DAVIS POLK & WARDWELL

Corporate Regulatory Report

A Summary of Current Regulatory Developments Affecting Publicly Listed Companies

Contents

SEC Developments

SEC Issues Final Rules Amending Tender Offer "Best-Price" Rule

On November 1, 2006, the SEC issued final rules containing amendments to the tender offer best-price rule, which requires that all shareholders be paid the same price in a tender offer. The amendments, which are effective as of December 8, 2006, make it clear that the best-price rule generally does not apply to compensatory arrangements.

For the DPW memorandum describing these amendments click here. The final rules are available at http://www.sec.gov/rules/final/2006/34-54684.pdf.

SEC Extends 2006 Fee Rate Until at Least December 8, 2006

The SEC has announced that it has not yet received the annual appropriation for its 2007 fiscal year that began on October 1, 2006. As a result, the continuing resolution funding the SEC for fiscal 2007 since October 1, 2006, has been extended through December 8, 2006. Therefore, fees paid under Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14(g) and 31 of the Exchange Act will remain at their current rates of $107 per million of securities registered. As previously announced, five days after the date of enactment of the SEC's regular fiscal year 2007 appropriation, the fee rate will decrease to $30.70 per million.

The SEC's press release announcing the extension of the current fee rate is available at http://www.sec.gov/news/press/2006/2006-194.htm.

SEC Speaks

SEC Staff Members Speak at PLI Securities Regulation Conference

At the PLI 38th Annual Institute on Securities Regulation held on November 9-11, 2006, SEC staff members and other panelists spoke on a variety of topics. Each of the SEC staff members provided a standard disclaimer that their remarks represent their own views and not necessarily those of the SEC, other SEC staff members or commissioners. Some of the remarks made by the SEC staff members are below.

SEC Speaks *(cont.)*

Impact of Securities Offering Reform

- Marty Dunn, Deputy Director, SEC Division of Corporation Finance, provided results of a survey of the roughly 5700 free writing prospectuses ("FWPs") filed in the first 10 months after effectiveness of the securities offering reforms. According to his survey, approximately 60% of those FWPs were filed by asset-backed issuers and 40% were filed by operating companies. Approximately 60% of the FWPs filed by operating companies were term sheets. The rest of the FWPs filed by operating companies related to one of the following categories (in order of the percentage filed) (1) offering marketing materials (*e.g.*, FAQs for investors), (2) press info (*e.g.*, full transcripts of media interviews), (3) prospectus updates (*e.g.*, to announce the filing of an amendment to the prospectus), and (4) company marketing materials (*i.e.*, information describing how great the company is).
- Mr. Dunn noted that there is great flexibility in what an issuer puts in an FWP and that the existence of FWPs and the rule that the FWP can not "conflict" with the information in the prospectus has changed the way that the SEC staff looks at filings. For example, historically the SEC staff has frowned upon the inclusion of advertising in a prospectus. However, under the new rules, an issuer could now just put the advertising in an FWP and not have Section 11 liability. Therefore, the SEC staff may be less likely to comment on the advertising in the prospectus because the staff would prefer that the issuer put the information in the prospectus rather than an FWP so that the information is subject to Section 11 liability.
- Mr. Dunn also noted that the SEC staff is trying to be very flexible with respect to the rule that the FWP can't "conflict" with the prospectus. He is not aware of any instances in which the SEC staff has commented that an FWP conflicts with a prospectus.
- Mr. Dunn noted that the SEC staff is no longer in the business of assessing whether an issuer has properly recirculated the prospectus to disclose material new information. The SEC staff will leave that determination to the issuer, underwriters and their advisers.
- The panelists seemed to agree that shelf registration statements generally look the same in terms of content and bulk despite the securities offering reforms.
- Mr. Dunn said that the SEC staff is generally seeing the same risk factors in Form 10-Ks that they would see in a registration statement. The SEC staff is trying really hard not to automatically ask issuers why risk factors are not included in their Form 10-K. As far as updating the risk factors in Form 10-Q, Mr. Dunn emphasized that it is only an update requirement and that is all that is required. If an issuer wants to wholly repeat the risk factors, however, the SEC will not tell it to do less.

