

DAVIS POLK & WARDWELL
Corporate Regulatory Report

A Summary of
Current Regulatory
Developments Affecting
Publicly Listed Companies

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SEC/PCAOB DEVELOPMENTS

SOX 404 Developments

SOX 404 Roundtable. On May 10, 2006, the PCAOB and SEC held a joint roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions. The general consensus among the roundtable participants was that SOX 404 costs decreased in year two, although the level of savings varied depending on which study was cited. Larger companies seemed to experience more savings than smaller companies, and most companies acknowledged an improvement in internal controls as a result of SOX 404. Despite these cost decreases and internal control improvements, many participants expressed the view that SOX 404 costs still outweigh the overall benefits and further guidance regarding SOX 404 implementation is needed.

SEC Announces SOX 404 Action Plan. On May 17, 2006, in response to the comments received from a variety of sources, including the roundtable discussed above, the SEC announced a series of actions that it intends to take to improve SOX 404 implementation, including the following:

- » *Guidance for Companies.*
 - *Concept Release and Opportunity for Public Comment.* The SEC expects to issue a Concept Release covering a variety of issues that might be the subject of future SEC guidance. The SEC hopes that feedback received by the SEC as a result of the Concept Release, particularly with respect to the management assessment process and the role of outside auditors, will help it to ensure that any ultimate guidance issued by the SEC addresses the needs and concerns of public companies.
 - *Consideration of Additional Guidance from COSO.* In developing its own SOX 404 guidance, the SEC expects to utilize the additional guidance that it anticipates the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) will provide with respect to its 1992 Internal Control - Integrated Framework.
 - *Issuance of Additional SEC Guidance in Form Not Yet Determined.* The SEC anticipates that it will issue additional guidance in a form not yet determined to assist management in its performance of a top-down, risk-based assessment of internal controls. According to the SEC, this guidance will be scalable and responsive to companies’ individual

SEC and PCAOB Developments (cont.)

circumstances and will also be sensitive to the fact that many companies have already invested substantial resources to implement SOX 404 over the last few years.

- » *Revisions to Auditing Standard No. 2.* The SEC will work closely with the PCAOB on any revisions to Auditing Standard No. 2 (An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements). The PCAOB intends that the proposed revisions will:
 - Ensure that auditors focus on higher risk areas;
 - Incorporate key concepts contained in the PCAOB guidance issued on May 16, 2005; and
 - Revisit and clarify the auditors' role in the company's process of assessing internal control effectiveness.

For a copy of the PCAOB announcement regarding these revisions see http://pcaobus.org/News_and_Events/News/2006/05-17.aspx.

- » *SEC Oversight of PCAOB Inspection Program.* Upon completion of the PCAOB's 2006 inspections, the SEC staff will examine whether the PCAOB inspections of audit firms have been effective in encouraging implementation of a more efficient approach to the SOX 404 process. On May 1, 2006, the PCAOB announced that it would focus its 2006 inspections on how well the audit firms had implemented the SOX 404 guidance published by the PCAOB on May 16, 2005 and November 30, 2005. For a copy of the PCAOB's May 1 announcement, see http://pcaobus.org/News_and_Events/News/2006/05-01a.aspx.
- » *Extension of Compliance for Non-Accelerated Filers.* In order to permit non-accelerated filers and their auditors to evaluate and implement the anticipated SEC guidance and revisions to AS No. 2, the SEC expects to issue a short postponement of the implementation of SOX 404 for non-accelerated filers. It is anticipated that any such postponement would nonetheless require all filers to comply with SOX 404 requirements for fiscal years beginning on or after December 16, 2006.

For a copy of the SEC's press release announcing the SOX 404 initiatives outlined above, see <http://www.sec.gov/news/press/2006/2006-75.htm>.

John White Comments on SOX 404 Action Plan. In a speech before the SEC Institute 21st Annual Mid-Year SEC Reporting Forum on May 25, 2006, John White, Director, Division of Corporation Finance, discussed the SEC's planned actions with respect to SOX 404. Mr. White emphasized that the SOX 404 guidance discussed above will largely apply to both large and small companies and encouraged both large and small companies to provide comments and feedback to the SEC. Mr. White also noted that as a result of the SEC's SOX 404 initiatives, companies should "look for improvements" in both the management assessment process as well as the auditor attestation process. Mr. White also assured accelerated filers that they need not worry that the proposed amendments to AS No. 2 "will somehow override the efforts that those companies and their auditors have already made at that point under the existing standard." For a copy of Mr. White's comments on the SOX 404 initiatives see <http://www.sec.gov/news/speech/2006/spch052506jww.htm>.

