Client Advisory

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Developments and Reminders Affecting Annual and Quarterly Disclosure

This advisory summarizes certain developments to keep in mind as you prepare your next annual or quarterly report.

Sarbanes Section 404 and Internal Controls: SEC Amends and Proposes Rules and Issues Interpretive Guidance

At an SEC open meeting on May 23, 2007, the SEC voted to:

- Issue interpretative guidance for management regarding its evaluation and assessment of internal control over financial reporting;
- Adopt amendments to
  - Exchange Act Rule 13a-15 and 15d-15, making it clear that an evaluation that complies with such SEC interpretative guidance would satisfy the annual management evaluation required by those rules;
  - Regulation S-X Rules 1-02(a)(2) and 2-02(f) to require the expression of a single opinion directly on the effectiveness of internal control over financial reporting by the auditors in its attestation reports;
  - Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define "material weakness" to mean "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis"; and
- Propose amendments to Exchange Act Rule 12b-2 and Regulation S-X Rule 1-02 regarding the definition of the term "significant deficiencies".

The guidance and rule amendments were issued on June 20, 2007 and published in the Federal Register on June 27, 2007, and become effective on August 27, 2007. The guidance is intended to help public companies (particularly smaller companies) bolster internal control over financial reporting while reducing costs, and concentrates on internal controls that best protect against risk of material financial misstatement. The guidance aims to reduce uncertainty regarding what is considered a reasonable approach to management's evaluation, yet still maintain flexibility for companies with existing procedures, and proposes a top-down, risk-based evaluation. The guidance is aligned with the Public Company Accounting Oversight Board's (PCAOB's) new

Auditing Standard No. 5, adopted by the PCAOB on May 24, 2007, discussed below, which currently awaits SEC approval before becoming effective. For a more detailed discussion, see the adopted rules at http://www.sec.gov/rules/final/2007/33-8809fr.pdf, the proposed rules at http://www.sec.gov/rules/proposed/2007/33-8811.pdf and the guidance at http://www.sec.gov/rules/interp/2007/33-8810fr.pdf.

Section 404 and Internal Control Requirements for Smaller Companies

The SEC determined in May 2007 not to extend the deadline for smaller public companies to comply with Sarbanes' internal control regulations. Non-accelerated filers (firms with less than $75 million of public float (i.e., portion of outstanding shares in the hands of public (non-insider) investors)) must file management's assessments with their annual report closing on or after December 15, 2007, consistent with rule requirements.

In the wake of the SEC's decision not to provide smaller public companies with Section 404 relief, the U.S. Congress has taken legislative efforts to intervene. On June 26, 2007, the U.S. House of Representatives passed an amendment to the fiscal year 2008 appropriations bill H.R. 2829 (relating to the fiscal year ending September 30, 2008), by a 267-154 vote, prohibiting the SEC from using the funds made available to enforce Section 404 compliance with respect to non-accelerated filers. The appropriations bill including the amendment was approved by the House on June 28, 2007 and referred to the Senate on June 29, 2007 for approval. The bill was read twice in the Senate and has been referred to the Senate Committee on Appropriations.

SEC Proposes Amending Requirements as to Small Public Companies

On July 5, 2007, the SEC proposed amending disclosure and reporting requirements for smaller companies. The proposal would allow companies with a public float of less than $75 million to benefit from the optional disclosure and reporting requirements for smaller companies (currently only those companies with a public float of less than $25 million qualify). The proposed rules would merge the "small business issuer" and "non-accelerated filer" categories into a single category of "smaller reporting companies" (which will be defined for most companies as companies having a public float of less than $75 million (and for other companies (e.g., those with no public float or who cannot calculate their public float) as companies with less than $50 million in annual revenues). The proposed rules would allow for automatic inflation adjustments in the $50 million and $75 million dollar thresholds on September 1, 2012 and every five years thereafter.