SEC Review and Comment Process

Shelley Parratt, Deputy Director, SEC Division of Corporation Finance, discussed the SEC review and comment process. According to Ms. Parratt and certain other SEC staff members:

- An issuer's filings are assigned to an industry group upon receipt by the SEC. If an issuer operates in more than one industry, the SEC will assign it to an industry group in which the issuer earns the largest portion of its revenues.
- The SEC has a risk-based selection process for reviews and may review all or part of a filing.

SEC Speaks *(cont.)*

- As part of the review process, the SEC will look at all public information available about an issuer, including information available on its website and in its press reports and other filings.
- Although the Sarbanes-Oxley Act ("SOX") requires the SEC to review all issuers at least once every three years, an issuer should not assume that once it has received a review it is "off the hook" for the next three years. Also, if an issuer has just received a review of one of its Exchange Act reports, the issuer should not assume that the SEC will not review its next transactional filing.
- The SEC plans to implement an executive compensation and related party disclosure review program in the upcoming Form 10-K and proxy season.
- Ms. Parratt wants to remind people that an issuer's receipt of SEC comments on only certain items in its filings and the eventual closure of a review is not an SEC confirmation that the issuer's disclosure is correct. Full disclosure remains the responsibility of the issuer. David Lynn, Chief Counsel, Division of Corporation Finance, echoed this sentiment. According to Mr. Lynn, because one issuer did something in a transaction and the SEC did not comment and let the transaction proceed, that does not necessarily mean that the approach to the transaction is okay, particularly with respect to Private Investment in Public Equity ("PIPEs") offerings.
- If an issuer does not respond to the comments within the 10-day response period noted in the SEC comment letter, they will not be placed in the "penalty box" as long as the issuer discusses its proposed response time with the SEC staff. The SEC includes the 10-day period in an effort to keep the process moving forward, but issuers can and do take longer to respond if necessary. What is important is that the issuer keeps the SEC informed.
- An issuer's comments are only posted on the SEC's website once all of the related correspondence is available for posting and the comment process is closed for that filing. Therefore, if the posting has occurred, there is nothing more. If the comment letter is posted but there is no issuer response, the issuer has likely just amended its filing to reflect the SEC comment and has not filed a response.
- According to John White, Director, SEC Division of Corporation Finance, the SEC staff has been trying to send issuers a letter when the staff has closed a review of the issuer's filings indicating that the staff has no further comments. If an issuer does not receive such a letter, the issuer should ask for it. Also, issuers should consider the date of such a letter as the first date of the 45-day period subsequent to which the SEC may post the comments on its website.

Principles-Based Disclosure

A conference attendee asked John White what standard is used by the SEC staff to determine whether an issuer has complied or failed to comply with the "principles-based" disclosure obligations that Mr. White has been speaking about recently. Mr. White responded that the SEC understands that it needs to keep up its end of the bargain if it is requiring principles-based disclosure and is training its staff to do so. Mr. White also said that he sat down with Linda Chatman Thomsen, Director, SEC Division of Enforcement, before putting forth this principles-based approach because it makes enforcement more difficult. Mr. White assured people that Ms. Thomsen is completely on board with a principles-based approach and is not interested in a "gotcha" approach to enforcement. He indicated that he has given several speeches on principles-based disclosure so that counsel have something to "wave in front of their clients" that outlines

SEC Speaks *(cont.)*

what is required to be disclosed although not explicitly set forth in the rules. An overview of Mr. White's "principles-based" approach to disclosure is included in his October 12, 2006, speech entitled "Principles Matter: Related Person Transactions Disclosure and Disclosure Controls and Procedures", which is available at http://www.sec.gov/news/speech/2006/spch101206jww.htm.

