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SEC/Corporate

SEC Votes to Propose Interpretive Guidance for Management to Improve Sarbanes-Oxley 404 Implementation

On December 13, the Securities and Exchange Commission voted to propose for public comment interpretive guidance for managements regarding their evaluations of internal control over financial reporting.

Section 404(a) of the Sarbanes-Oxley Act directed the Commission to adopt rules requiring each annual report of a company, other than a registered investment company, to contain (i) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (ii) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls structure and procedures for financial reporting. However, the Commission's final rules adopted in 2003 did not prescribe any specific method or set of procedures for management to follow in performing its evaluation and management often looked to Auditing Standards for guidance. The new proposals would amend the Commission's rules to state that an evaluation conducted in accordance with the SEC's new interpretive guidance would satisfy the Commission'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 Commission's 2003 rules.

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

First, management should evaluate the design of the controls 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 material misstatement in the financial statements.

Second, management should gather and analyze evidence about the operation of the controls being evaluated based on its assessment of the risk associated with those control. 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.

The proposed guidance describes a risk-based approach and addresses many of the concerns that have been raised to the Commission 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;
- Evaluation of the operating effectiveness of controls;
- Reporting the overall results of management's evaluation, including material weaknesses; and
- Documentation.

In addition, the Commission noted that the Public Company Accounting Oversight Board will be proposing next week a new Auditing Standard that will supersede Auditing Standard No. 2. Comments on the proposed interpretative guidance and rule amendments will be due no later than 60 days from their publication in the Federal Register.
http://www.sec.gov/news/press/2006/2006-206.htm

SEC Votes to Adopt E-Proxy Rule Amendments

On December 13, the Securities and Exchange Commission voted to adopt amendments to its proxy rules that would, beginning July 1, 2007, allow companies to furnish proxy materials to shareholders through a “notice and access” model using the Internet. Pursuant to the amendments to the proxy rules, a company may, but will not required to, furnish proxy materials to shareholders by posting its proxy materials on an Internet web site and sending a notice (meeting specified content requirements) of internet availability to shareholders at least 40 days before the meeting date. A proxy card may not accompany the notice. The rules for a soliciting person other than the Company are similar, but its notice must be sent by the later of 40 days before the meeting or 10 days after the Company filed its proxy materials. The Commission also voted to propose rule changes that would, in the future, require companies and soliciting persons to follow the notice and access model for all solicitations not related to a business combination transaction.
http://www.sec.gov/news/press/2006/2006-209.htm

SEC Votes to Repropose Rules Allowing Foreign Private Issuer Deregistration Under the Exchange Act

On December 13, the Securities and Exchange Commission voted to repropose amendments to the rules that govern when a foreign private issuer may terminate the registration of a class of equity securities under Section 12(g) of the Securities Exchange Act of 1945 and the corresponding duty to file reports required under Section 13(a) of the Exchange Act, and when it may cease its reporting obligations regarding a class of equity or debt securities under Section 15(d) of the Exchange Act. Under the current rules, a foreign private issuer may exit the Exchange Act registration and reporting regime if the class of the issuer's securities has less than 300 record holders who are U.S. residents. Moreover, currently a foreign private issuer can only suspend, and cannot terminate, a duty to report arising under Section 15(d) of the Exchange Act.

Reproposed Exchange Act Rule 12h-6 would permit the termination of Exchange Act reporting regarding a class of equity securities under either Section 12(g) or Section 15(d) of the Exchange Act by a foreign private issuer that meets a quantitative benchmark designed to measure relative U.S. market interest for that class of securities, which does not depend on a head count of the issuer's U.S. security holders. The reproposed benchmark would require the comparison of the average daily trading volume of an issuer's securities in the United States with that in its primary trading market. If the U.S. average daily trading volume has been no greater than 5 percent of the average daily trading volume in the issuer’s primary trading market during a recent 12 month period, and all other conditions are met, reporting is permitted to terminate. Because the Commission did not fully address this approach when it originally proposed Rule 12h-6 last December, and because of other proposed changes to Rule 12h-6 not fully discussed in the original rule proposal, it has reproposed Rule 12h-6 and the accompanying rule amendments. The

Commission is also reproposing amendments to Rule 12g3-2(b) to increase its availability to foreign private issuers.
http://www.sec.gov/news/press/2006/2006-207.htm

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Banking

Federal Banking Regulators Issue Revised Interagency Policy on the Allowance for Loan and Lease Losses

On December 13, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the National Credit Union Administration and the Office of Thrift Supervision issued a new interagency policy statement on the Allowance for Loan and Lease Losses (ALLL) and supplemental FAQs that focus on topics about which examiners, institutions and accountants frequently inquire. The previous guidance was issued in 1993.

