enforcement actions.

» *PCAOB Review of Public Company Financial Statements as Part of Ongoing Auditor Inspection Process.* Daniel Goelzer, Board Member of the PCAOB, discussed the PCAOB's ongoing inspections of public accounting firms, noting that the majority of the PCAOB's time and resources is spent on this process. He said that in order to assess the auditors' work, the PCAOB must inevitably look at the GAAP presentation of public companies. Though the PCAOB doesn't directly communicate with the public company itself, it can raise issues about the company's accounting to the auditors and these often lead to restatements. While the PCAOB is an independent, non-governmental entity and is not the ultimate arbitrator of GAAP, it does report to the SEC any instances in which it believes a public company's financial statements contain material errors.

COSO Issues Draft Guidance on Section 404 Compliance

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has issued draft guidance for smaller public companies to assist them in applying the COSO Internal Control Integrated Framework in connection with implementing Section 404 of the Sarbanes-Oxley Act. The new guidance outlines 26 fundamental principles associated with the five key components of internal control: control environment, risk assessment, control activities, information and communication and monitoring. The report defines each principle and describes its attributes, lists a variety of approaches smaller companies can use to incorporate the principles, and includes real-world examples of how smaller companies have effectively applied the principles.

On October 27, 2005, the SEC issued a press release commending COSO for publishing the draft. In the press release, Alan Beller, Director of Corporation Finance, notes that the guidance, when finalized "may help not only smaller businesses, but organizations of all sizes, better understand and apply COSO's 1992 Framework." Donald Nicolaisen, the SEC's Chief Accountant until November 4, 2005, has also noted publicly that he believes that all companies should review this guidance as it applies to entities well beyond small businesses.

The COSO exposure draft and news release are available on its web site at **http://www.coso.org**. The SEC's press release regarding the new guidance is available at **http://www.sec.gov/news/press/2005-153.htm.**

SEC Speaks

SEC Commissioner Cynthia Glassman Speaks on the SEC in the Global Marketplace: Current Issues

On October 7, 2005, in remarks before the Center for the Study of International Business Law Breakfast Roundtable Series, SEC Commissioner Cynthia Glassman noted that the SEC is pursuing the following five initiatives in the international arena:

» An ongoing dialogue with various other financial regulators outside of the United States, including regulators in Japan and China, to address issues of mutual concern and meet shared objectives;

» A cooperative dialogue between the SEC and the EU with respect to the EU's Financial Conglomerates Directive; which calls for the application of consolidated supervision to all EU financial holding companies, specifically requiring that non-EU holding companies of EU financial institutions be subject to consolidated supervision "equivalent" to that described in the Directive;

» An assessment of the impact of Section 404 of the Sarbanes-Oxley Act on both U.S. and non-U.S. companies and efforts to ensure that the goals of Section 404 are met in the most efficient manner;

SEC Speaks (cont.)

» The taking of a "fresh look" at the SEC's deregistration rules in order to ease the deregistration process for non-U.S. issuers; and

» The convergence of U.S. and international accounting standards.

In discussing these initiatives, Commissioner Glassman noted that while international conformity and consistency is a goal, she is committed to finding the best way to resolve cross-border issues as opposed to merely endorsing the "U.S. way." The full text of Commissioner Glassman's speech is available at **http://www.sec.gov/news/speech/spch100705cag.htm.**

SEC Commissioner Paul Atkins Discusses Ways to Encourage Global Competition in the Financial Markets

In a speech on October 26, 2005, before the European Parliamentary Financial Services Forum, SEC Commissioner Paul Atkins noted that Europeans and Americans benefit greatly from a market that allows competition across borders and need to work together to ensure that regulatory solutions are enhancing, not inhibiting, worldwide economic integration. Commissioner Atkins highlighted accounting standards as one issue with respect to which cooperation is crucial and remarked that the SEC is watching the transition of European companies to International Financial Reporting Standards (IFRS) with great interest. He noted that he is hopeful that the current U.S. GAAP reconciliation requirement can be eliminated as experience is gained with IFRS in practice. Commissioner Atkins also acknowledged concerns and disappointment with the implementation of Section 404 of the Sarbanes-Oxley Act and noted that he thinks the SEC needs to review whether the PCAOB's Auditing Standard No. 2, which has been the focus of the criticism of the Section 404 process, is a workable standard. Commissioner Atkins encouraged non-U.S. accounting firms to raise any concerns regarding their interactions with the PCAOB with the SEC. The full text of Mr. Atkin's speech is available at **http://www.sec.gov/news/speech/spch102605psa.htm.**

NASD Developments

DPW has been advised by representatives of the NASD that with respect to shelf offerings of well known seasoned issuers ("WKSIs") that are required to be filed under the NASD Corporate Financing Rule (Rule 2710), NASD review procedures will be modified so that these offerings are cleared within one day of the date they are filed. This change will affect offerings subject to Rule 2720 (which applies to offerings in which a distribution participant is an affiliate of or has a conflict of interest with the issuer) and offerings that do not meet the exemptions discussed below. This is significant news because a full review of such offerings under the Corporate Financing Rule could take weeks, which would deny this class of WKSIs the benefit of automatic registration.