New Executive Compensation and Related Party Rules

SEC staff members noted that the SEC will issue FAQs or telephone interpretations soon to provide guidance on the new executive compensation and related party rules. In the meantime, issuers should call David Lynn with technical compensation questions. SEC staff members also noted that:

» The SEC plans to act soon on the re-proposal of the "Katie Couric" provision (which would require compensation disclosure for non-executive officers with a policy-making role if they were among the most highly paid). The SEC staff believes that there is enough time to implement this requirement for the upcoming proxy season.

» The new Form 8-K rules are designed to impose a materiality standard on what should be disclosed. Only information that is "presumptively material" is required to be disclosed.

» When asked whether an issuer could include its outside compensation consultant on its disclosure committee, John White said that this is up to the issuer. In his view, because the SEC hasn't said that issuers need to have a disclosure committee, they also haven't said who can or can't be on the disclosure committee.

» John White said that an issuer that is not yet required to fully comply with the new executive compensation rules (for example, an issuer with a 9/30/06 year end) may provide disclosure that fully complies with the old rules and then add some, but not all, of the disclosures called for by the new rules. The issuer needs to be careful, however, that the disclosure under this format does not become confusing or misleading.

Accounting Issues

Carol Stacey, Chief Accountant, SEC Division of Corporation Finance, noted that the Division continues to focus on revenue recognition and segment reporting. She also noted that both the Division of Corporation Finance and the Division of Enforcement are looking closely at asset impairment issues. Ms. Stacey said that the Division of Corporation Finance looks for "early warning signals" of impairment and emphasized that issuers should warn investors of any potential impairments early.

SOX 404

Throughout the conference, various panelists discussed what is wrong with SOX 404 and what should be and is being done to fix it. Some of the highlights are as follows:

» Both John White and Annette Nazareth, SEC Commissioner, indicated that the anticipated SEC guidance will be finalized at the December 13, 2006, meeting. The goal is to provide guidance that can be utilized in the internal control assessments to be made as of December 31, 2006.

SEC Speaks *(cont.)*

» Ms. Nazareth said that the anticipated SEC guidance will not dismantle the current documentary procedures but will instead set forth general principles and guidelines aimed at assisting issuers and auditors in applying the current requirements. According to Mr. White, the goal is not to require issuers already subject to SOX 404 to redo their procedures but to make the SOX 404 process easier.

The PCAOB will convene in December to consider revisions to Auditing Standard No. 2 ("AS2") or other guidance to assist auditors in the SOX 404 process. Daniel Goelzer, a PCAOB Board Member, indicated that the PCAOB hopes to adopt a final revised version of AS2 by next spring.

Enforcement

Linda Chatman Thomsen, Director, SEC Division of Enforcement, said that PIPEs, options backdating and hedge funds are among the SEC's top enforcement priorities, although the SEC "wants to be everywhere."

SEC Enforcement Director Notes Basic Lessons Learned from Options Backdating Scandals

In a recent speech, SEC Enforcement Director Linda Chatman Thomsen noted that the SEC is currently investigating over 100 matters relating to potential abuses of employee stock options. According to Ms. Thomsen, while the SEC expects to bring additional enforcement actions, it does not expect to bring enforcement cases relating to all of the ongoing stock option investigations. Ms. Thomsen went on to note the following basic lessons that can be drawn from the stock option backdating investigations:

» *Beware the morphing monster and its unintended consequences.* According to Ms. Thomsen, "tools devised for one purpose can have dramatic unintended consequences when employed for different purposes in a different legal and tax environment." In this regard, Ms. Thomsen likened the stock option abuses that have recently come to light to the abuses of special-purpose entities. According to Ms. Thomsen, while these special-purpose entities were designed as special forms of off-balance sheet accounting in the aircraft industry, they "morphed into a monster that was used extensively by the likes of Enron in perpetrating financial frauds." Ms. Thomsen also analogized to the research analyst IPO scandals in which investment bankers used research coverage as a tool to clinch banking deals.