SEC and PCAOB Developments (cont.)

SEC and Chinese Securities Regulators Announce Plan for Increased Cooperation

On May 3, 2006, the SEC and the China Securities Regulatory Commission announced a new effort to increase their cooperation and collaboration through the formalization of a dialogue between the two agencies.

Among the issues identified for the 2006 SEC/CSRC agenda are:

- » Corporate governance reforms, including requirements for audit committees, auditor independence and internal controls;
- » Convergence of national accounting standards with International Financial Reporting Standards;
- » The use of information technology, including interactive data-tagging systems, to enhance the usefulness of reported financial information;
- » Enhanced communication between the two agencies and the provision of timely and thorough assistance on enforcement related matters; and
- » Promotion of China's securities market regulatory and oversight structure through a comprehensive technical assistance and training program.

For a copy of this announcement, see <http://www.sec.gov/news/press/2006/2006-63.htm>.

PCAOB Lists Seven Steps for Auditors When Reporting on Existence of Material Weakness

On April 27, 2006, the PCAOB released a list of steps that auditors should take when reporting on whether a previously reported material weakness in a company's internal controls continues to exist. These steps were developed in connection with an order from the SEC in the adopting release for Auditing Standard No. 4 (for auditors reporting on whether previously reported material weaknesses continue to exist) that the PCAOB "issue a clear and concise outline of the affirmative audit steps set forth in" AS No. 4. For a copy of this announcement, see http://www.pcaob.org/standards/standards_and_related_rules/AS4/2006-04-27_2006-003_AS4_summary.pdf.

SEC Reduces FY 2007 Registration and Transaction Fees

On May 3, 2006, the SEC announced a fee rate reduction that would amount to approximately \$1 billion in fiscal year 2007. Effective the earlier of October 1, 2006, or five days after the date on which a regular appropriation to the SEC for FY 2007 is enacted, 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. Effective the earlier of October 1, 2006, or 30 days after the date on which a regular appropriation to the SEC for FY2007 is

SEC and PCAOB Developments (cont.)

enacted, the Section 31 fee rate applicable to securities transactions on the exchanges and certain OTC markets will decrease to \$15.30 per million from the current rate of \$30.70 per million. For a copy of this announcement, see <http://www.sec.gov/news/press/2006/2006-64.htm>.

SEC Continues to Focus on Reporting Interactive Data

The SEC continues to focus on the disclosure of financial data in periodic reports to the SEC using the XBRL data-tagging format informally known as “interactive data.” On May 23, 2006, the SEC issued a press release announcing the addition of three new companies to its interactive data test group: General Electric Company; PepsiCo, Inc.; and Banco Itaú Holding Financeira S.A. The now 20 companies that have joined the initiative to date will receive expedited reviews of their SEC registration statements and annual reports. For their part, the companies will furnish the financial data in their periodic reports to the SEC using the XBRL format. The arrangement will last for at least one year, during which the firms will provide feedback to the SEC on their experience with interactive data.

On May 16, in a speech before the 13th XBRL International Conference, SEC Chief Information Officer and Director, Corey Booth, noted that there is a shortage of XBRL expertise and the preparation of XBRL statements is still perceived to be difficult because it requires interpretation and a preparer that is comfortable with both the technology associated with XBRL and the accounting aspects of the statements. As a result, Mr. Booth currently believes that the SEC’s “role as a government agency should focus for now on supporting adoption, not dictating it” and that “a mandatory requirement ought to happen only after voluntary adoption spreads further.”

For a copy of the SEC’s May 23, 2006, press release announcing the expansion of the XBRL test group, see <http://www.sec.gov/news/press/2006/2006-79.htm>. For a copy of Mr. Booth’s speech, see <http://www.sec.gov/news/speech/2006/spch051606rcb.htm>. For a copy of the SEC webpage “Spotlight On: Interactive Data and XBRL Initiatives,” see <http://www.sec.gov/spotlight/xbrl.htm>.

