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Corporate and Financial Weekly Digest

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SEC/Corporate

SEC Announces Next Steps for Sarbanes-Oxley Section 404 Implementation; Smaller Public Companies Will Be Required to Comply

On May 17, the Securities and Exchange Commission announced a series of actions it intends to take to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002. SEC Chairman Christopher Cox said that "by providing practical guidance to companies, by working with the Public Company Accounting Oversight Board on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost- effectiveness of the audit process, we will take a giant step toward 'getting it right' when it comes to Section 404 compliance." The SEC also indicated that it would provide a short postponement of the effective date of the rules implementing Section 404 for non-accelerated filers, but that it expects that all filers will be required to comply with the management assessment required by Section 404(a) for fiscal years beginning on or after December 16, 2006. The actions the Commission expects to take include:

- Providing additional guidance for management on how to complete its assessment of internal control over financial reporting, as required by Section 404(a) of the Sarbanes-Oxley Act. The SEC intends to solicit views on the management assessment process by issuing a Concept Release seeking comment on issues for management guidance, the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) and the manner in which outside auditors provide the attestation required by Section 404(b). The SEC intends that such additional guidance will provide for top-down, risk-based assessment of internal control over financial reporting and will be scalable and responsive to the individual circumstances of non-accelerated filers and smaller public companies, while being sensitive to the fact that many companies have already invested substantial resources to establish and document programs and procedures to perform their assessments over the last few years.

- Working closely with the PCAOB on its revisions to its Auditing Standard No. 2. The SEC intends to ensure that the revisions cause auditors to focus on areas that pose higher risk of fraud or material error and clarify what, if any, role the auditor should play in evaluating the company's process of assessing internal control effectiveness.

- Focusing its oversight of the PCAOB Inspection Program on examining whether the inspections have been effective in encouraging implementation of the principles outlined in the PCAOB's May 1, 2006, statement. The PCAOB intends to focus its

2006 inspections on whether auditors achieved cost-saving efficiencies in the audits they have performed under AS No. 2, and on whether auditors have followed the guidance that the PCAOB issued in May and November 2005 urging them to do so.

The SEC acknowledged with appreciation the significant efforts and valuable contributions of its Advisory Committee on Smaller Public Companies, the PCAOB and the participants in the PCAOB's roundtable on second-year experiences with the reporting and auditing requirements promulgated by the Sarbanes-Oxley Act of 2002.
http://www.sec.gov/news/press/2006/2006-75.htm
http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx

Commissioner Glassman Announces Her Intention to Leave the SEC

On May 15, Securities and Exchange Commissioner Cynthia A. Glassman announced that she intends to leave the SEC after the completion of her current term on June 5, 2006.

Since joining the SEC in January 2002, Commissioner Glassman has advocated the use of better cost-benefit analysis in SEC decisions to promote more effective investor protection and improved disclosure to help investors make informed decisions. On May 8, at the Twelfth Annual CFO Summit, Commissioner Glassman expressed her belief that the most pressing regulatory issues confronting CFOs relate to the Sarbanes-Oxley Act of 2002, particularly Section 404, and the Public Company Accounting Oversight Board's Auditing Standard No. 2. She highlighted the following four areas as needing to be addressed: (1) companies need more practical guidance as to how to conduct their assessments and evaluate and document their internal controls, (2) the role of the auditor needs broad reconsideration, (3) absent significant modification to the auditor's role, revisions to Audit Standard No. 2 should be considered and (4) the challenges regarding smaller filers.
http://www.sec.gov/news/speech/2006/spch050806cag.htm

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Broker Dealer

NASD Requests Comment on Publicly Disseminating Buy/Sell and Customer/Dealer TRACE Information

NASD member firms that are parties to a transaction in a TRACE-eligible security (certain dollar-denominated debt securities) report several types of information to the Trade Reporting and Compliance Engine (TRACE) system, including that the firm is a buyer or a seller (Buy/Sell Information) and that the firm's counterparty is another broker-dealer or a customer (Customer/Dealer Information). While certain TRACE information is disseminated publicly (e.g., the bond identifier, price, quantity, etc.), the Buy/Sell Information and Customer/Dealer Information currently is not. Consequently, TRACE data users cannot readily identify those transactions reflecting inter-dealer prices for mark-up purposes, because inter-dealer prices are intermingled with dealer-customer prices. The NASD has proposed publicly disseminating the Buy/Sell Information and the Customer/Dealer Information for each transaction because such information, when combined, will allow users to determine if the disseminated price includes a mark-down or a commission or the disseminated price includes a mark-up or a commission. Given both Customer/Dealer and Buy/Sell Information, users would be able to compare the disseminated "all-in price" of their purchases and sales with other transactions, thereby permitting dealers to use the information for mark-up

and best execution determinations and permitting investors to use the information to request better, lower prices. The proposal does not include the dissemination of the MPID or dealer identity.