» *Your mother was right — just because your friend jumps off a bridge doesn't mean you should too.* Ms. Thomsen commented that "if the only reason that can be offered as a justification for backdating is that 'everyone else is doing it,' that's a poor excuse for what amounts to unjust enrichment of a few employees at the expense of corporate shareholders."

» *You can't have your cake and eat it too.* According to Ms. Thomsen, "a stock option can be granted either in the money or at the money, but not both. You can take your pick, but you have to accept the consequences of your choice."

» *Process can be your friend.* Ms. Thomsen said that this is a variant of the "sunscreen and dental floss rule" which provides that sunscreen and dental floss are beneficial only if you use them everyday. If a company has specific processes in place for granting options and applies them consistently, it should have no problems. It is when a company "abandons its regular process and starts to award stock options on an ad hoc basis" that problems occur.

SEC Speaks *(cont.)*

» *If you're ever in doubt as to whether a particular practice is right, imagine explaining it to your family, especially your children.* This rule has two advantages. First, it requires you to break down a concept into a simple explanation that will help you to see its true strengths and weaknesses. Second, your family is probably the most sympathetic audience you'll ever face "so if you can't explain why its right to them, it probably isn't right."

» *Character matters.* Lastly, Ms. Thomsen emphasized that integrity begins at the top and if the CEO is known for integrity, the other employees will follow suit.

Ms. Thomsen's speech is available at http://www.sec.gov/news/speech/2006/spch103006lct.htm.

NYSE Developments

Compliance with Regulation S-K, Item 407(a) SEC Disclosure Requirements Satisfies NYSE Director Independence Disclosure Requirements

At a meeting at Davis Polk on November 29, 2006, Annemarie Tierney, Assistant General Counsel, Office of the General Counsel, NYSE Group, Inc., said that NYSE-listed companies that fully comply with the director independence disclosure requirements in Regulation S-K, Item 407(a), will also satisfy their NYSE director independence disclosure obligations under Section 303A.02(a) of the NYSE rules.

NYSE and NASD Announce Formation of Joint SRO to Regulate Broker-Dealers

On November 28, 2006, the NYSE and NASD announced the signing of a letter of intent to consolidate their member regulation operations into a new self-regulatory organization ("SRO") that will be the private sector regulator for all securities brokers and dealers doing business with the public in the United States. According to the NYSE, the plan is aimed at increasing the efficiency and consistency of securities industry oversight. It also is expected to reduce regulatory costs.

The NYSE has announced that the new SRO, which will be named at a later date and is expected to begin operations in second quarter 2007, will consist of the current 2,400-person NASD organization and approximately 470 of NYSE Regulation's member regulation, arbitration and related enforcement team. The formation of the new SRO will not impact NYSE market surveillance and listed company compliance, which will continue to be overseen by NYSE Regulation.

The plan is subject to satisfaction of certain conditions, including the execution of definitive documentation. In addition, the plan must be reviewed and approved by the SEC. SEC Chairman Christopher Cox has strongly endorsed the consolidation of the NYSE and NASD broker-dealer regulatory functions.

The NYSE's press release announcing the NYSE and NASD consolidation is available at http://www.nyse.com/Frameset.html?nyseref=&displayPage=/press/1164625606086.html. The statements

NYSE Developments *(cont.)*

by SEC Chairman Cox at the news conference announcing the NYSE and NASD consolidation is available at http://www.sec.gov/news/press/2006/2006-195.htm.

SEC Approves NYSE Trading of Unlisted Debt Securities

On November 17, 2006, the NYSE announced that the SEC has approved the trading of certain unlisted debt securities on the NYSE. As a result, the NYSE will be able to trade the corporate debt issues of all NYSE-listed equity issuers and their wholly-owned subsidiaries, allowing NYSE customers to access nearly 6,000 additional bonds compared to approximately 1,000 today.

