DAVIS POLK & WARDWELL

Corporate Regulatory Report

A Summary of Current Regulatory Developments Affecting Publicly Listed Companies

Contents

SEC Developments

SEC Publishes 2007 Performance Budget; Gives Insight into Future Action

In the SEC's 2007 performance budget published earlier this month, the SEC set forth its goals for fiscal year 2007, which begins on October 1, 2006. Highlights from the budget are set forth below:

» *Regulatory Agenda.* Corporation Finance anticipates its regulatory calendar to be as follows:

- Final action on the proposals related to executive compensation and other corporate governance disclosure, deregistration of foreign private issuers, tender offer rule changes (related to Rule 14d-10's "best price" requirement) and electronic proxy statement delivery is expected for FY 2007.
- The SEC expects to decide whether to propose mandatory rules on XBRL by the end of FY 2006.
- No action is indicated for the shareholder access proposal in FY 2006 or FY 2007.

» *Review of 1933 Act and 1934 Act Filings.* Corporation Finance expects to have reviewed at least 47 percent of all corporate filers by the end of FY 2006 and plans to review 44 percent of all corporate filers in FY 2007 even though an estimated one quarter of those issuers already will have been reviewed in FY 2005 or 2006. The budget also provides that while Corporation Finance's target is to issue comments within 30 days of receipt of a filing, in FY 2005 the Division issued comments within 26.1 days on average. The staff plans to work to decrease the amount of time attributable to staff review.

» *Enforcement.* The Enforcement Division anticipates that there will be an increase in the number of first enforcement cases filed within two years of opening an investigation or inquiry. In addition, the SEC anticipates that the percentage of enforcement cases resulting in a favorable judgment for the SEC or a settlement will continue to be around 85 percent. The budget also shows that both the amount of monetary disgorgement and penalties ordered by the SEC and the number of cases referred to Enforcement by Corporation Finance as a result of their disclosure reviews have increased significantly. In FY 2005, monetary disgorgement and penalties ordered by the SEC totaled $3.1 billion

SEC Developments (cont.)

compared to $1.3 billion in FY 2004 and $313 million in FY 2003. In FY 2005 Corporation Finance referred 640 cases to Enforcement to 415 cases in FY 2004 and 231 cases in FY 2003.

» *Timeframe for No-Action Letters and Exemptive Relief.* The SEC completed 89 percent of no-action or exemptive relief requests within six months of receipt in FY 2005 and plans to complete at least 85 percent of these requests within six-months in FY 2006 and FY 2007.

For a copy of the performance budget, see http://www.sec.gov/about/2007budgetperform.pdf.

SEC Offers One-Time Chance to Correct Cash Flow Classifications Related to Discontinued Ops

According to an AICPA alert-to-members, the SEC has advised that companies whose cash flow classifications related to discontinued operations are not consistent with FAS 95 (Statement of Cash Flows) may correct that error through retrospective modifications to presentations, without need for a restatement, in their next 10-K or 10-Q filed after February 15, 2006. If such corrections are made in a later 10-K or 10-Q, the AICPA suggests that a restatement would likely be required. According to the AICPA alert, retrospective modifications of presentations must be accompanied by enhanced disclosure to make readers aware that the cash flow presentation has been changed. For a copy of the AICPA alert-to-members, click here.

SEC and U.K. FSA Sign Cooperation Arrangement

On March 14, 2006, the SEC and the U.K.'s Financial Services Authority signed a memorandum of understanding to increase cooperation in market oversight and supervision. Among other things, the MOU formalizes information sharing (including the exchange of confidential information) between the SEC and the FSA. For a copy of the press release on this development, see http://www.sec.gov/news/press/2006-36.htm. For a copy of the MOU, see http://www.sec.gov/about/offices/oia/oia_multilateral/ukfsa_mou.pdf.

