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Securities and Exchange Commission Votes to Propose Interpretative Guidance for Management to Improve Sarbanes Oxley Section 404 Implementation and Adopt Amendments to the Proxy Rules Under Section 14 of the Exchange Act

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At an open meeting held December 13, 2006, the Securities Exchange Commission ("SEC") voted to propose interpretative guidance for management to improve Sarbanes-Oxley Section 404 implementation. The SEC also proposed amendments to Rules 13a-15 and 15d-15 that would make it clear that a company choosing to perform an evaluation of internal control in accordance with the interpretive guidance would satisfy the annual evaluation required by those rules. The SEC also voted to adopt amendments to the proxy rules under Section 14 of the Securities Exchange Act of 1934 that will give issuers greater latitude in using electronic proxies.

Sarbanes-Oxley Section 404(a) Guidance

Section 404 Generally

Section 404(a) of the Sarbanes-Oxley Act directed the SEC to adopt rules requiring each annual report of a publicly traded company (other than registered investment companies) to contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting.

On June 5, 2003, the SEC adopted rules implementing Section 404(a) with respect to management's obligations to report on its internal control over financial reporting. The final rules did not prescribe any specific method or set of procedures for management to follow in performing its evaluation.

The new proposal would amend the SEC's rules adopted in 2003 to state that an evaluation conducted in accordance with the interpretive guidance would satisfy the SEC's rules. However, in order to retain the flexibility that was desired by the 2003 rules, the proposed amendments would afford management the latitude to either follow the interpretive guidance or to develop and use other methods that achieve the objectives of the SEC's 2003 rules.

Proposed Section 404(a) Guidance

The proposed guidance is principles-based guidance that is organized around two important principles:

- First, management should evaluate the design of the internal controls over financial reporting that it has implemented to determine whether there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a timely manner. This principle promotes efficiency by allowing management to focus on those controls that are needed to prevent or detect a material misstatement in the financial statements.
- Second, management should gather and analyze evidence about the operation of the internal controls over financial reporting being evaluated based on its assessment of the risk associated with those controls. The principle allows

management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable financial reporting.

By following these two principles, the SEC believes that companies of all sizes and complexities will be able to implement its rules more effectively and efficiently. As smaller public companies often have less complex internal control systems than larger public companies, this proposed approach would enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.

The proposed guidance describes a risk-based approach and addresses many of the concerns that have been raised to the SEC including: excessive testing of controls generally; excessive documentation of processes, controls, and testing; and the ability to scale the evaluation to smaller companies. The guidance addresses four specific areas including:

- Identification of risks to reliable financial reporting and the related controls that management has implemented to address those risks. The proposed guidance describes a risk-based approach that would require the use of judgment to determine those areas that are both material and which pose a risk to reliable financial reporting. Management would then identify the controls that address those risks, including the risk of material misstatement due to fraud. The guidance would not require that every control in a process be identified. Once those controls are identified that adequately address the risk of material misstatement in the financial statements, it would be unnecessary to include additional controls within management's evaluation.
- Evaluation of the operating effectiveness of controls. Once management has determined the controls within the scope of its evaluation, management would then gather and analyze evidence about the operation of those controls. The proposed guidance provides for a risk-based approach that would require the use of judgment to direct management's evaluation efforts towards those areas that pose greatest risk to reliable financial reporting based on the company's unique facts and circumstances. The proposed guidance would allow management to support its evaluation in a variety of ways and illustrates how management can consider and utilize its existing daily interaction with its business, self-assessment, and other ongoing monitoring activities to support its evaluation.
- Reporting the overall results of management's evaluation. Once management has completed its evaluation, management must decide if any identified control deficiencies are material weaknesses. The proposed guidance provides management with a framework, outside of the auditing literature, for making these judgments and includes situations that are considered strong indicators that a material weakness exists. The guidance describes the factors that management should consider to evaluate the severity of a deficiency. If the deficiency is a material weakness, consistent with the SEC's existing rules, management must conclude that internal control over financial reporting is not effective and management has reporting responsibilities surrounding that material weakness. In addition, the guidance addresses the disclosure requirements for internal control reports in situations such as scope limitations and restatements.
- Documentation. The proposed guidance explains the nature and extent of evidential matter that management must maintain in support of its assessment including how management has flexibility in approaches to documentation. The proposed guidance indicates that such documentation can take many forms, can be presented in a number of ways, and does not need to include all controls within a process that impacts financial reporting. The proposed guidance provides that the evidential matter maintained in support of the assessment would also include the methods and procedures it utilizes to gather and evaluate evidence and the basis for its conclusions about the controls related to individual financial reporting elements. The proposed guidance indicates that in those situations in which

management is able to rely on its daily interaction with its controls as a basis for its assessment, management may have limited documentation created specifically for the evaluation beyond documentation regarding how its interaction provided it with sufficient evidence.