The proposed amendments would also integrate the Regulation S-B disclosure requirements for smaller companies into Regulation S-K, thus removing Regulation S-B and its forms from the securities rules. As part of the rules, the SEC is proposing to add a new Item 310 (Financial Statements of Smaller Reporting Companies) to Regulation S-K to set forth the alternative requirements on form and content of financial statements for smaller companies that now appear in Regulation S-B Item 310. The SEC is proposing to allow a company that qualifies as a smaller reporting company to choose, on an item-by-item or "a la carte" basis, to comply with either the scaled disclosure requirements made available in Regulation S-K for smaller reporting companies or the disclosure requirements for other companies in Regulation S-K, when the requirements for other companies are more rigorous. A smaller reporting company would have the option to take advantage of the smaller reporting company requirements for one, some, all or none of the items, at its election, in any one filing, in such cases. The SEC would require, however, that a smaller reporting company provide its financial statements on the basis of either Item 310 of Regulation S-K or Regulation S-X for an entire fiscal year, and not be permitted to switch back and forth from one to the other in different filings within a single fiscal year.

The SEC is seeking comments on the proposed rules on or before 60 days after Federal Register publication. For a more detailed discussion, see http://www.sec.gov/rules/proposed/2007/33-8819.pdf.

PCAOB Adopts New Auditing Standard

On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements." Auditing Standard No. 5, which will replace the previous internal control auditing standard, Auditing Standard No. 2, is principles-based, with the aim of increasing the likelihood that material weaknesses in internal control will be discovered before they lead to material financial misstatements. The new standard also seeks to eliminate unnecessary procedures and guide the auditor towards an audit tailored to a company's facts and circumstances. The PCAOB worked closely with the SEC on the new standard, and auditors may use the new standard immediately following SEC approval (which is currently pending; the SEC was taking comments until July 12, 2007 and expected to act no later than July 27, 2007). In its standard, the PCAOB listed four objectives of the new standard: (1) to focus the internal control audit on the most important matters (i.e., those areas with the greatest risk that the internal control will not prevent or discover a material misstatement in the financial statements), (2) to eliminate procedures that are unneces-

sary for achieving the intended benefits of the audit, (3) to make the audit clearly scalable to fit the size and the complexity of any company, and (4) to simplify the text of the standard.

The PCAOB also adopted Rule 3525, "Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting" and conforming amendments to other auditing standards. Audit Standard No. 5 (following SEC approval), Rule 3525 and conforming amendments will be required for audits of internal control for the fiscal year ending on or after November 15, 2007.

On June 7, 2007, the PCAOB gave notice of filing of a proposed rule on Auditing Standard No. 5, which notice was published in the Federal Register on June 12, 2007. For more information, see http://www.sec.gov/rules/pcaob/2007/34-55876fr.pdf.

PCAOB Guidance and Other Proposals

On April 3, 2007, the PCAOB issued guidance on Rule 3522 (Tax Transactions) and Rule 3523 (Tax Services for Persons in Financial Reporting Oversight Roles). The guidance focuses on ethics and independence and can be found at http://www.pcaobus.com/Standards/Staff_Questions_and_Answers/2007/Tax_Services.pdf. On the same date, the PCAOB also proposed:

- an auditing standard and amendments regarding the consistency of the financial statements and removal of the hierarchy of GAAP from its interim auditing standards, which proposal can be found at http://www.pcaobus.com/Rules/Docket_023/2007-04-03_Release_No._2007-003.pdf and
- a concept release concerning Rule 3523 (Tax Services for Persons in Financial Reporting Oversight Roles); it also extended the implementation schedule for Rule 3523, which rule will not apply to tax services provided on or before July 31, 2007 if those services are provided during the audit period and completed before the professional engagement period begins; the proposal can be found at http://www.pcaobus.com/Rules/Docket_017/2007-04-03_Release_%202007-002.pdf.

NYSE Amends Proposal Regarding Section 303A of the Listed Company Manual

On June 8, 2007, the NYSE filed with the SEC an amendment to its proposal filed on November 23, 2005, as amended, regarding the corporate governance listing standards found in Section 303A of the NYSE Listed Company Manual. The most significant change is to the independent director disclosure requirements: the NYSE is seeking to eliminate those disclosure requirements that are also required by SEC Item 407 of Regulation

S-K. The NYSE is also seeking to amend Section 203.01 to provide that no press release or Section 203.01 undertaking is required for listed companies that are subject to U.S. proxy rules (or those foreign private issuers that provide audited financial statements consistent with the delivery requirements of the U.S. proxy rules). Additionally, the NYSE is seeking to eliminate Sections 307.00 and 314.00, which have guidance regarding related party transactions that the NYSE feels are outdated. The full text of the proposal can be found at http://apps.nyse.com/commdata/pub19b4.nsf/docs/0889B6394084FF8D852572F400719992/$FILE/NYSE-2005-81%20A-1.pdf.