SEC Speaks

Highlights from PLI's SEC Speaks Conference

At the annual SEC Speaks conference sponsored by the Practising Law Institute, the SEC commissioners and staff conveyed some helpful information, including the following:

Disclosure Issues

Early adoption of executive compensation disclosure proposal. David Lynn, Chief Counsel of the Division of Corporation Finance, reminded early adopters of the SEC's proposal on executive compensation and other corporate governance disclosure that they should provide such new information in addition to, not in place of, currently required items. For example, with respect to the compensation tables, companies may not delete or modify a currently required column but may add a new column or table based on the proposals.

SEC Speaks (cont.)

Form S-3ASR and incorporation by reference. At the conference, SEC staff stated that a WKSI may not complete a takedown off its Form S-3ASR automatic shelf if it incorporates by reference a Form 10-K that further incorporates Part III information from a proxy statement until such information is filed or otherwise included in a prospectus supplement. We have, however, been advised that the staff has withdrawn the foregoing position, and its current position is that they will not object to a takedown during that period. However, the staff reminds companies that they must make their own decisions with counsel as to whether the registration statement and prospectus satisfy applicable securities law requirements. For the DPW Newsflash on this development, click here.

Large accelerated filers. SEC staff reminded companies that there is a new check box regarding large accelerated filer status on the cover of Form 10-K. Similarly, companies should update their EDGAR filer status to reflect their large-accelerated, accelerated or non-accelerated status.

NASDAQ's change in status to a securities exchange. SEC staff indicated that NASDAQ's change in status to a national securities exchange will not result in a change to companies' file numbers or CIKs.

Corporate Governance

Shareholder proposals and majority voting. David Lynn also discussed shareholder proposals. He noted that there have been fewer no-action requests this year than in recent years and that his office's response time to no-action requests is currently 42 days on average. One of the hot topics of this proxy season has been director majority voting proposals, which he noted are generally considered not excludable by his office.

Mr. Lynn further reminded companies with director resignation policies (where a director must submit his or her resignation to the board upon receipt of a majority of withheld votes) that an Item 5.02 Form 8-K filing is triggered by a director's submission of a resignation, regardless of whether such resignation is contingent upon further review by the board or subject to any other conditions.

NASD fairness opinion proposal. Brian Breheny, Chief of the Office of Mergers and Acquisitions of the Division of Corporation Finance, noted that the NASD fairness opinion proposal is still being reviewed at the SEC. He did not give a sense of timing on the publication of the proposal, but assured attendees that there would be time to comment after such publication. He also noted that the SEC is reviewing whether changes to the proxy rules would be appropriate to reflect the NASD's proposal.

Non-GAAP Financial Measures

Carol Stacey, Chief Accountant of the Division of Corporation Finance, and Barry Summer, Associate Director of the Division of Corporation Finance, each noted that many companies are presenting financial results that eliminate a recurring item, such as share-based payments accounted for under FASB 123(R), and reminded companies of FAQ #8 in Corp. Fin.'s FAQs on the use of non-GAAP financial measures (see http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm), which cautions against such elimination unless the use of such measures can be justified and certain specified disclosures are present. Ms. Stacey and Mr. Summer each also noted that issuers are not permitted to include full pro forma income statements in situations where pro formas are not required by Article 11 of Reg. S-X. For example, an issuer generally may not present a complete income statement that eliminates share-based payments.

SEC Speaks (cont.)

Enforcement

Microcap fraud. Commissioner Atkins reiterated his prior statements that the SEC should refocus on fraud involving microcap companies (such as boiler room, cybersmear and bear raid schemes), instead of on the financial frauds of recent years. He is concerned that the SEC staff has not focused on microcap frauds because they are not "glamorous" enough. Commissioner Atkins wants to incentivize SEC staff to pursue these types of cases by, among other things, increasing efficiency and flexibility in staffing and rethinking the role of the SEC regional offices.

SEC reviewing SOX 404 reports. Carol Stacey noted that, in addition to information received from the SEC's complaints hotline and the PCAOB, the other primary source of SEC accounting enforcement actions is companies' own SOX 404 reports. According to Ms. Stacey, SEC staff reviews those reports for possible enforcement action.