As described in the press release, the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. As such, this revision "reiterates key concepts and requirements included in GAAP and existing ALLL supervisory guidance."

According to the Interagency Statement, institutions must arrive at an appropriate allowance which "involves a high degree of management judgment and results in a range of estimated losses." Moreover, the allowances should be "prudent and conservative" but not "excessive."
http://www.occ.treas.gov/

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Broker Dealer

SEC Extends Order Regarding Broker-Dealer Financial Statement Requirements

The Securities and Exchange Commission has extended the deadline by which non-public broker-dealers must file financial statements that have been certified by a registered public accounting firm. The order was originally issued in 2003 and was most recently extended on December 7, 2005. The 2005 order provided that non-public broker-dealers may file with the SEC and may send to their customers documents and information required by Section 17(e) of the Securities Exchange Act of 1934 certified by an independent public accountant, instead of by a registered public accounting firm, for fiscal years ending before January 1, 2007. The original order was issued in response to the Sarbanes-Oxley Act of 2002. Under the 2006 SEC order, all non-public broker-dealers may file with the SEC a balance sheet and income statement, and may send to their customers a balance sheet that has been certified by an independent public accountant, instead of by a registered public accounting firm, for fiscal years ending before January 1, 2009.
http://www.sec.gov/rules/other/2006/34-54920.pdf

SEC Proposes Amendments to Regulation M Concerning Short Selling in Connection with a Public Offering

The Securities and Exchange Commission has proposed amendments to Rule 105 of Regulation M. Rule 105 currently prohibits a person from covering a short sale made within the shorter of 5 days prior to the pricing date or the date the registration statement was filed with securities sold in the offering. To address what the SEC perceives as attempts to conceal Rule 105 violations, the SEC is proposing to amend the rule to eliminate the covering component. Thus, the proposed amendment would make it unlawful for a person to effect a short sale during a limited time period, shortly before pricing, and then purchase such security in the offering.
http://www.sec.gov/rules/proposed/2006/34-54888.pdf

SEC Approves Amendment to the Portfolio Margining Rules of NYSE and CBOE

The Securities and Exchange Commission approved the amendments to NYSE Rule 431 and CBOE Rule 12.4 (as parallel rule filings) previously proposed by the New York Stock Exchange and the Chicago Board Options Exchange, respectively. The approved amendments expand the scope of products that are eligible for portfolio margining, eliminate the $5 million minimum equity requirement for certain market participants, establish a simplified mechanism for carrying futures positions in a portfolio margining account and allow the offsetting of positions in equities, options and futures for purposes of determining the required margin maintenance as well as numerous other technical and clarifying amendments.

Specifically, the amendments broaden the list of eligible instruments to include any “margin equity security,” as well as unlisted derivatives and futures contracts on narrow-based security indexes. The amendments also eliminate the $5 million minimum equity requirement for market participants that are not broker-dealers or members of a futures exchange except in cases where the portfolio margining calculation includes unlisted derivatives. The special day-trading margin requirements would continue to apply, however, to portfolio margin accounts that have less than $5 million in equity unless the trades are part of a hedge strategy. The amendments also strengthen the requirement adopted in the pilot which requires member broker-dealers to monitor the risk of portfolio margin accounts and maintain a written risk analysis methodology for assessing potential risk to the firm’s capital, by providing that the member broker-dealer must file the risk analysis methodology with the firm’s designated examining authority or the relevant exchange and submit it to the SEC prior to implementation. Finally, the amendments extend portfolio margining treatment to futures and futures option positions, but only to the extent that they are carried in a portfolio margin account, as opposed to a “cross-margin” account, and eliminate the requirement to remove instruments that are no longer offset by options positions.

Additionally, the SEC approved Amendment No. 1 to the revised NYSE Rule 431 on an accelerated basis. The changes proposed by the NYSE are designed to ensure consistency with the CBOE proposed rule filing, to respond to comments received as a result of the Federal Register notice and to otherwise clarify certain terms and definitions.
http://www.sec.gov/rules/sro/cboe/2006/34-54919.pdf
http://www.sec.gov/rules/sro/nyse/2006/34-54918.pdf

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Investment Advisor and Investment Company

SEC Proposes New Antifraud Rule and Revises Accredited Investor Standard for Hedge Funds

On December 13, the Securities and Exchange Commission unanimously approved two proposed rules regarding hedge funds in the post-Goldstein era. In Goldstein v. SEC, the D.C. Court of Appeals vacated an SEC rule that required most investment advisers to hedge funds register under the Investment Advisers Act of 1940.

