

SEC Actions:

Adoption of Revised PCAOB Auditing Standard for Internal Control
Proposal of Alternative Proxy Access Rules
Approval of Concept Release on Use of IFRS by U.S. Issuers

New York Office
July 26, 2007

At its open meeting on July 25, the Securities and Exchange Commission took the following actions:

- it adopted Auditing Standard No. 5 of the Public Company Accounting Oversight Board, the revised auditing standard for internal control of financial reporting, and adopted a definition of “significant deficiency” as part of the SEC’s rules;
- it approved what appear to be alternative proposals to amend its proxy rules to address the unresolved question of access by shareholders to the proxy process for the purpose of the nomination of directors; and
- it approved the issuance of a concept release seeking comment regarding the use of International Financial Reporting Standards, or IFRS, by U.S. issuers in the preparation of their financial statements.

The releases and rule texts adopted and proposed are not yet available. The information in this memorandum is based on statements made at the open meeting.

Adoption of Auditing Standard No. 5

Auditing Standard No. 5, regarding the audit of internal control of financial reporting, was approved in the form in which it was adopted by the PCAOB and published for comment by the SEC in June. It replaces PCAOB Auditing Standard No. 2. The new standard requires only an opinion regarding the effectiveness of internal control over financial reporting and eliminates the additional requirement of Auditing Standard No. 2 for a report on the adequacy of management’s evaluation of internal control.

As the open meeting made clear, the new standard is part of a multi-year process, which began in 2004 after the experience of the first year’s internal control audits, to achieve the benefits of the internal control audit at a cost to issuers more commensurate with the

benefits. Statements at the meeting emphasized that the SEC and the PCAOB and their respective staffs had worked cooperatively to develop a standard that provides for a more principles-based and risk-based approach to the audit and encourages auditors to exercise professional judgment and use the work of others as appropriate. The new standard is intended to be aligned with the SEC's recently published interpretive guidance for management¹ and to be scalable with a company's size and complexity.

While the standard had general support in the final stages of the comment process, concerns continue to be expressed about whether it will in fact facilitate meaningful change in auditor behavior or issuer costs. Particular concerns have been expressed about the cost of the internal control evaluation and audit process for smaller issuers.² Statements at the open meeting indicated that the SEC and PCAOB would seek to address issues in respect of the conduct of internal control audits, including through the PCAOB's inspection process.

Alternative Proposals for Proxy Access

The SEC approved the issuance of two releases for comment that, based on the open meeting, provide diametrically opposed approaches to whether and how to provide shareholders access to the company proxy for purposes of the nomination of directors. Both proposals were approved by a 3-2 vote, with Chairman Cox providing the third vote in each case, joining Commissioners Atkins and Casey on one proposal and Commissioners Campos and Nazareth on the other. It would appear that the result is to keep the discussion of alternatives alive and to reopen the comment process, even though the SEC still has not reached consensus and has again avoided signaling the ultimate direction it will take on this longstanding controversial issue. Chairman Cox did reiterate at the open meeting his commitment to have a final solution in place for the 2008 proxy season.

The recent history of this issue at the SEC revolves around two events. First, the SEC proposed for comment in October 2003 a rule that would have required an issuer to allow access to the company proxy for shareholder nominees in limited circumstances. The conditions included requirements that the shareholder nomination be consistent with state law, that the number of directors nominated be limited and that the shareholder (or group of shareholders) seeking access hold 5% of the company's voting stock. That proposal provoked significant controversy, attracting strong support from investor groups and equally strong opposition from companies. No final action was taken on the proposal.

¹ See SEC Rel. No. 33-8810, 34-55929, FR-77 (June 20, 2007).

² Indeed, the House of Representatives included a provision in its appropriations bill for the SEC that would prohibit the SEC from using appropriated funds through September 2008 to enforce internal control reporting requirements for companies with less than \$75 million of public float.

Second, the SEC staff had long permitted companies to exclude shareholder proposals to permit shareholder access to the company proxy for purposes of nominating directors. However, in 2006, the Second Circuit ruled that the SEC interpretation was contrary to the SEC's rules and that inclusion of such proposals in a company proxy is required.³ Following this decision, one interpretation of the SEC's rules applies in the Second Circuit, but it is unclear what interpretation applies elsewhere. As suggested by Chairman Cox at the open meeting, this uncertainty requires SEC action to provide for uniform interpretation of its rules on this subject.

The first proposal advanced at the open meeting would permit a by-law proposal by shareholders regarding director nominations that meets three conditions:

- the by-law proposal must be binding under state law (*i.e.*, precatory proposals in this area would appear not to be permitted);
- the proposal must be made by shareholders or groups of shareholders that hold more than 5% of the issuer's securities; and
- the shareholder or group making the proposal must have filed a Schedule 13G under the Securities Exchange Act of 1934.

Additional disclosure requirements regarding the proponents of a proposal and nominees would also apply. However, no other limitations or requirements would be imposed as to the substance or content of the shareholder by-law proposal. In this respect, the proposal would eschew both the additional conditions and the resulting complexity that characterized the 2003 access proposal, but would also eliminate the limitations (other than the 5% holding requirement) that would have narrowed the application of that earlier proposal.⁴

This first proposal also contains provisions that would promote online interaction among shareholders by eliminating restrictions on such communications and clarifying limitations of liability for statements in such a setting.

The second proposal advanced at the open meeting would appear to reverse the effect of the Second Circuit decision described above by setting out an SEC interpretation and

³ *American Federation of State, County and Municipal Employees v. American International Group, Inc.*, 462 F.3d 121 (2d Cir. 2006).

⁴ See SEC Rel. No. 34-48626, IC-26206 (Oct. 14, 2003).

amending Rule 14-8 to permit companies to exclude shareholder proposals to obtain access to the company proxy for purposes of director nominations. This approach would leave intact existing proxy contest rules, including the rules permitting so-called “short slate” contests, which would be a dissident’s sole means of nominating directors. The SEC’s new “e-proxy” rules providing for Internet delivery of proxy materials should reduce the cost of such contests.

Use of IFRS by U.S. Issuers

The SEC has recently proposed for comment rules that would permit foreign private issuers to use IFRS to prepare their financial statements in their SEC filings without requiring a reconciliation of the IFRS statements to U.S. generally accepted accounting principles, or U.S. GAAP.⁵ The concept release approved at the open meeting will ask questions about, among other matters, the utility and implications of an approach to accounting that would permit a U.S. company to use IFRS, rather than U.S. GAAP, in preparing its financial statements.

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The opening statement of Chairman Cox may be found at the following link: <http://sec.gov/news/speech/2007/spch072507cc.htm>, and those of the staff of the Division of Corporation Finance are available at <http://sec.gov/news/speech/2007/spch072507jww.htm> and <http://sec.gov/news/speech/2007/spch072507lcb.htm>. Finally, the opening statements of the staff of the Office of the Chief Accountant concerning Auditing Standard No. 5 and IFRS are available at the following links: <http://sec.gov/news/speech/2007/spch072507cwh.htm> and <http://sec.gov/news/speech/2007/spch072507zvp.htm>.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Securities and Capital Markets or Corporate Governance in the “Our Practice” section of our website (<http://www.clearygottlieb.com>).

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⁵ See SEC Rel. No. 33-8818, 34-55998, International Series Release No. 1302 (July 2, 2007).

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