

## *SEC Meets on Proxy Rules, Accounting Standards and International Financial Reporting Standards*

*by Brian R. Boch, Jerry J. Burgdoerfer, Joseph P. Gromacki, William L. Tolbert, Jr. and Marc E. Harrison*

On July 25, 2007, the Securities and Exchange Commission (the "SEC") held an open meeting at which it: (1) voted to move forward with two separate proxy access rule proposals; (2) approved Auditing Standard No. 5, as recently adopted by the Public Company Accounting Oversight Board ("PCAOB"), and a definition of "significant deficiency"; and (3) published a Concept Release to solicit comments on the role of International Financial Reporting Standards (as published by the International Accounting Standards Board) ("IFRS") in the financial reports of United States issuers.

### **SEC Proposes Proxy Rules Concerning Shareholder Proposals.**

Current Exchange Act Rule 14a-8(i)(8) provides that a company may exclude from its proxy materials any shareholder proposal that "relates to an election for membership on the company's board of directors." The SEC Staff, in a series of no-action letters dating back to 1990, has interpreted this rule as allowing companies to exclude any shareholder proposal that would establish a process for conducting contested elections outside the framework of a traditional proxy battle. The SEC Staff's purpose behind its position has been to prevent the use of the shareholder proposal rules to circumvent of the proxy contest rules, which are designed to ensure that

shareholders receive adequate disclosure and an opportunity to make informed voting decisions in election contests.

In its *AFSCME v. AIG* decision last September, the U.S. Court of Appeals for the Second Circuit rejected this long-standing line of Rule 14a-8(i)(8) interpretations, on the grounds that the no-action letters were contrary to an earlier rule interpretation of the Staff and the Staff, in issuing these no-action letters, never explained its reasons for reversing its earlier interpretation. The court then held that the company could not exclude from its proxy materials a shareholder proposal to amend the company's bylaws in a manner that would allow shareholders to nominate candidates for the company's board of directors and require the company to include those nominees in the company's proxy materials. This Second Circuit opinion has led to uncertainty among practitioners about the application of Rule 14a-8 for these types of shareholder proposals.

In light of this issue, the Commissioners, in a 3-2 vote at the SEC's open meeting, voted to move forward with two separate rule proposals that we expect will present two alternative revisions to the proxy rules. Although the SEC Staff has not revealed the text of these proposals, based on statements made by SEC Staff members at the

open meeting, we expect that the first proposal will be to amend Rule 14a-8(i)(8) to codify the SEC Staff's interpretation of the election exclusion from its line of no-action letters. More specifically, under this proposal, a company would be able to exclude from its proxy materials any proposals that would result in an election contest, or that would initiate a process whereby shareholders could conduct a future election contest by requiring that the company's proxy materials include director candidates nominated by shareholders.

Based on statements made by SEC Staff members, we expect that the second proposal will be to require a shareholder nomination bylaw proposal if:

- the proposal relates to a change in the company's bylaws that would be binding on the company if approved;
- the proposal is submitted by a shareholder or shareholder group that has continuously held more than 5% of the company's stock for at least one year; and
- the shareholder or shareholder group has filed a Schedule 13D or Schedule 13G containing expanded disclosure about the proponent and its prior interactions with the company.

We also expect that the second proposal will include new rules that would facilitate greater online interaction among shareholders and between shareholders and management. We expect it will amend the proxy rules to remove current obstacles to electronic shareholder communications, clarify that a company or shareholder who maintains an electronic shareholder forum would not be liable for statements by any other participant in the forum, and clarify that participation in an electronic shareholder forum would not constitute a proxy solicitation.

The period for public comment extends for 60 days after the proposed rules are published in the Federal Register.

### **SEC Approves PCAOB Auditing Standard No. 5; Adopts Definition of "Significant Deficiency"**

**Approval of Auditing Standard No. 5.** The SEC also unanimously voted in favor of 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").

The new standard provides a top-down, risk-based approach intended to focus auditors on those areas that present the greatest risk to each audited company with respect to the adequacy of that company's internal controls.