SEC SPEAKS

Commissioners Nazareth and Campos Discuss Electronic Proxy Proposal, Executive Compensation Proposal and Majority Voting

In May, SEC Commissioners Roel Campos and Annette Nazareth each separately discussed the SEC’s electronic proxy proposal and executive compensation proposal and majority voting. Highlights from their remarks on these topics include the following:

Electronic Proxy Proposal. In his remarks to the SIA Operations Conference on May 12, 2006, Commissioner Roel Campos discussed some of his concerns about the currently pending SEC proposal for the electronic delivery of proxy statements. Among other things, Commissioner Campos expressed concern that:

SEC Speaks (cont.)

- » *Anticipated savings may not materialize.* Comments received to date have raised questions as to whether anticipated cost savings will materialize. One commenter submitted data showing that only 5 percent of the costs associated with proxy contests are related to the printing and mailing of proxy materials, while the other 95 percent are related to professional fees. Also, commenters have raised the question of whether companies would choose to use electronic delivery in contested situations or whether they would prefer to continue to mail copies of such materials.
- » *Electronic delivery of proxy materials may decrease voting levels.* One commenter stated that based on survey data, investors would be less likely to vote if the proposed rules were adopted, which result would be contrary to the goals of the proposed change. Lower voting levels might cause quorum problems for companies thereby leading to higher overall meeting costs of companies, *e.g.*, if they must hire proxy solicitors to generate enough votes for a quorum or if there are delays in company action because of quorum failures.
- » *Separation of the proxy card from the proxy materials might encourage shareholders to vote without reading the materials.*
- » *Requiring shareholders affirmatively to request paper copies may disproportionately impact certain investor groups, such as seniors.*

In remarks before the 38th Annual Rocky Mountain Securities Conference, Commissioner Nazareth also acknowledged the concerns expressed with respect to the electronic proxy proposal, particularly the impact of the proposal on investors who prefer paper copies of proxy materials. Commissioner Nazareth noted that a “fundamental principle must be to require companies to provide paper materials to those investors who feel most comfortable with them.” Commissioner Nazareth also noted that she hopes that “we can find a way to allow investors to make a more comprehensive permanent election to receive paper copies if they so choose, so they need not call or e-mail each of the companies in which they own stock each year.”

Notwithstanding the above concerns, however, Commissioner Campos and Commissioner Nazareth each seemed to express the view that the e-proxy proposal is a positive measure overall.

Executive Compensation Proposals. On the pending executive compensation proposals, Commissioner Campos noted that of the comments received to date, he finds the following the most interesting:

- » *Advisory vote by shareholders.* A number of commenters have suggested that the SEC require companies to put the compensation report to an advisory shareholder vote. Commissioner Campos feels that this is a topic worthy of additional discussion, but that the SEC should carefully examine its power in this area before adopting any such rules.
- » *Disclosure of Performance Targets.* Some commenters urge disclosure of the performance targets used in setting executive compensation, while others did not like such disclosure because of the potential to expose confidential commercial or business information. An alternative that Commissioner Campos focused on in his speech is disclosure of such targets after the time period for

SEC Speaks (cont.)

which the factors apply. He stated that the SEC will definitely consider this issue and that he intends to approach it with an open mind.

Commissioner Nazareth addressed the attention paid by commenters and the press to the proposed requirement that companies disclose compensation of up to three non-executive officers. Commissioner Nazareth stated that she believes that this requirement, called the “Katie Couric provision,” raises “legitimate concerns about privacy and competitiveness issues” and should be reconsidered.

Commissioner Nazareth also emphasized that a fundamental principle of the proposed rules is that “all means all. All forms of compensation would need to be disclosed, even if they are not specifically enumerated in the proposal.” According to Commissioner Nazareth, the proposals are meant to be comprehensive and flexible enough to “keep pace with changing practices” in executive compensation. Commissioner Nazareth also stressed that the proposals would require executive compensation disclosures to be in “plain English.”

Majority Voting. On May 9, 2007, in his remarks at Harvard University, Kennedy School of Government, Commissioner Campos noted that he finds that both the voluntary “majority voting” policies adopted by companies and the binding bylaw amendments are indicative of a willingness of management to listen to shareholders and make enlightened decisions. He views this movement as generally favorable and a step towards shareholder democracy.