Coordination with the Public Company Accounting Oversight Board

The SEC has also been working closely with the Public Company Accounting Oversight Board (the "Board") over the past few months to develop a new auditing standard that would supersede Auditing Standard No. 2, the Board's existing auditing standard on internal control over financial reporting. The proposed standard is expected to provide for more efficient, risk-based, scalable audits of internal control over financial reporting while retaining the important investor protection benefits. The Board has announced that it intends to consider proposing the new auditing standard at the Board's open meeting to be held next week on Tuesday, Dec. 19, 2006.

The full text of the proposal and changes to Rule 13a-15 and 15d-15 is not yet available.

E-Proxy Rule Amendments

In addition to the Sarbanes-Oxley Section 404(a) changes discussed above, the SEC voted to adopt amendments to its proxy rules that would allow companies to furnish proxy materials to shareholders through a "notice and access" model using the Internet. The SEC also voted to propose rule changes that would require companies and soliciting persons to follow the notice and access model for all solicitations not related to a business combination transaction in the future.

Internet Availability of Proxy Materials

Pursuant to amendments to the SEC's proxy rules, a company may, but is not required to, furnish proxy materials to shareholders through a "notice and access" model. A company choosing to follow the model must post its proxy materials on an Internet Web site and send a Notice of Internet Availability of Proxy Materials ("Notice") to shareholders at least 40 days before the meeting date. A proxy card may not accompany the Notice. However, a company may send a paper proxy card accompanied by another copy of the Notice ten days or more after it sending the initial the Notice.

The new alternative model for furnishing proxy materials seeks to substantially decrease the expense incurred by issuers to comply with the proxy rules and provide persons other than the company with a more cost-effective means to undertake their own proxy solicitations.

The Notice must be written in plain English and contain a prominent legend that advises shareholders of the date, time, and location of the meeting; the availability of the proxy materials at a specified Web site address; a toll-free phone number, e-mail address and a website that shareholders may use to request copies of the proxy materials; and a clear and impartial description of the matters to be considered at the meeting.

The company must send a copy of the materials within three business days after receiving a request from a shareholder. A shareholder may make a permanent election to receive all proxy materials in paper or by e-mail with respect to future proxy solicitations conducted by the company or soliciting person.

When a company or soliciting party chooses to rely on the notice and access model, brokers, banks and similar intermediaries must prepare and send their own Notices designed for beneficial shareholders. A beneficial shareholder desiring a paper or e-mail copy of the proxy materials must request one from the intermediary.

A soliciting person other than the company may follow the notice and access model in substantially the same manner as a company. However, its Notice must be sent to shareholders by the later of 40 days before the meeting or 10 days after the company filed its proxy materials. It may limit its solicitation to shareholders who have not previously requested paper or e-mail copies. But if the soliciting person sends a Notice to a shareholder, it must send that shareholder a paper or e-mail copy upon request.

This change in the proxy rule could make proxy contests less expensive.

The compliance date for the amendments is July 1, 2007. No person may comply with the notice and access model before that date.

The SEC also is proposing to require companies and soliciting persons to follow the notice and access model for all solicitations not related to a business combination transaction in the future. The proposed mandatory model would operate in substantially the same manner as the voluntary model. However, under the proposal, the Notice could be accompanied by a full set of proxy materials, including the proxy statement, annual report, and proxy card.

The full text of the detailed release is not yet available.

Left off the SEC's agenda were rule proposals dealing with shareholders' nomination of directors. The SEC had originally planned to propose new rules on October 18th. Until it proposes new rules, the SEC has said that the 2nd Circuit's decision in *AFSCME vs. AIG*, 462 F.3d 121 (2006), will stand, giving shareholders more power to nominate directors.

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