On May 24, 2007, the PCAOB adopted Auditing Standard No. 5 replacing the previous internal control auditing standard, Auditing Standard No. 2. At its July 25 meeting, the SEC approved Auditing Standard No. 5 along with a related independence rule and conforming amendments. Auditing Standard No. 5 is aligned with new rules and SEC guidance applicable to issuers' evaluation of the effectiveness of internal controls over financial reporting that were adopted on May 23, 2007, and set forth in SEC

Auditing Standard No. 5 sets forth new professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal controls over financial reporting. At the open meeting, representatives of the PCAOB and the SEC staff highlighted some of the improvements new Auditing Standard No. 5 will provide.

- **Auditing Standard No. 5 is less prescriptive.** Many of the mandatory requirements that existed in Auditing Standard No. 2 have been removed. This allows for a top-down approach to planning the audit and frees the auditor to engage management in a more meaningful dialogue about the company's particular areas of risk and materiality. The auditor can then focus on performing tests in those particular areas where, in the auditor's judgment, the individual company most needs auditor review.
- **Auditing Standard No. 5 is scalable to better fit the size and complexity of any company.** There are notes throughout the new standard explaining how to apply the principles to smaller or less complex companies. Under the new standard, companies' control systems will not have to be designed to fit the audit standard, but rather to achieve the intended objective of improving the quality of financial statements.

- **Auditing Standard No. 5 will focus the Section 404 audit on the most important matters.** Auditing Standard No. 5 directs auditors to focus on those areas that present the highest risk, such as the financial statement close process and controls designed to prevent fraud by management. The new standard also makes clear that the focus of the audit is on the effectiveness of a company's internal controls (emphasizing those areas of highest risk) and not the adequacy of management's evaluation process.
- **Auditing Standard No. 5 includes a principles-based approach to determine when and where the auditor can use the work of others.** The new standard itself expressly permits auditors to use, in the internal control audit, testing and other internal control work performed by persons other than internal auditors. This principles-based approach is in fact based on the auditor's consideration of the objectivity and competence of those performing the work. These two factors are the most important considerations in the auditor's determination of when and to what extent the auditor can use the work of others.

**Adoption of a Definition of "Significant Deficiency:"** The SEC also adopted a definition of "significant deficiency." The term is 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 the registrant's financial reporting. This definition is used in the context of evaluating the required communications under both Sections 302 and 404 of the Sarbanes-Oxley Act of 2002 and the SEC's implementing rules, and supplements the definition of

"material weakness" defined by the Commission in Rules 12b-2 and Rule 1-02 of Regulation S-X.

### **SEC Solicits Public Comment on the Role of IFRS in Financial Reporting of United States Issuers.**

In addition to the proposed changes to proxy rules and the adoption of PCAOB's Auditing Standard No. 5, the SEC Commissioners voted unanimously to publish a Concept Release calling for public comment on the role of International Financial Reporting Standards (as published by the International Accounting Standards Board) (IFRS) in the U.S. capital markets and on whether and to what extent U.S. issuers, including investment companies, should be allowed to prepare their financial statements using International Financial Reporting Standards (IFRS).

Under the SEC's current rules, U.S. issuers are required to prepare financial statements in accordance with accounting principles that are generally accepted in the United States (U.S. GAAP). The Concept Release is an information-seeking document that describes the policy issues and, in the form of questions, seeks public input regarding the possibility of allowing U.S. issuers to report under IFRS.

On June 20, 2007, the Commission proposed to eliminate the requirement that foreign private issuers using IFRS reconcile their financial statements to U.S. GAAP. At its July 25 open meeting, the Commission addressed a more far-reaching prospect – the possible choice by U.S. issuers to use IFRS instead of U.S. GAAP in their financial reporting. As nearly 100 countries require or allow the use of IFRS, this move by the SEC is a noteworthy step toward one set of accounting standards for all reporting companies.

The comment period extends for 90 days after the Concept Release is published in the Federal Register.

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### **For more information, please contact the following Jenner & Block attorneys:**

#### **Brian R. Boch**

Partner  
Tel: 312 923-2880  
Email: bboch@jenner.com

#### **William L. Tolbert, Jr.**

Partner  
Tel: 202 639-6038  
Email: wtolbert@jenner.com

#### **Jerry J. Burgdoerfer**

Partner  
Tel: 312 923-2820  
Email: jburgdoerfer@jenner.com

#### **Marc E. Harrison**

Associate  
Tel: 312 923-8333  
Email: mharrison@jenner.com

#### **Joseph P. Gromacki**

Partner  
Tel: 312 923-2637  
Email: jgromacki@jenner.com