Future Rulemaking and Other SEC Developments

Private offerings. Commissioner Glassman mentioned the area of private offerings as one which should be revisited in the near future. Among the items that she thought needed review are whether the net worth ($1,000,000) and income ($200,000 income in last three years or $300,000 combined income with a spouse) thresholds for a natural person in the definition of accredited investor are too low.

Cross-border tender offer rules. Paul Dudek, Chief of the Office of International Corporation Finance, mentioned that it may be time to revisit the cross-border tender offer rules. Among other things, he thought the SEC should examine whether 30 days before the offering is the right time to assess the level of U.S. share ownership.

Deregistration. Mr. Dudek noted that the SEC is reviewing the comment letters submitted with respect to the proposed amendments to the deregistration process and is working as quickly as possible towards final rules but does not have a definitive timeframe. Items that were most commented on and which the SEC are reviewing are the trading thresholds and the length and scope of the period during which a deregistering foreign private issuer must not have made any public or private offering of its securities in order to qualify for deregistration under certain provisions.

SEC Review Program

Frequency and focus of reviews. Mr. Summer reminded issuers that SOX mandates that the SEC review an issuer at least once every three years, but does not prevent the SEC from reviewing an issuer more frequently. Mr. Summer also noted that the SEC has changed its review procedures such that it now takes an in-depth look at a filing (called a preliminary review) before determining whether to review the filing. This allows SEC staff an opportunity to understand the issuer and the filing before deciding whether to review. The SEC has increased its target reviews which allows it to focus on particular industries or issues. While these targeted reviews generally result in fewer comments, issuers can expect the staff to be more focused on the comments that do result.

SEC Speaks (cont.)

Form S-3ASRs and free writing prospectuses. Ms. Parratt noted that while the SEC does not review Form S-3ASRs, it does take a quick look at some and keeps track of the number of ASRs filed. She also noted that the SEC wants to make sure that issuers do not put things in free writing prospectuses that should otherwise be disclosed in the statutory prospectus.

Commissioner Campos Expresses Concern with Demutualization of SROs

In a March 10, 2006, speech, Commissioner Campos expressed concern over the current scheme of stock exchange self regulation, especially in the current era of demutualization and publicly held, for-profit stock exchanges. He is worried about whether for-profit exchanges can successfully fulfill their regulatory responsibilities. Increasing competition between exchanges and various other trading vehicles and the need to return shareholder value could lead SROs to cut adequate funding for the regulatory program or trigger a "race to the bottom" in regulatory standards. Commissioner Campos examined two options to counteract possible regulatory failure, including (1) having separate regulatory and market entities within a holding company structure, as the NASD/NASDAQ and NYSE have done, and (2) splitting regulation into two functions, with the exchange retaining SRO responsibilities specific to market operations and with a separate SRO responsible for all other regulation (the "hybrid model"). Under the hybrid model, the non-market related SRO could be a single-member SRO or a combination of multiple SRO's joined into one centrally managed entity. Commissioner Campos favors the hybrid model as it reduces duplicative regulation and conflicts of interest, echoing a theme he raised at the SEC Speaks conference. Pending implementation of the foregoing longer-term solutions, Commissioner Campos believes that there are several short-term solutions that should be undertaken, among them being better coordination of SRO and state and federal regulators in conducting examinations of companies. For a copy of this speech, see http://www.sec.gov/news/speech/spch031006rcc.htm.

NYSE Developments

NYSE Proposes Amendments to Its Listing Requirements

On March 20, 2006, the NYSE filed with the SEC proposed changes to adjust its criteria for listing common equity securities. Among other things, the NYSE proposes to strengthen or adjust its current distribution criteria for listing common equity securities and add a new listing standard for preferred stock. The proposal would also modify evaluation and follow up procedures for U.S. companies that are identified as being below the NYSE's continued listing criteria. The proposed rule change does not provide for a comment period but is subject to publication and approval by the SEC. For a copy of the proposal, see http://apps.nyse.com/commdata/pub19b4.nsf/docs/3F6EFEF602C10E3A85257137007CD9EC/$FILE/NYSE-2006-22.pdf.