Commissioner Nazareth expressed similar views on majority voting, stating that she believes the adoption of mandatory resignation policies under which a director who receives more “withhold” votes than “for” votes must tender his or her resignation as a “positive step indicating that shareholder participation in the voting process is not a fruitless exercise.”

Commissioner Campos also addressed his views on how directors might respond to increased shareholder activism. Commissioner Campos stated that while he thinks that a director of a company with a cogent long-term strategy is certainly within his or her right to react negatively to what he or she believes is an effort merely to pump up the stock in the short run, he also thinks that it would be prudent to have an open mind when confronted by large shareholders. “It may be that a short-term reform, despite an immediate disruption, will prove beneficial in the long run,” said Commissioner Campos.

For a copy of Commissioner Campos’ remarks on the SEC’s electronic proxy proposal, see <http://www.sec.gov/news/speech/2006/spch051206rcc.htm>. For a copy of Commissioner Campos’ remarks on the SEC’s executive compensation proposal, majority voting and shareholder activism, see <http://www.sec.gov/news/speech/2006/spch050906rcc.htm>.

For a copy of Commissioner Nazareth’s remarks on the SEC’s electronic proxy proposal, executive compensation proposal and majority voting, see <http://www.sec.gov/news/speech/2006/spch051906aln.htm>.

SEC Speaks (cont.)

Commissioner Campos Discusses SROs

Echoing similar themes from past speeches, in his remarks to the SIA Operations Conference on May 12, 2006, Commissioner Campos expressed concern for the demutualization and for-profit status of SROs. He urged the SEC to work faster to address the problems of self-regulation, and to do so from three starting points:

- » First, the SEC should follow-up on the concept release that it issued on this topic (see <http://www.sec.gov/rules/concept/34-50700.htm>) by reviewing comment letters and exploring alternatives to the current SRO structure. Commissioner Campos favors a hybrid model of regulation (e.g., splitting regulation into two functions, with the exchange retaining SRO responsibilities specific to market operations and with a separate SRO (which could be a single-member SRO or multiple SROs joined into one centrally managed entity) responsible for all other regulation).
- » Second, the SEC should act on its proposal regarding fair administration, transparency, governance and ownership of SROs. See <http://www.sec.gov/rules/proposed/34-50699.htm>.
- » Third, the SEC should actively assist in the harmonization project undertaken by the NYSE and NASD to produce one rule book for member regulation.

For a copy of Commissioner Campos' remarks, see <http://www.sec.gov/news/speech/2006/spch051206rcc.htm>.

Commissioner Atkins States that Single Set of Global Accounting Rules May Be Impractical

In a May 15 speech, Commissioner Atkins noted that the level of cooperation between FASB and IASB on the GAAP/IFRS convergence project was "excellent" and that the process is progressing faster than he expected. However, he expressed concern over suggestions from European groups that U.S. companies should be required to reconcile their U.S. GAAP financial statements to IFRS. "This runs against the direction that we are taking in the United States and undermines our efforts towards mutual recognition," Commissioner Atkins said. He does not believe that "it is necessary to impose a single set of accounting rules on all participants in the global marketplace in order to allow competition across borders. In fact, due to differences in culture, legal systems, and liability regimes, true equivalence in accounting standards may be an impractical objective." Instead, Commissioner Atkins thought that the critical point is that accounting standards be clearly stated and evenly applied by all nations and companies adopting those standards. "Achieving evenness in the application of the new standards may be as important as narrowing the differences between the formal accounting systems." For a copy of this speech, see <http://www.sec.gov/news/speech/2006/spch051506psa.htm>.

