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SEC Proposes Shareholder Nomination Alternatives, Approves PCAOB Auditing Standard No. 5 and Definition of Significant Deficiency and Seeks Comment on IFRS for U.S. Companies

At yesterday's open meeting, the SEC took the unusual step of proposing two very different approaches to address the rights of shareholders to nominate directors for inclusion in a company's proxy materials. Under one approach, the status quo would be maintained, effectively codifying the SEC's 1990 position that permits the exclusion from proxy materials of shareholder proposals that would result in a current or future contested election. Under the second approach, a new process would be established pursuant to which companies must include in their proxy materials any shareholder nomination proposals for binding bylaw changes that are submitted by 5% or greater shareholders, subject to certain conditions.

The SEC also approved final versions of PCAOB Auditing Standard No. 5 and a definition of significant deficiency and the issuance of a concept release seeking comment on whether to allow U.S. companies to use International Financial Reporting Standards as published by the International Accounting Standards Board instead of U.S. GAAP.

Shareholder Proposals Related to Director Elections

The SEC finally laid to rest the proxy access rule proposed in 2003 and instead approved the issuance of two separate proposals that would amend Rule 14a-8's shareholder proposal requirements in different ways as follows:

- The "shorter proposal" (the phrase used to refer to this proposal by the Commissioners at the open meeting) would amend Rule 14a-8(i)(8) to allow the exclusion from a company's proxy materials of any shareholder proposal that would result in an immediate election contest or that would set up a process for shareholders to conduct a future election contest by requiring the inclusion of shareholders' director nominees in subsequent proxy materials. This proposal effectively codifies the SEC's 1990 interpretation of Rule 14a-8(i)(8)'s election exclusion.
- The "longer proposal" would alternatively amend Rule 14a-8 to allow the inclusion in a company's proxy materials of shareholder nomination proposals that would result in

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binding bylaw changes, where the proposal is submitted by a shareholder or group of shareholders that owns more than 5% of the company's outstanding shares continuously for over a year and is eligible to file and has filed a Schedule 13G related to such share ownership. The shareholder or shareholder group could structure its proposed shareholder nomination process and related bylaw change in any way it sees fit so long as they comply with applicable state law and the company's governing documents. The SEC believes that this more flexible approach improves upon the "one size fits all" approach taken by the 2003 proxy access proposal, thereby promoting shareholder choice and private ordering.

To ensure that adequate information about shareholder proposal proponents is available, the proponents would be required to provide the disclosure currently required of shareholders soliciting proxies in opposition to the company and would be liable for any false or misleading statements in such disclosure.

Finally, the longer proposal also would amend the proxy rules to promote online shareholder forums. Among other things, the proposed rules would specify that shareholders and companies that sponsor such forums would not be liable for the statements of other forum participants and would clarify that participation in a forum would not constitute a proxy solicitation under certain conditions (such as that the statements are not made within 60 days before a shareholder meeting and the particular shareholder is not soliciting proxies).

Not surprisingly, the Commissioners split on which proposal they supported. Commissioners Campos and Nazareth supported the longer proposal, while Commissioners Casey and Atkins supported the shorter proposal. Commissioner Cox voted in support of both proposals, but it was unclear which proposal or combination of proposals he would ultimately support. It was, however, clear that Chairman Cox intends to have an unambiguous rule in place in time for the next proxy season.

PCAOB Auditing Standard No. 5 and Definition of Significant Deficiency

The SEC also approved the PCAOB's Auditing Standard No. 5, which relates to the conduct of audits of internal controls over financial reporting. This new standard replaces the much criticized Auditing Standard No. 2 and seeks, among other things, to conform to the SEC's management guidance on internal controls, provide for a scalable audit that accounts for the particular facts and circumstances of each company, encourage auditors to use their professional judgment during the audit (particularly in using risk assessment) and provide a principles based approach for determining when auditors may rely on the work of others in the audit process. Although new AS No. 5 is officially effective beginning with audits for fiscal years ending on or after November 15, 2007, early adoption is permitted, and indeed encouraged, by the SEC Staff, so that shareholders may benefit from increased efficiencies as soon as possible.

The SEC also approved a definition of significant deficiency in substantially the form as proposed. "Significant deficiency" is now defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material

weakness, yet important enough to merit attention by those responsible for oversight of a registrant's financial reporting.”

The SEC intends to work closely with companies, auditors and others to monitor ongoing implementation of the Sarbanes-Oxley Act's Section 404, so that it can make further adjustments to standards, guidance or rules as needed.

Use of IFRS by U.S. Companies

In the wake of the SEC's recent move to allow foreign private issuers to use financial statements in conformity with the English language version of IFRS as published by the IASB without reconciliation to U.S. GAAP, the SEC has approved the issuance of a concept release to seek comment on the effects of extending such option to U.S. companies. As posed in the concept release, companies could continue to use U.S. GAAP if they so choose. The Staff stressed that this concept release functions solely to gather information and is not meant to recommend that U.S. companies use or be allowed to use IFRS.

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Please note that the above is based on oral discussions from the open meeting, and the exact wording of the proposed and final rules and standards will not be known until they are published. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to any of the following:

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