NASD Developments (cont.)

This change does not affect shelf offerings exempt from the filing requirements of the Corporate Financing Rule that are not subject to Rule 2720. Exemptions are available under the Corporate Financing Rule for shelf offerings of (i) investment grade rated non-convertible debt or preferred securities, (ii) securities of an issuer that has investment grade rated non-convertible debt or preferred securities outstanding that meet the requirements of Rule 2710(b)(7)(A)1 and (iii) securities registered with the SEC on Forms S-3 or F-3 that meet the eligibility criteria for those forms in effect prior to October 21, 1992 (the "old S-3/F-3 eligibility criteria")2. DPW has also been advised that while it will still be necessary to file prospectus supplements and post-effective amendments to registration statements of offerings required to be filed under the Corporate Financing Rule, the NASD will not require that such materials be approved prior to use. The NASD is likely to "spot check" these materials for compliance with NASD rules.

According to NASD sources, an amendment to the NASD's shelf proposal, which was filed with the SEC last December, will be filed with the SEC in the near future reflecting these changes. We were told that the rule change will, among other things, exempt shelf offerings of WKSIs not subject to Rule 2720 from the filing requirements of the Corporate Financing Rule (i.e., offerings that are not exempt from the filing requirements of the Corporate Financing Rule will become exempt because the issuer is a WKSI).

NYSE Developments

NYSE Files Proposed Rule Changes to Eliminate Mailing of Annual Reports

The NYSE has filed with the SEC proposed rule changes that would eliminate the current NYSE requirement that listed companies physically distribute an annual report to shareholders, and allow companies to satisfy the annual financial statement delivery requirement by making the company's Form 10-K, 20-F or 40-F available on or by a link through their corporate website and agreeing to provide a hard copy of the annual report upon request.

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[1] The exemption from filing is available for securities offered by a corporate, foreign government or foreign government agency issuer that has unsecured non-convertible investment grade rated debt with a term of issue of at least 4 years or unsecured non-convertible investment grade rated preferred securities.

[2] Generally, the old S-3/F-3 eligibility criteria require that the issuer has filed reports under the '34 Act for three years and has a specified public equity float. For domestic issuers, the aggregate market value of the issuer's voting stock held by non-affiliates must be $150 million or, alternatively, $100 million if the stock has had an annual trading volume of three million shares. For foreign issuers, the aggregate market value worldwide of the issuer's voting stock held by non-affiliates must be $300 million. Also exempt are offerings registered on Form F-10 of Canadian foreign private issuers that have reported under Canadian reporting requirements for three years and whose outstanding equity has an aggregate market value of (CN) $360 million.

NYSE Developments (cont.)

As a practical matter, the proposed rule changes do not have much of an impact on U.S. issuers because Rule 14a-3(b) of the Exchange Act still requires issuers that are subject to the proxy rules to deliver an annual report to investors in conjunction with their proxy statement for their annual shareholder meeting. The proposed rule change will be helpful to foreign private issuers that are exempt from the proxy rules as result of Exchange Act Rule 3a12-3. The NYSE proposal, which has not yet been published or approved by the SEC, is available at: **http://www.nyse.com/pdfs/NYSE-2005-68.pdf.**

NYSE Files Two Separate Proposed Rule Changes to Amend Delisting Procedures

The NYSE has filed two separate proposed rule changes with the SEC that would affect the NYSE's current delisting procedures in two regards.

Proposed Amendments to Continued Listing Criteria Related to Filing of Annual Report with SEC. The first proposed rule change would amend the NYSE's continued listing criteria to provide that for certain companies that remain suitable for listing, the NYSE may forbear, in its sole discretion, from commencing suspension and delisting procedures despite the company's failure to timely file its annual report with the SEC. The proposed rule filing states that this is a codification of current practice.

Under the proposed rule, the factors that the NYSE would consider in allowing a company's continued listing despite its failure to file its annual report with the SEC include the following:

» compliance with quantitative and qualitative listing standards,

» ability to meet debt obligations and finance operations,

» progress in completing its financial statements,

» public transparency regarding its status in completing its financial statements, and

» a reasonable expectation that the company will resume timely filings in the future.

In such cases, the NYSE will continue ongoing discussions with the company and will append an "LF" indicator to the company's ticker symbol to indicate its late filer status.