Corp Fin Director John White's Speech on Executive Compensation Disclosures

In a May 3, 2007 speech entitled "Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures", Mr. White discussed in detail (i) the "Analysis" part of the Compensation Disclosure & Analysis disclosure, reiterating that "[t]he purpose of the… disclosure is to provide material information about the compensation objectives and policies for named executive officers without resort to boilerplate disclosures," (ii) the length of the disclosures and (iii) areas still under Staff scrutiny, which include performance targets, alternative disclosures when performance targets may be excluded, negative numbers, disclosure about the role of the CEO and disclosure about prerequisites. A report will be published regarding these issues in fall 2007. The full text of Mr. White's speech can be found at http://www.sec.gov/news/speech/2007/spch050307jww.htm.

Foreign Private Issuers and New Deregistration Rules

New deregistration rules for foreign private issuers went into effect on June 4, 2007. According to the SEC Final Rule entitled "Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934", dated March 27, 2007, these amendments were made in order to ease the difficulty a foreign private issuer may have in terminating its Exchange Act registration and reporting obligations even when there is relatively little interest from U.S. investors in the issuer's U.S.-registered securities. Additionally, under Section 15(d) of the Exchange Act, the foreign private issuer was able only to suspend (but not to terminate) its duty to report. The new rules allow a foreign private issuer to compare the average daily trading volumes of its securities in the United States and worldwide, using a 5% benchmark over a 12-month period. Foreign private issuers have already been deregistering since early June when the registration rules were adopted; a major impetus

seems to be the costs of compliance with reporting and listing obligations.

Foreign Private Issuers and SEC Proposals Regarding International Financial Reporting Standards (IFRS)

On July 2, 2007, the SEC issued a Proposing Release on proposed rule changes allowing IFRS as published by the International Accounting Standards Board (IASB) to be used in financial reports filed by foreign private issuers registered with the SEC without a reconciliation to U.S. GAAP. Currently, any foreign private issuer who reports in non-U.S. GAAP, such as IFRS, must also provide a reconciliation of those financial statements to U.S. GAAP. The proposed rule changes will effect Forms 20-F, F-4 and S-4, Rule 701 and sections of Regulation S-X. Under the proposed changes, a foreign private issuer must file its financial statements in full compliance with the English language version of IFRS as published by the IASB (no deviations allowed) in order to file without a reconciliation. The issuer must state in a prominent footnote that the financial statements are in compliance with IFRS as published by the IASB and the independent auditor must give its opinion on whether the financial statements are in compliance with IFRS as published by the IASB. The SEC is taking comments regarding this proposal until September 24, 2007. For a more detailed discussion, see http://www.sec.gov/rules/proposed/2007/33-8818.pdf.

In addition, on April 25, 2007, the SEC, the United Kingdom Financial Services Authority and the United Kingdom Financial Reporting Council signed a protocol for sharing information on application of IFRS by issuers listed in the UK and the U.S.

SEC Makes Annual Adjustments to Fees

On May 7, 2007, the SEC made its annual adjustments to the fee rates paid under Section 6(b) of the Securities Act and Sections 13(e), 14(g), and 31 of the Exchange Act. The Sections 6(b), 13(e) and 14(g) fee rates will increase to $39.30 per million (from $30.70 per million), effective the later of October 1, 2007 or 5 days after the date on which the Commission receives its fiscal year 2008 regular appropriation. The Section 31 fee rate will decrease to $11.00 per million (from $15.30 per million), effective the later of October 1, 2007 or 30 days after the date on which the Commission receives its fiscal year 2008 regular appropriation. The Section 31(d) fee rate will remain unchanged.

SEC Proposes Revisions to Rule 144 and Rule 145

On June 22, 2007, the SEC proposed revisions to Rule 144 and Rule 145, which includes:

- shortening the Rule 144 holding period requirement for restricted securities of companies subject to the reporting requirements of the Securities Exchange Act of 1934 to six months; this would be extended, for up to another six months,

by the amount of time during which the security holder engaged in hedging transactions;

- substantially reducing restrictions on the resale of securities by non-affiliates;
- eliminating the manner of sale restrictions with respect to debt securities;
- increasing the Form 144 filing thresholds;
- eliminating the presumptive underwriter position in Rule 135(c), except for shell company transactions; and
- revising the resale requirements in Rule 145(d).

