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SEC/Corporate

SEC Issues Concept Release Concerning Management's Report on Internal Control Over Financial Reporting

Following its May 10 Roundtable devoted to Sarbanes-Oxley Section 404 implementation issues, the Securities and Exchange Commission issued a roadmap for improvements entitled "Next Steps for Sarbanes-Oxley Implementation" (SEC Press Release 2006-75, May 17, 2006). On July 11, the SEC published a concept release that is one of the steps in the roadmap, soliciting public comment on contemplated additional guidance to management of public companies that are subject to the SEC's rules related to management's assessment of internal control over financial reporting.

The SEC anticipates that the forthcoming guidance for management (which will ultimately be in the form of a rule) will cover at least these areas:

- Identifying risks to financial statement account and disclosure accuracy and the related internal controls that address the risks, including how management might use company-level controls to address the risks;
- Objectives of the evaluation procedures and methods or approaches available to management to gather evidence to support its assessment;
- Factors management should consider to determine the nature, timing, and extent of its evaluation procedures; and
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements.

The concept release seeks feedback on each of these topics and on whether guidance should be provided in other areas as well.

The full text of the SEC's concept release is available at http://www.sec.gov/rules/concept/2006/34-54122.pdf

COSO Releases New Guidance for Smaller Companies

On July 11, the Committee of Sponsoring Organizations (COSO) published new guidance on its internal control framework to address the needs of smaller businesses in fulfilling the requirements of Section 404

of the Sarbanes-Oxley Act. The COSO guidance also was among the items discussed by the SEC in its May 17 roadmap for improvements in Section 404 implementation.
The guidance provides an overview, in three volumes, of internal control over financial reporting in smaller businesses, including the 20 basic principles and 75 related attributes and approaches in the COSO framework, examples of how smaller businesses can apply the principles in a cost-effective manner and illustrative tools to assist management in evaluating internal controls. The guidance reiterates the five basic components of the COSO framework that work together as a means to achieving effective internal control over financial reporting: (1) Control Environment, (2) Risk Assessment, (3) Control Activities, (4) Information and Communication and (5) Monitoring. The guidance provides no definition of "smaller" companies, but sets out several characteristics of a "smaller" company, suggesting a wide range of companies to which the guidance is directed.

The report stresses a risk-based approach that is believed to "bring significant efficiencies to internal controls," and states that "the extent of documentation supporting design and operating effectiveness of the five internal control components is a matter of judgment, and should be done with cost-effectiveness in mind." COSO expressed its desire that the new guidance "may be useful to management in more efficiently assessing internal control effectiveness in the context of assessment guidance provided by regulators."
http://www.coso.org/Publications/SB_Executive_Summary.pdf
http://www.coso.org/Publications/SB_FAQs.pdf
http://www.iian.ibeam.com/events/aicp001/15941

Delaware Adopts Amendments for Majority Voting

The Delaware legislature has adopted amendments to the Delaware General Corporation Law facilitating the adoption of a majority standard for the election of directors. Section 141(b) is amended to provide that a director resignation can be made effective upon a future event, coupled with the authority to make such a resignation irrevocable if the director fails to achieve a specified vote for re-election. Section 216(b) is amended to provide that a by-law adopted by stockholders that prescribes the vote required for director elections may not be further amended or repealed by the board of directors.

The new amendments, which are effective August 1, demonstrate the continuing momentum of the majority voting movement, and the adoption of the amendments should give further impetus to the majority voting movement for next year's proxy season.
http://www.legis.state.de.us/LIS/lis143.nsf/vwlegislation/sb+322/$file/2381430398.doc?open

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Broker Dealer

NASD Files Proposed Rule Change to Amend the Safe Harbor for Business Expansion

The National Association of Securities Dealers, Inc. filed with the Securities and Exchange Commission a proposed rule change to amend NASD Interpretive Material 1011-1, the Safe Harbor for Business Expansions. The proposed rule change would limit the types of violations of NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade) that would result in a member being ineligible to use the safe harbor for business expansions and to make certain technical changes. The amended rule concerns