The proposed rule change would also (i) shorten the initial monitoring period for companies that miss their SEC filing due date from 9 to 6 months and (ii) lengthen from 3 to 6 months the additional period that the NYSE may grant companies prior to the commencement of suspension and delisting procedures. The practical effect of this proposed change is that, while companies will now be subject to delisting 6 months after the SEC due date for their annual report (instead of 9 months), if the NYSE grants the company the additional compliance period, the company will continue to have 12 months after missing an SEC annual report filing deadline before delisting procedures are commenced, which is the same period currently in effect if the additional period for compliance is granted. The NYSE will also continue to have the right to commence delisting at any time if it is necessary for the protection of investors.

NYSE Developments (cont.)

The proposed rule change regarding delisting of companies that fail to file their annual report with the SEC is subject to SEC approval and has not yet been published by the SEC. A copy of the proposed rule change filed with the SEC is available at **www.nyse.com/pdfs/NYSE-2005-75.pdf**.

Proposed Amendments to Modify Delisting Rules to Conform to Exchange Act Rule 12d2-2. The NYSE has also filed a proposed rule change that would modify the NYSE's delisting rules to conform with the requirements of Exchange Act Rule 12d2-2, which was adopted by the SEC in July 2005. These proposed amendments, which are subject to approval and publication by the SEC, would be operative as of April 24, 2006, the date upon which the amendments to Exchange Act Rule 12d2-2 become operative. The amendments proposed by the SEC provide that any issuer wishing to voluntarily delist a security from the NYSE must comply with all the requirements of Exchange Act Rule 12d2-2(c) and must furnish the NYSE a copy of the Form 25 filed in connection with the delisting simultaneously with its filing with the SEC. The amendments proposed by the NYSE also provide that, before the NYSE files a Form 25 with the SEC in connection with its delisting of a security, the NYSE will give public notice of its final determination to delist the security by issuing a press release and posting a notice on its website. The notice will remain posted on the NYSE's website until the delisting is effective pursuant to Exchange Act Rule 12d2-2(d)(1) (*i.e.*, 10 days after filing the Form 25 with the SEC unless the SEC acts to delay its effectiveness). A copy of the proposed rule change to conform the NYSE's delisting requirements in accordance with Exchange Act Rule 12d2-2 is available at **http://www.nyse.com/pdfs/NYSE-2005-72.pdf.**

SEC Approves Changes to NYSE Listing Fees

On October 28, 2005, the SEC approved changes to the NYSE's initial and continued listing fees, including the amendment and reorganization of Sections 902.00 through 902.04 of the NYSE Listing Company Manual that provides for NYSE fees. The SEC order approving the changes to the NYSE listing fees is available at **http://www.sec.gov/rules/sro/nyse/34-52696.pdf.** Sections 902.00 through 902.04 of the NYSE Listed Company Manual, as amended to provide for the new fees, are available at **http://www.nyse.com/lcm/lcm_subsection.html.**

NASDAQ Developments

SEC Approves Change to Nasdaq Listing Standards Applicable to Companies in Bankruptcy Proceedings

On October 13, 2005, the SEC approved a change to the Nasdaq's listing rules that requires a reorganized company to re-apply for listing on the Nasdaq and meet all initial listing criteria, including the payment of initial listing fees, upon discharge from bankruptcy proceedings. As noted in the discussion of the proposed rule change in the Davis Polk & Wardwell September Corporate Regulatory Report, the Nasdaq's rules previously provided that an issuer that files for bankruptcy protection was subject to delisting but on occasion, the Nasdaq allowed companies to retain their listing throughout the bankruptcy proceeding. Under the amended rule, in the event that the Nasdaq allows the continued listing of an issuer during a

NASDAQ Developments (cont.)

bankruptcy reorganization, the issuer would nevertheless be required to satisfy all requirements for initial listing upon emergence from bankruptcy proceedings. The amended rule also clarifies that any securitiesissued by a Nasdaq-listed issuer pursuant to a court-approved plan of reorganization are exempt from Nasdaq's shareholder approval rules. A copy of the SEC order approving the rule change is available at **http://www.sec.gov/rules/sro/nasd/34-52603.pdf**.

PCAOB Developments

PCAOB Standing Advisory Group Sets Priorities for 2006

At a meeting held on October 5th and 6th, the PCAOB Standing Advisory Group discussed its agenda for 2006 which includes the following: engagement quality review; fraud; audit committee communications; principles of reporting; fair value; risk assessment; quality control; and codification of PCAOB standards/authority of PCAOB interim standards. The PCAOB also said that it remains committed to continuing its dialogue with issuers, investors and others regarding implementation of its Auditing Standard No. 2 and Section 404 of the Sarbanes-Oxley Act. A copy of the press release issued by the PCAOB regarding its 2006 agenda is available at **http://www.pcaob.org/News_and_Events/News/2005/10-05.aspx.**

Other Developments

CII Adopts Director Compensation Policies

The Council of Institutional Investors (CII) has adopted compensation policies for non-employee directors. The CII policies, while not binding on companies, are influential since they are used by many institutional investors in evaluating corporate management and in shareholder voting decisions. The new CII policies say that director pay should include only the following two components, with some noteworthy exclusions:

» Cash Retainer: The CII policies state that a cash retainer should be the only form of cash compensation paid to directors and should reflect an amount appropriate for a director's expected duties, including meeting attendance, preparation for meetings and discussions and performance of due diligence by communicating with employees on site. The CII opposes meeting attendance fees. Retainer fees may be differentiated to recognize that independent board chairs, independent lead directors, committee chairs or members of certain committees are expected to spend more time on board duties than others.