The NYSE press release announcing this development is available at http://www.nyse.com/Frameset.html?nyseref=&displayPage=/press/PressReleases.html. The SEC's approval notice is available at http://www.sec.gov/rules/sro/nyse/34-51999.pdf.

NASDAQ Developments

Nasdaq Files with SEC Proposal to Eliminate Paper Annual Report Delivery Requirement

Nasdaq has filed with the SEC a proposal to modify Rule 4350(b) to allow (but not require) issuers to satisfy their annual report delivery requirement by posting their annual report on their website along with a prominent undertaking to deliver a paper copy upon request. The issuer would also need to issue a press release announcing that the annual report has been filed with the SEC. As with the recent comparable change by the NYSE, this proposal would have little impact on domestic issuers, which are still required by the proxy rules to deliver a paper annual report to shareholders. The SEC has indicated, however, that it may adopt an electronic alternative to the current paper annual report delivery requirement in the proxy rules at its December 13, 2006, meeting.

Nasdaq also proposes to specify that the Nasdaq annual report delivery requirement is applicable only to issuers of common stock and voting preferred stock (and their equivalents) and not issuers of listed debt. Further, Nasdaq proposes to remove the provisions in its rules that dictate the timing for delivery of the annual report because the SEC's proxy rules already provide a deadline.

The Nasdaq has also proposed to modify Rule 4350(a) relating to disclosure by foreign private issuers of non-conforming corporate governance practices. Under the proposed change, FPIs would be able to disclose significant differences between the corporate governance practices they follow and the requirements applicable to U.S. companies in either their annual report *or on their website*. In the case of FPI IPO companies, these corporate governance differences would need to be disclosed in either the registration statement *or on the issuer's website*. Under current rules, Nasdaq FPI issuers do not have the option of making these disclosures on their website.

This proposed rule change is subject to publication and approval by the SEC. The text of the NASDAQ's rule filing is available at http://www.complinet.com/file_store/pdf/rulebooks/SR-NASDAQ-2006-045.pdf.

NASDAQ Developments (cont.)

Nasdaq Soliciting Comments on New Method of Valuing Warrants for Shareholder Approval Rules

The Nasdaq Stock Market is soliciting comments on a new method of valuing warrants for purposes of applying the Nasdaq shareholder approval listing requirements to transactions. Under current rules, a company is required to obtain shareholder approval if it will be issuing 20% or more of the company's pre-transaction shares outstanding.

The new model being considered by Nasdaq would employ more modern valuation techniques such as Black-Scholes Option Pricing and other pricing models. It contemplates the use of a simple formula that would produce a comparable share equivalent value for each warrant. Alternatively, Nasdaq has developed tables that could be used instead of the formula, which is based on the percentage of premium or discount of the warrant exercise price to the closing bid price.

Nasdaq's proposal is available at http://www.nasdaq.com/about/Warrant_Solicitation_102606.pdf. The comment deadline is January 15, 2007.

NASD Developments

NASD Staff Member Speaks at PLI Securities Regulation Conference

At the PLI 38th Annual Institute on Securities Regulation held on November 9-11, 2006, Gary Goldsholle, Vice President and Associate General Counsel, NASD Regulatory Policy & Oversight, provided the following insights regarding the NASD's pending rule changes:

» The NASD shelf proposal has stalled but the NASD is pressing the SEC Division of Market Regulation to move this forward.

» The SEC staff and the NASD are still looking at comments on the fairness opinion proposal. The SEC staff also had a number questions for the NASD, and the NASD is working on its responses. The NASD anticipates revising the proposed fairness opinion rule to require a member issuing a fairness opinion to disclose in the fairness opinion:
  – contingent compensation;
  – material relationships;
  – whether information that formed a substantial basis for the fairness opinion was verified; and
  – if the opinion was approved by a fairness committee.

In addition, no opinion may be expressed about the fairness of the compensation to insiders.