the types of business expansions that will not require a member to submit a Rule 1017 application to obtain the NASD's pre-approval of the expansion. NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations) requires that a member submit an application to NASD for approval prior to, among other things, making a ''material change in business operations,'' which is defined in NASD Rule 1011. NASD IM-1011-1 creates a safe harbor for certain types of expansions that do not require NASD approval. This safe harbor applies to: (1) firms that do not have a membership agreement, and (2) firms that have a membership agreement that does not permit expansion beyond certain limits. In addition, the NASD proposed to make a technical correction to the rule text with respect to the inclusion of Section 15(b)(4)(E) of the Securities Exchange Act of 1934 in the list of rules the violation of which would preclude a member from relying on the safe harbor. The proposed rule change clarifies that a member would be ineligible to use the safe harbor in the event that a member or any of its principals has been found to have engaged in one or more violations of the type specified in Section 15(b)(4)(E) in the past five years.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-10434.pdf

SEC Plans Investment Adviser Broker-Dealer Regulation Study

The Securities and Exchange Commission announced that it plans to use an outside contractor for a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect individual investors. The study was announced in April 2005 when the SEC adopted Investment Advisers Act Rule 202(a)(11)-1, which allows broker-dealers to offer fee-based brokerage accounts without being required to register as investment advisers pursuant to the Investment Advisers Act of 1940. The recent request for information published by the SEC provides that a contractor conducting the study must have a proven track record of producing high quality, unbiased, qualitative and quantitative research and be knowledgeable about the subject matter of the study. The release further states that the contractor would summarize and evaluate the data for the use of the SEC in assessing the current legal and regulatory environment. The study's core objectives include, but are not limited to: (i) identifying the financial products, accounts, programs and services, including advisory services such as financial planning and discretionary asset management, provided to individual investors by broker-dealers and investment advisers, and the context in which they are provided, (ii) determining the fees and costs paid by individual investors for the products, accounts, programs and services provided, (iii) determining how and from what other sources broker-dealers, investment advisers and their associated persons are compensated for the different financial products, accounts, programs and services they offer to individual investors, and (iv) identifying the information provided to individual investors, whether orally, in sales literature, required statements, or in account agreements, regarding the products, accounts, programs and services provided, including the nature of the responsibilities that the broker-dealer or investment adviser owes to the investor and any contractual limitations on those responsibilities. The SEC usually conducts studies of this type through its staff; the use of an outside contractor may signify a more ambitious effort.
http://www.sec.gov/news/press/2006/2006-106.htm

NASD Files Amendment to Create the Nasdaq Global Select Market and Rename the Nasdaq National Market

The National Association of Securities Dealers, Inc. filed with the Securities and Exchange Commission a rule amendment to rename the Nasdaq National Market as the Nasdaq Global Market and to create the Nasdaq Global Select Market, a new tier within the Nasdaq Global Market with higher initial listing standards. Nasdaq's proposal to rename the Nasdaq National Market as the Nasdaq Global Market is intended to reflect the international reach and leadership of many of the companies listed on that market and the market itself. Nasdaq also proposed to create a new segment within the Nasdaq Global Market to be known as the Nasdaq Global Select Market, and new, higher initial listing requirements would apply to

companies listing on the Nasdaq Global Select Market. All listing and trading rules applicable to securities on the Nasdaq Global Market would also apply to the Nasdaq Global Select Market. Nasdaq believes that the creation of this segment would more clearly align Nasdaq's financial and liquidity listing standards with its corporate governance standards and its regulatory enforcement program, as well as its trading system. While Nasdaq believes its existing standards protect investors, Nasdaq also believes that, to the extent these higher initial listing standards help attract and maintain listings on Nasdaq and identify companies that meet these high listing standards, investors would benefit. Companies on the Nasdaq Global Select Market would be required to meet the same rigorous corporate governance standards applicable to companies on the Nasdaq Capital and Nasdaq Global Markets. These standards require a majority independent board, an independent audit committee, and for independent directors to participate in compensation and nomination decisions. Shareholders are also required to approve significant transactions and the use of equity compensation.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-6038.pdf