New Antifraud Rule

The SEC proposed a rule under Section 206(4) of the Advisers Act that seeks to address an unintended side effects of the Goldstein decision. The rule would make it a fraudulent, deceptive, or manipulative act for an investment adviser to make false or misleading statements or to otherwise defraud investors or prospective investors in a pooled investment vehicle. Commissioner Atkins noted that the SEC's proposed rule is not a change in substantive law, but rather a clarification that the Section 206 general antifraud provision, which explicitly protects "any client or prospective client," covers both a fund (held to be the "client" in the Goldstein decision), and the individual investors in the fund.

Change in Accredited Investor Standard

The SEC proposed a two-prong "accredited investor" standard that would apply to natural persons seeking to invest in Section 3(c)(1) private funds. Private pooled investment vehicles typically rely on one of two exclusions from regulation under the Investment Company Act of 1940. Section 3(c)(7) excludes from the definition of "investment company" pooled investment vehicles that accept only "qualified purchasers." Natural persons must maintain a minimum of $5 million in net investments to be "qualified purchasers." Section 3(c)(1) excludes pooled investment vehicles that have no more than 100 beneficial owners of their outstanding securities and are not making or proposing to make a public offering. As a practical matter, most funds rely on the Regulation D private offering exemptions, which require that funds generally accept accredited investors.

While the proposed rule makes no change to the existing accredited investor requirement (established in 1982) that a natural person have at least $1 million in net worth (including home equity) and $200,000 ($300,000 if joint with spouse) in annual income in each of the past two years, it would add a second requirement that natural persons have $2.5 million in certain investments (excluding home equity). The purpose of the investment asset requirement is to improve measurement of an investor's level of investment sophistication. Essentially the same assets that count toward the qualified purchaser standard in Section 3(c)(7) would qualify as investments under the new standard.

The proposed investment requirement would apply only in offerings of private funds relying on Section 3(c)(1) and not in other Regulation D offerings. In addition, the SEC proposed to exempt venture capital funds from the requirement, noting its desire not to impinge on critical capital formation for small businesses.

If adopted, the new standard will not affect investors admitted to funds prior to its adoption, although those who do not meet the new investment standard will not be permitted to make further investments. The accredited investor standard would be indexed for inflation beginning on April 1, 2012 and every five years thereafter.
http://www.connectlive.com/events/secopenmeetings/
http://www.sec.gov/news/press/2006/2006-208.htm

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United Kingdom Developments

FSA Publishes Third International Regulatory Outlook Report

The UK Financial Services Authority (FSA) published its third International Regulatory Outlook report on December 13.

The IRO focuses on four main topics: (i) better regulation; (ii) consistent implementation of the European Financial Services Action Plan and common European standards; (iii) cross-border supervision; and (iv) future initiatives of which regulated firms' senior management should take notice. Particularly the key European directives being implemented in 2007 such as the Markets in Financial Instruments Directive, Capital Requirements Directive, Transparency Directive and the Third Money Laundering Directive. The Report also identified issues which particularly affected specific financial services sectors.
http://www.fsa.gov.uk/pubs/iro/iro_2006.pdf

FSA Consultation on Investment Entities Listing Review

On December 14, the Financial Services Authority (FSA) published Consultation Paper (CP06/21) setting out further proposals in relation to its Investment Entities Listing Review. The revised proposed changes to UK listing rules include:

- a proposal to permit investment companies incorporated outside the UK to obtain a London listing based on compliance with the minimum requirements of the EU Prospectus Directive rather than the more stringent listing rules applicable to UK investment companies;
- a proposal to remove the prohibition on closed-ended funds controlling companies in which they invest, thus allowing these private equity funds and other closed ended vehicles to pursue a wider range of investment strategies;
- clarification of the information which a primary listed closed-ended fund will have to include in the investment policy it will be required to publish and adhere to;
- revised proposals on the disclosure required in relation to the risk profile of an investment entity whose primary listing is in the UK. The aim of the revised proposals being to provide investors with sufficient information to evaluate an investment company's risk profile while addressing concerns that the FSA's earlier proposals required a disproportionate level of disclosure; and
- the introduction of new categories that more accurately reflect the listing obligations that attach to the different types of listing.

http://www.fsa.gov.uk/pubs/cp/cp06_21.pdf

Treasury Announces Working Group to Consider Taxation of UK Funds

On December 14, HM Treasury announced the establishment of a joint working group comprising representatives of the Investment Management Association (IMA), HM Treasury, and HM Revenue and Customs (HMRC) to consider key tax issues identified in recent studies of the effect of the UK tax regime on UK-based funds and fund managers, in particular the report *Taxation and the Competitiveness of UK*

Funds commissioned by the IMA. The working group will consider how to improve consultation and communication between HMRC and the fund management sector and will address a number of detailed technical issues.
http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/econsecspeeches/speech_est_141206.cfm