PCAOB Developments

PCAOB Modifes Implementation Schedule for Rules Prohibiting Auditors from Providing Certain Tax Services to Certain Employees of Audit Clients

The PCAOB has modified the implementation schedule for a portion of Rule 3523, which prohibits registered public accounting firms from providing any tax services during the *"audit and professional engagement period"* to persons in a financial oversight role at an audit client. The audit and professional engagement period is defined to include two discrete periods of time defined as follows:

> *Audit Period.* The *audit period* is the period covered by the financial statements being audited or reviewed (for example, January 1, 2006 – December 31, 2006, would be the audit period for an audit of financial statements for the year ended December 31, 2006).
>
> *Professional Engagement Period.* The *professional engagement period* is often different than the *audit period* and defined to include the period that begins when the auditor either (i) signs the initial engagement letter or (ii) begins audit procedures and ends when the audit client or the accounting firm notifies the SEC that the client is no longer that firm's audit client.

While Rule 3523 as adopted prohibits auditors from providing tax services to certain employees of an audit client during each of the *audit period* and the *professional engagement period*, the PCAOB is reconsidering whether the prohibition should apply to services provided during the *audit period* if the issuer is not yet an audit client during this time. To enable it to revisit this issue, the PCAOB has revised the implementation schedule for Rule 3523 as it relates to the *audit period* only so that PCAOB will not apply Rule 3523 to tax services provided on or before April 30, 2007, when those services are provided *during the audit period* and are *completed before the professional engagement period begins*.

The implementation schedule for Rule 3523 as it applies to tax services provided during the *professional engagement period* remains unchanged. Under the current implementation schedule, Rule 3523 does not apply to any tax services being provided pursuant to an engagement in process on April 19, 2006 (the date the Rule was approved by the SEC), provided that such services were completed on or before October 31, 2006. Accordingly, as of November 1, 2006, registered public accounting firms may not provide any tax services to persons in a financial oversight role at a *current audit client*.

A copy of the PCAOB's press release is available at http://www.pcaobus.org/Rules/Docket_017/2006-10-31_Release_2006-006.pdf.

Other Developments and DPW Memos

ISS Issues 2007 Corporate Governance Policy Recommendations

On November 17, 2006, the Institutional Shareholder Services ("ISS") issued its 2007 proxy voting policy updates. ISS will begin to apply the policies to all companies with shareholder meeting dates on or after February 1, 2007. According to ISS, the policies were developed based on feedback from its client Policy Survey, its issues-based advisory roundtables and its new policy review and comment period. The ISS claims that the policies reflect the multiple viewpoints of institutional investors on the key corporate governance issues that will face investors and corporations this proxy season.

According to ISS, the policies include:

» A case-by-case analysis approach to the options backdating issues. ISS may recommend withholding votes from compensation committee members, depending upon the severity of the practices and the subsequent corrective actions on the part of the board.

» A majority voting policy pursuant to which ISS will generally support precatory and binding resolutions requesting that the board change the company's bylaws to stipulate that directors need to be elected with an affirmative majority of votes cast, provided it does not conflict with state law where the company is incorporated. Binding resolutions need to allow for a carve-out for a plurality vote standard when there are more nominees than board seats.

» Updates to ISS's poor pay practices policy pursuant to which it may recommend a vote to withhold votes from the compensation committee and/or the CEO in cases where ISS identifies poor pay practices. In addition, ISS may consider recommending withhold votes from the entire board if the whole board was involved in and contributed to the egregious compensation problems.

The ISS press release announcing the issuance of the policies is available at http://www.issproxy.com/pdf/2007PolicyUpdatesFinal%20111706.pdf. The ISS US policies are available at http://www.issproxy.com/pdf/2007%20US%20Policy%20Update.pdf. The ISS International proxy voting policies are available at http://www.issproxy.com/pdf/2007%20International%20Policy%20Update.pdf.

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