SEC Grants Nasdaq National Market Securities Short Sale Exemption

The Securities and Exchange Commission has granted the NASD's February 16, 2006 Request for exemption from Rule 10a-1 under the Securities Exchange Act of 1934 to permit (1) Nasdaq National Market securities traded over-the-counter and reported to a NASD facility to be subject to proposed NASD Rule 5100 rather than Rule 10a-1, which governs short sales of securities; and (2) Nasdaq Capital Market securities traded over-the-counter and reported to a NASD facility to not be subject to either Rule 10a-1 or proposed NASD Rule 5100, and to remain uncovered by any price test. The SEC provided the exemption from Rule 10a-1 subject to the following conditions: (1) the continued application of NASD Rule 3350 (or, when renumbered, NASD Rule 5100) to Nasdaq National Market securities; (2) the NASD will issue a Notice to Members regarding what activity would not be deemed bona fide market making activity for purposes of claiming the exception to NASD Rule 5100's bid test; and (3) the NASD will implement a surveillance program to monitor whether firms claiming the bona fide market maker exception in NASD Rule 5100 are engaged in bona fide market making activity. The exemption is effective until completion of the Pilot Program or at such other time if the SEC determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.
http://www.sec.gov/divisions/marketreg/mr-noaction/nasd062606.pdf

No-Action Letter Denied to Finder for an Investment Bank

In a June 29 letter to counsel, the staff of the Securities and Exchange Commission denied a no action request from broker-dealer registration under the Securities Exchange Act of 1934 to a finder that would receive a portion of the broker dealer's investment banking fee. Under the no-action request a finder for a broker-dealer would introduce growth companies seeking additional capital to the broker dealer. The broker-dealer would pay the introducer a referral fee equal to a portion of the investment banking fee received from the private placement of securities of the growth company. The introducer would not be involved in the negotiation of the transaction with the broker-dealer, would not discuss the details of the transaction, and would not make any investment recommendations. The broker-dealer and the issuer would negotiate the transaction, and only the broker-dealer would handle the placement. Notwithstanding these limitations, the request for a no-action determination was denied.
http://www.sec.gov/divisions/marketreg/mr-noaction/loofbourrow062906.htm

SEC Approves NASD Rule on Disclosures When Trading Net

The Securities and Exchange Commission approved adoption of Rule 2441 by the National Association of Securities Dealers, Inc. Rule 2441 requires written pre-trade disclosure and consent on an order-by-order basis when a member firm is trading net with non-institutional customers. When the member is trading net with institutional customers, the member may either (1) issue a negative consent letter to the customer, or (2) on a trade-by-trade basis orally explain the terms and conditions for handling the order and obtain the institutional customer's oral consent. In the case of orders placed by a fiduciary for a non-institutional customer, the member may look to the status of the fiduciary for purposes of Rule 2441. In the case of orders placed with a member firm by another broker-dealer for the benefit of a customer of the placing broker-dealer, the executing firm need not comply with Rule 2441, but the placing broker-dealer must comply.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-10718.pdf

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Banking

FDIC Issues Updates in Light of Increased Deposit Insurance Coverage

On April 1, deposit insurance coverage for certain retirement plan deposits increased from $100,000 to $250,000. The basic insurance amount for all other ownership categories remains unchanged. As a result of the changes in insurance coverage, the Federal Deposit Insurance Corporation is updating all of its publications and other resources on deposit insurance coverage for consumers and bankers.

The FDIC recently released updated versions of its three most widely used publications – *Insuring Your Deposits* (English), *Your Insured Deposits* (English), and *Financial Institution Employee's Guide to Deposit Insurance Coverage*. The FDIC is now releasing updated versions of the following products:

- *FDIC's Inventory of Deposit Insurance Guidance*, which is a CD-ROM with a searchable database of deposit insurance information categorized by topic, links to all FDIC deposit insurance publications and resources, detailed questions and answers, and an A-to-Z glossary of deposit insurance terms.
- *FDIC's Video-Overview on Deposit Insurance Coverage*, which is a 30-minute video that reviews the most common categories of insurance coverage. It can be viewed on the FDIC's Web site and is available to bankers on VHS, DVD and CD-ROM.
- *Electronic Deposit Insurance Estimator – Banker Version*, which allows bank personnel to calculate insurance coverage of customers' accounts. It is available on CD-ROM or downloadable from the FDIC 's Web site.
- *Insuring Your Deposits* (Spanish), which provides a basic overview of FDIC deposit insurance coverage.
- *Your Insured Deposits* (Spanish), which provides a comprehensive explanation of FDIC 's deposit insurance coverage rules.

http://www.fdic.gov/deposit/deposits/

FDIC Proposes New Risk-Based Insurance Assessment System

The Federal Deposit Insurance Corporation's Board of Directors, on July 11, approved for public comment two proposed rules governing deposit insurance assessments under the Federal Deposit Insurance Reform Act of 2005 (the Reform Act). One proposal would create a new system that would more closely tie what banks pay for deposit insurance to the risks they pose. It also would adopt a new base schedule of rates that the FDIC Board could adjust up or down, depending upon the revenue needs of the insurance fund. The second proposal issued would continue to set the designated reserve ratio (DRR) for the fund at 1.25 percent of estimated insured deposits.