The SEC is taking comments regarding this proposed release until September 4, 2007.

SEC Proposes Revisions to Form S-3 and Form F-3 Eligibility Requirements

On June 20, 2007, the SEC proposed amendments to the Form S-3 and Form F-3 eligibility requirements that would permit more companies to use these forms. These proposals would allow private issuers to use these forms in conducting primary securities offerings regardless of the their public float size or the debt rating, as long as they meet the other eligibility conditions and do not sell more than the equivalent of 20% of their public float in primary offerings over any 12 calendar month period. Shell companies will not be able to use these forms. The SEC is taking comments regarding this proposed release until August 27, 2007.

E-Proxy (Internet Availability of Proxy Materials)

On January 22, 2007, the SEC released its final rule allowing companies to furnish proxy materials by posting them on the internet and sending to shareholders a Notice of Internet Availability of Proxy Materials at least 40 calendar days before the shareholder meeting. Companies may send the Notice of Internet Availability of Proxy Materials on and after July 1, 2007. More information can be found at http://www.sec.gov/rules/final/2007/34-55146.pdf. Some companies have already started using the new e-proxy rules.

Direct Registration System (DRS) Eligibility Requirement

On August 8, 2006, the SEC approved new exchange rules requiring companies listed on AMEX, NASDAQ and NYSE be eligible to participate in DRS. This requirement applies to all new issues as of January 1, 2007 and, beginning on January 1, 2008, to all listed securities. Pink Sheet securities are excluded, as they are not listed securities on the exchanges. The rules require listed issuers to be eligible to participate in DRS, but do not require actual participation. DRS eliminates the need for physical securities certificates and allows an investor's position to be made as a book entry and ownership to be transferred electronically. To be DRS-eligible, issuers must:

- Participate in the Depository Trust Company's (DTC) Profile Modification System, which electronically conveys investor requests to change the form of securities ownership to another form;

- Participate in DTC's FAST program, which minimizes certificate movement and streamlines transfer processing;

- Mail annually DRS book-entry statements to registered owners;

- Use of a transfer agent that meets DTC's DRS transfer agent requirements and is considered to be a DTC DRS Limited Participant;

- Ensure governing documents allow for DRS participation (or at least do not require certificated securities). By-laws may have to be amended. Shareholder approval or 8-K filing requirements may be triggered if bylaws must be amended to allow for uncertificated shares or otherwise clarify that uncertificated ownership is acceptable; and

- Ensure state law permits issuance of uncertificated shares. Many states have recently amended corporate laws to remove the ability of holders to demand certificated securities. New York and Delaware corporate laws permit uncertificated shares.

NYSE's Proposal to Eliminate Discretionary Broker Voting in Director Elections

On October 24, 2006, the NYSE filed with the SEC a proposed change to Rule 452 (as amended May 23, 2007) to eliminate discretionary broker voting in uncontested director elections (discretionary broker voting in contested director elections are already prohibited). Pending SEC approval, this rule change will apply to all shareholder meetings held on or after January 1, 2008 (except to the extent that a shareholder meeting was scheduled to be held in 2007 but was adjourned to 2008). The proposal adds director elections to the list of items that brokers are not permitted to vote on without direction from beneficial owners ("non-routine" items). Brokers can vote on "routine" items if no voting instructions are received at least 10 days before the meeting. Companies registered under the Investment Company Act of 1940 would be exempt.

There are two notable concerns regarding the adoption of this proposal:

- Companies with majority vote requirements for director elections may find it harder to get the needed majority vote, as brokers currently tend to vote on the side of management; and

- Quorums may be harder to establish, thus becoming more expensive and time consuming (and to the more regular decision of companies to hire proxy solicitors). Currently, broker discretionary votes in uncontested director elections count toward the establishment of quorums at shareholder meetings. If only non-routine matters are on the proxy cards, brokers may not be inclined to return proxy cards at all (or if they do, an argument in favor of non-vote counting toward a quorum may be hard to make). Thus companies may find it prudent to include routine matters (such as ratification of auditor appointments) on every proxy card to encourage brokers to return those proxy cards to be counted toward

the quorum. Likely, the NYSE will allow broker non-votes to be counted toward a quorum for a non-routine item, and then once the quorum is established, allow the quorum to apply for all items, including non-routine items.

This issue has been receiving a lot of attention recently; the SEC discussed broker voting in its proxy roundtable held on May 24, 2007.

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