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Litigation

Granting of Stock Options May Constitute Public Offering of Securities

Plaintiff, one of the owners of a company that merged with defendant company, received options for shares of defendant company's stock concurrently with the merger. When defendants rejected plaintiff's attempt to exercise those options, claiming they had expired, plaintiff sued, alleging, among other things, that defendants had made untrue statements in violation of Section 12(a)(2) of the Securities Act of 1933. In rejecting defendants' argument that, as a matter of law, the stock option plan was a private offering immune from Section 12(a)(2)'s regulations, the Court relied on the test set forth in *S.E.C. v. Ralston Purina*, 346 U.S. 119 (1953), under which the determination of whether a securities offering is public or private depends on: (i) the number of offerees; (ii) their sophistication; (iii) the size and manner of the offering; and (iv) the relationship of the offerees to the issuer. Finding no evidence as to the level of sophistication of the 40 employees to whom the options were offered, the Court denied defendants' motion for summary judgment, holding that an issue of fact remained as to whether the offering was private or public. (*West v. Innotrac Corporation*, 2006 WL 3477610 (D. Nev. Nov. 29, 2006))

Court Reaffirms Dismissal of Securities Fraud Claim

Following the grant of defendants' Rule 12 motion to dismiss the Second Amended Complaint on a "with prejudice" basis, plaintiffs moved for reconsideration of the district court's decision. Plaintiffs argued that, among other things, the Court failed to properly consider the legal significance of documents affixed to the declaration submitted by one of plaintiffs' attorneys in opposition to the dismissal motion. Plaintiffs argued that these documents sufficiently supported their argument that the defendant officers and directors knowingly violated generally accepted accounting principles (GAAP) and federal securities laws. Relying on Third Circuit precedent, plaintiffs contended that the documentation, including information from confidential sources, established a pattern of GAAP violations that amounted to securities fraud under the Securities and Exchange Act of 1934. After noting that violations of GAAP, standing alone, are insufficient to state a securities fraud claim, the Court ruled that, among other things, the plaintiffs had not established the requisite strong inference of scienter. The Court explained that none of the documents demonstrated that the individual defendants knowingly committed any accounting violations or that the accounting violations were brought to their attention. Further, plaintiffs' assertions that defendants "must have known" of the GAAP violations because of their senior positions within the company also failed to provide a sufficient basis for imputing knowledge of the alleged violations to the individual defendants. (*Payne v. DeLuca, 2006 WL 3590014* (*W.D. Pa. Dec. 11, 2006*))

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CFTC

CFTC Commissioner Frederick W. Hatfield to Resign

Commodity Futures Trading Commission Commissioner Frederick W. Hatfield has submitted a letter of resignation to President George W. Bush, effective December 31. Commissioner Hatfield was nominated as a Commissioner of the CFTC by President Bush in 2004 and has served since December 6 of that year.
http://www.cftc.gov/opa/press06/opa5264-06.htm

NFA Amends Interpretive Notice Regarding FCM and IB Anti-Money Laundering Programs

The National Futures Association has amended its "Interpretive Notice to Compliance Rule 2-9: FCM and IB Anti-Money Laundering Programs" to include all Futures Commission Merchant and Introducing Broker anti-money laundering requirements that have been adopted by the Financial Crimes Enforcement Network and/or the Commodity Futures Trading Commission since NFA first issued the interpretive notice in April 2002. The amendments to the notice do not expand FCM and/or IB responsibilities, but rather consolidate the current requirements into one document.
http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=1716

NFA Proposes Amendment to Forex Dealer Financial Requirements

The National Futures Association recently proposed to increase the minimum adjusted net capital that must be maintained by a forex dealer member (FDM). Section 11 of the NFA Financial Requirements currently provides that an FDM must maintain minimum adjusted net capital equal to the greater of $1 million or 1% of the total net aggregate notional value of all open forex futures and options transactions in retail customer and non-customer accounts. Under the proposed amendment, FDMs would be required to maintain capital equal to the greater of $1 million or 5% of all liabilities owed to retail customers.
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1705

NFA Proposes Rule Regarding Assignment and Liquidation of Forex Positions and Cessation of Customer Business

The National Futures Association has proposed a new Compliance Rule 2-40 to govern the bulk assignment and liquidation of retail customers' open forex positions by a forex dealer member. The proposed rule permits a forex dealer member (FDM) to assign customers' open positions and transfer account balances to certain assignees where the FDM obtains each customer's prior written consent or notifies each customer of the contemplated assignment or transfer at least seven days before it occurs. The proposed rule further requires the FDM to notify and provide pertinent information to NFA's Compliance Department to allow NFA to monitor the transfer of positions or the closing of the FDM's business. Finally, the proposed rule states that the assignee FDM may not accept orders initiating new positions until it has provided all necessary disclosures to, and obtained all required information from, the assigned customer.
http://www.nfa.futures.org/news/newsRuleSubLetter.asp?ArticleID=1699

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