PCAOB Developments

PCAOB's Proposed Tax Ethics and Auditor Independence Rules Published for Comment

On March 7, 2006, the SEC published for comment the PCAOB's proposed ethics and independence rules concerning independence, tax services and contingent fees, which were first proposed by the PCAOB in July 2005 and later amended in November 2005. These proposals would, among other things, prohibit public company auditors from providing three types of services to their audit clients:

- Services involving contingent fee arrangements between the auditor (or its affiliates) and the audit client;
- Tax marketing, planning, or advice regarding the tax treatment of confidential transactions or aggressive tax position transactions; and
- Tax services to persons in a financial reporting oversight role at the audit client, or tax services to immediate family members of those persons.

The proposed rules would also require that the audit firm provide the audit committee with certain types of information (such as the potential effects of the services on the audit firm's independence) when obtaining audit committee pre-approval for permissible tax services. The comment period ends April 3, 2006. For a copy of the SEC rule proposal, see http://www.sec.gov/rules/pcaob/34-53427.pdf.

In recognition of the delay in the SEC's publication of these rules, the PCAOB published on March 28, 2006, updated transition rules. Among other things, (1) the prohibition on audit firms' provision of certain tax services to their audit clients will not apply to tax services already being provided pursuant to an engagement in process at the time the SEC approves the rules, except that such services must be completed on or before the later of October 31, 2006, or 10 days after the date that the SEC approves the rules, and (2) the requirement to provide certain types of information to audit committees when seeking pre-approval of certain tax services will not apply to any such tax service that is begun within one year after SEC approval of the rules. For a copy of this release, see http://www.pcaobus.org/Rules/Docket_017/2006-03-28_Release_2006-001.pdf.

Release of Audit Firm Inspection Reports

On March 21, 2006, the PCAOB issued two releases to implement the Sarbanes-Oxley Act requirement that portions of inspection reports dealing with criticisms or defects in an audit firm's quality control systems not be released if such criticisms or defects are addressed to the PCAOB's satisfaction within 12 months of the inspection report. In the first release, the PCAOB provided information about its process for determining whether an audit firm has satisfactorily addressed quality control criticisms in an inspection report and described its approach to implementing SOX and the meaning and effect of the PCAOB's determination in this regard. In the second release, the PCAOB described observations about efforts undertaken by the four largest U.S. audit firms to address quality control concerns identified during the

PCAOB Developments (cont.)

initial, limited inspections of those firms. The PCAOB noted that each firm engaged in substantial dialogue with PCAOB staff concerning the firm's efforts to address the concerns, and each firm made a timely submission of evidence to describe those efforts. For a copy of the first release, see http://www.pcaobus.org/Inspections/2006-03-21_Release_104-2006-077.pdf. For a copy of the second release, see http://www.pcaobus.org/Inspections/Public_Reports/2003/2006-03-21_Release_104-2006-078.pdf.

Other Developments and DPW Memos

Antitrust Developments

There have been a number of significant U.S. antitrust law developments already in 2006, including three important decisions by the U.S. Supreme Court and an initiative by the Federal Trade Commission to reduce the burdens of complying with Second Requests. For a copy of the DPW update on these developments, click here.

Disclosure of Foreign Corrupt Practices Act Violations

In recent weeks, several U.S. companies (including Pride International, Universal Corporation, Outback Steakhouse and United Parcel Service) have disclosed potential violations of the U.S. Foreign Corrupt Practices Act in connection with their international operations or foreign subsidiaries. For a discussion of the types of disclosure that these companies are making, click here.

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

Frances Mi
212-450-4048
frances.mi@dpw.com