Comments on the proposed rules are due within 60 days of publication in the Federal Register, which is expected to occur within a week.

In a related action, the FDIC Board also issued for comment a proposed new official sign for institutions to display at teller stations and elsewhere. The proposal also would, for the first time, require both banks and savings associations to use the same sign and rules for advertising FDIC membership. Comments on this proposed rule are also due within 60 days of publication in the Federal Register.

The proposed rules issued today are in addition to three others governing deposit insurance assessments that the Board approved for public comment on May 9, including a proposed rule that would allocate a one-time $4.7 billion assessment credit among insured institutions. Comments on these earlier published rules are due August 16.

The Reform Act requires the FDIC to prescribe final regulations in these areas by November 5.
http://www.fdic.gov/news/news/press/2006/pr06070a.pdf
http://www.fdic.gov/news/news/press/2006/pr06070b.pdf

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Litigation

LLC Member Has Common Law Standing to Pursue Derivative Claims on LLC's Behalf

A member of a limited liability company alleged that defendants, controlling members and managers of the LLC, diverted millions of dollars in profits to an affiliated company in which they had a greater ownership interest. Rejecting defendants' arguments that plaintiff lacked standing to sue derivatively on behalf of the LLC, the Court held that LLC members had rights to pursue derivative claims under common law similar to the rights of corporate shareholders and limited partners. In its view, the exclusion of a derivative suit provision from the New York Limited Liability Company Law did "not necessarily signify an intent to eliminate derivative rights that undoubtedly existed under the common law." In reaching its determination and denying defendants' motion to dismiss, the Court declined to follow lower state court decisions to the contrary. (*Bischoff v. Boar's Head Provisions Co., Inc*., 2006 WL 1793653 (S.D.N.Y. June 29, 2006))

Complaint Dismissed for Failure to Plead Economic Loss

Plaintiff asserted federal securities law and common law claims alleging that defendants, a private equity partnership and its general partner, issued a materially misleading Private Placement Memorandum on

which plaintiff relied in investing in the partnership. Upon receipt and review of the partnership's subsequent financial statement, which had not been available when plaintiff made its investment, plaintiff determined that defendants materially overstated the past performance of the partnership's largest asset. Finding the "record is devoid of any evidence that the value of [plaintiff's] partnership interest has actually declined," or that any such decline would have been attributable to defendants' alleged fraud, the Court granted summary judgment dismissing plaintiff's federal securities law claims; in addition, it declined to exercise supplemental jurisdiction over plaintiff's common law claims. (*JSMS Rural LP v. GMG Capital Partners III, LP*, 2006 WL 1867482 (S.D.N.Y. July 6, 2006))

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CFTC

CFTC and SEC Jointly Enact Rules Permitting Trading of Futures on Debt Indexes and Debt Securities

The Commodity Futures Trading Commission and the Securities and Exchange Commission jointly issued final rules permitting the trading of futures and futures options on debt indices and debt securities. The final rules provide that futures on an exempted security – including for this purpose U.S. Treasuries or sovereign debt of any of the twenty-one countries enumerated in SEC Rule 3a12-8 – or an index of such securities is not a narrow-based index and can, therefore, be traded on futures exchanges that are solely under the jurisdiction of the CFTC. A future on any other type of debt security index must be broad-based to avoid characterization as a "narrow-based security index," which would make such an index a "security futures product" subject to the joint jurisdiction of the CFTC and SEC. The new rules include criteria that also apply to narrow-based stock indices, such as the requirement for ten or more unaffiliated issuers, as well as standards that are specifically relevant to debt securities.
http://www.cftc.gov/opa/press06/opa5195-06.htm
http://www.cftc.gov/files/foia/fedreg06/foi060713a.pdf

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