NYSE DEVELOPMENTS

NYSE Proposes to Eliminate Treasury Share Exception from Shareholder Approval Requirements

On May 5, 2006, the NYSE submitted to the SEC a proposal to eliminate the treasury share exception from the shareholder approval requirements in Rule 312.03 of the NYSE Listed Company Manual. Currently, issuances of treasury shares are not subject to shareholder approval, even if, for instance, the treasury shares being issued would constitute more than 20 percent of the issued shares or voting power outstanding of the company. If adopted as proposed, the rule change will apply to any and all share issuances after the date of SEC approval, even if such issuance is contracted for prior to such date. The proposed rule change has yet to be published or approved by the SEC and also contemplates a period of at least 35 days between the publication of the proposed rule change in the Federal Register (which generally occurs shortly after SEC publication) and the effective date of the rule change. For a copy of the NYSE proposal, see [http://apps.nyse.com/commdata/pub19b4.nsf/docs/1DC6180BAFA9FB73852571680054C8A9/\\$FILE/NYSE-2006-30.pdf](http://apps.nyse.com/commdata/pub19b4.nsf/docs/1DC6180BAFA9FB73852571680054C8A9/$FILE/NYSE-2006-30.pdf). For a copy of the DPW Newsflash on this topic, [click here](#).

NYSE Updates Written Affirmations and CEO Certification Forms

On April 28, 2006, the NYSE issued updated forms of its annual and interim written affirmations and CEO certifications and related instructions for U.S. companies. For a copy of these documents, see <http://www.nyse.com/about/listed/1101074752859.html>. Companies due to file such affirmations in conjunction with their annual meetings and any other matters are reminded to use these new forms without alteration or to file such forms through the NYSE's online portal for such filings, www.eGovDirect.com. For a comparison of the old forms against the new forms, see [http://www.nyse.com/pdfs/Comparison of 2006 and 2005 Domestic Written Affirmation Forms 4 28 06.pdf](http://www.nyse.com/pdfs/Comparison%20of%202006%20and%202005%20Domestic%20Written%20Affirmation%20Forms%204%2028%2006.pdf).

NYSE Amends Initial Financial Listing Standards

The SEC has published and approved an amendment to the NYSE's domestic financial listing standards for companies proposing to list on the NYSE. The amendment, which became effective upon SEC approval, allows a U.S. company to qualify for listing on the basis of its earnings, cash flows or revenues, as applicable, in the most recently completed nine-month period and two immediately preceding fiscal years in lieu of the three most recently completed fiscal years, in circumstances where there has been a significant change in the company's operations or capital structure. In such cases, the NYSE must conclude that the company can reasonably be expected to qualify under the regular three fiscal year standard upon completion of its then current fiscal year.

Although the amendment is already effective, it is subject to a 21-day comment period that ends on June 14, 2006. At any time before July 17, 2006, the SEC may summarily abrogate the rule change if it appears to the SEC that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

The full text of the final rule change is available at <http://www.sec.gov/rules/sro/nyse/2006/34-53825.pdf>.

NASDAQ DEVELOPMENTS

NASDAQ Delays Target Date for Conversion to Exchange Status to August 2006

NASDAQ has announced that it will not become operational as an exchange in June 2006 as previously announced. The NASDAQ is now targeting August 2006 for operation as an exchange.

When NASDAQ begins operating as an exchange, all securities listed on NASDAQ must be converted from being registered under Section 12(g) of the Exchange Act to being registered under Section 12(b). To facilitate this process, NASDAQ will file an application on behalf of listed companies to register their NASDAQ-listed securities under Section 12(b) on the day that NASDAQ begins operating as an exchange. Thus, unless a company chooses to opt-out of this process, no action is required by companies in connection with this transition. NASDAQ will notify listed companies once it begins operating as a national securities exchange. Thereafter, any filings a company makes pursuant to the Exchange Act should indicate that its NASDAQ-listed securities are registered under Section 12(b) of the Exchange Act.

NASD DEVELOPMENTS

NASD Publishes Amended Revision to Corporate Financing Rule

The NASD has posted to its website an amendment to its proposed revision of the Corporate Financing Rule (Rule 2710). The revision relates primarily to shelf offerings and reflects changes made in response to comments received when the SEC published the proposal for comment in December 2004. It is expected that the SEC will publish the revised proposal for comment. The rule change will not take effect until approved by the SEC.

On the positive side, the amendment will provide an exemption from filing for WKSJ shelves that are not subject to Rule 2720, which is applicable to offerings in which members are affiliated or have a conflict of interest with the issuer. Unfortunately, other proposed exemptions have not been revised sufficiently to be very useful. The amendment can be reviewed at http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_016451.pdf.

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