» Equity-Based Compensation: The CII policies state that directors should receive stock awards or stock-related awards such as phantom stock or share units, which are fully vested on the grant date. Equity pay should include an ownership requirement or incentive and a minimum holding period requirement. The CII suggests ownership requirements of at least three to five times annual compensation. Directors should be required to retain a significant portion (such as 80%) of equity grants until after they retire from the board.

Other Developments (cont.)

Directors should not receive performance-based compensation, any perquisites (aside from meeting-related expenses) or change-in-control or severance payments. Although non-employee directors should not receive retirement benefits, they should be allowed to defer cash pay for retirement. CII policies support disgorgement - requiring directors to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

The new CII policies also discuss the role of the compensation committee and various disclosure issues. The complete text of the CII's policies is available at: **http://www.cii.org/policies/dir_compensation.htm.**

Second Circuit Rules That Shareholders Can't Sue for Merger Agreement Breach

The U.S. Court of Appeals for the Second Circuit has held that shareholders of a company party to a merger agreement cannot sue the other company party to the merger agreement for an alleged breach of the agreement. In the case before the court, Northeast Utilities had agreed to merge with Consolidated Edison but shortly before the merger, Consolidated Edison declared that Northeast had suffered a material adverse change and declined to proceed with the merger absent a reduction in price, which Northeast refused. Northeast shareholders subsequently sued Consolidated Edison to recover the lost premium those shareholders would have earned in the merger.

The Second Circuit held that as a matter of New York law the intention of the parties governed the question of whether shareholders would have rights as third-party beneficiaries under the merger contract. The court found the parties did not intend to convey such third-party rights to Northeast's shareholders when they entered into the merger agreement. The court said that under the provisions of the agreement, "the only third-party right conferred on [Northeast's] shareholders is a right, arising upon completion of the merger, to receive payment for their shares. Since it is undisputed that the [completion of the merger] never arrived, that right never arose." The Second Circuit's opinion is available at: **http://nuwnotes1.nu.com/apps/corporatecommunications/empinfo.nsf/0/9d6fef3e188c2d0e852570980073e136/$FILE/04-5393-cv_opn.pdf.**

IOSCO Issues Consultation Paper on International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers

The International Organization of Securities Commissions (IOSCO) has issued a consultation paper entitled "International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers (International Debt Disclosure Principles)." The Consultation Report sets forth substantive disclosure principles for documents used in public offerings and listings of "plain vanilla" corporate debt securities that are generally consistent with current SEC disclosure requirements for debt offerings. According to IOSCO, the stated purpose of the principles is "not to override existing requirements, but rather to facilitate a better understanding of issues that should be considered in developing disclosure requirements for debt securities as a means of enhancing investor protection." IOSCO has asked that

Other Developments (cont.)

comments on the proposed principles be submitted by December 22, 2005. After the consultation process has concluded and all comments have been considered, the IOSCO intends to issue a final version of International Debt Disclosure Principles. The IOSCO consultation paper is available at **http://www.iosco.org/library/pubdocs/pdf/IOSCOPD202.pdf.**

U.S. District Court Rules No Right of Private Action Under SOX 304

In a case of first impression, the U.S. District Court for the Eastern District of Pennsylvania has ruled that there is no private remedy implied by Section 304 of the Sarbanes-Oxley Act. Section 304 provides for the forfeiture of certain bonuses and profits by CEOs and CFOs when a restatement is required due to an issuer's noncompliance with any financial reporting requirements of the securities laws, if the noncompliance arises from misconduct. In its opinion, the court found that Congress clearly intended for Section 304 to be enforced only by the SEC. For a copy of the decision in *Neer v. Pelino*, E.D. Pa., No. 04-4791, 9/27/05, click **[here].**

DPW Memos

For a copy of the Davis Polk memorandum on WKSI Preparedness for the Securities Offering Reforms, click **[here].**

For a copy of the Davis Polk & Wardwell memorandum regarding the U.S. government's recent indictment of certain individuals for violation of the Foreign Corrupt Practices Act, click **[here].**

Contacts

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

Kevin Cavanaugh
212 450 6811
kevin.cavanaugh@dpw.com