The NASD requests submission of comments on publicly disseminating the Buy/Sell and Customer/Dealer information by June 15, 2006.
http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_016573.pdf

NASD Issues Reminder and Guidance to FINOPs under NASD Rule 1022

The NASD has issued a reminder to member firms and all registered financial and operations principals (FINOPs) of a FINOP's duties and responsibilities under NASD Rule 1022. During recent examinations of broker-dealer firms with part-time FINOPs, the Securities and Exchange Commission noted a variety of significant books and records and financial responsibility rule deficiencies and errors (including net capital errors by approximately half of the firms in question). Accordingly, the NASD's reminder reiterated that FINOPs are not relieved of responsibility for compliance with Rule 1022 even if they provide services off-site, work part-time or hold multiple registrations with different member firms. A firm with a part-time FINOP is required to establish procedures that thoroughly describe the FINOP's duties, must conduct an ongoing assessment of the FINOP's capabilities and should provide the FINOP with complete access to all of the firm's books and records. The reminder also provides guidance to part-time, off-site and multiply registered FINOPs concerning the frequency and substance of scheduled and surprise on-site visits each calendar year.
http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_016627.pdf

Proposed NYSE Rule Change Regarding the Independent Contractor Filing Requirements

The New York Stock Exchange filed proposed changes to Interpretation (a)/02 of NYSE Rule 345. The Interpretation currently permits a registered representative associated with a member to assert "independent contractor" status, but requires the filing of certain written representations prior to Exchange approval. The proposed changes would eliminate this filing requirement, which the Exchange deems to be duplicative in light of the information now submitted via branch office and Form U4 applications processed through the Central Registration Depository (CRD). The amended Interpretation would retain language confirming certain regulatory requirements relative to independent contractor relationships (for example, the member firm would be required to directly supervise and control all activities effected on its behalf by independent contractors to the same degree as is required to regulate the activities of other persons registered with the firm) and would require firms to obtain the written attestation of each prospective independent contractor that he or she will be subject to the direct supervision, control and discipline of the firm and be bound by all relevant rules. Also, the proposed amendments would remove the prohibition against supervisory persons asserting the status of independent contractors, except for those persons designated as principal executive officers.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-7466.pdf

NASD Provides Guidance to Member Firms Concerning Upcoming Examinations

On May 17, the NASD issued a letter to members advising that routine examinations typically conducted by the NASD now will be broader in scope to address recent regulatory changes. The letter also identifies certain established regulatory requirements that will be of particular significance during upcoming examinations.

Specifically, areas that may be subject to particular scrutiny during upcoming examinations include, but are not limited to, compliance with: NASD Rules 3012 (concerning the testing and verification of the firm's supervisory system and supervision of producing managers) and 3013 (concerning CEO annual certification of the firm's supervisory procedures); amendments to NASD Rule 2510 limiting the use of

time and price discretion in a customer account; anti-money laundering requirements, including recent amendments that require each member firm to conduct an annual independent test of its AML compliance program; NASD Contact System designation requirements; sales of new products (such as structured products and equity indexed annuities); obligations concerning the testing of electronic compliance/monitoring systems; applicable rules concerning supervision and retention of e-mail correspondence; new requirements concerning registration of branch offices; business continuity planning requirements; municipal security transaction reporting obligations; prohibition on the sale of any initial public offering to a restricted person and most accounts in which a restricted person has a beneficial interest; Regulation SHO; and amendments to the Order Audit Trail System (OATS) rules.
http://www.nasd.com/web/groups/corp_comm/documents/home_page/nasdw_016638.pdf

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United Kingdom Developments

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FSA and HM Treasury Publish Joint Implementation Plan for MiFID

The Financial Services Authority (FSA) and HM Treasury have published a Joint Implementation Plan for the European Union Markets in Financial Instruments Directive (MiFID). MiFID will bring about the most significant changes to the European financial services regulatory landscape since the 1995 implementation of the Investment Services Directive which MiFID replaces.

The Plan provides a "comprehensive update on how the Treasury and the FSA intend to approach implementation of MiFID in the United Kingdom" and sets out EU and UK timetables for MiFID implementation and industry consultation. It also discusses the FSA's "Better Regulation" approach to MiFID implementation and the implementation process.
http://www.fsa.gov.uk/pubs/international/joint_mifid.pdf

MiFID: FSA Publishes Discussion Paper on Best Execution Requirements

On May 17, the Financial Services Authority (FSA) published a discussion paper entitled "Implementing MiFID's best execution requirements" (DP 06/3).

DP 06/3 addresses the best execution requirements the FSA will need to put in place as part of the implement in the UK of the EU Markets in Financial Instruments Directive (MiFID). DP 06/3 is aimed at firms which will fall within the MiFID definition of investment firm and which: execute client orders; receive and transmit client orders for execution or manage client portfolios; are on the buy-side or are users of execution services; are information vendors; and/or operate Multilateral Trading Facilities (MTFs), as defined in the Directive.

The paper attempts to clarify the new concepts and terminology that will be introduced by MiFID, and to present for comment a number of questions regarding the impact of MiFID's best execution requirements on UK market participants. The comment period lasts until August 17, 2006.
http://www.fsa.gov.uk/pubs/discussion/dp06_03.pdf

Financial Services and Markets Tribunal Overturns High Profile FSA Market Abuse Decision

On May 17, the Financial Services and Markets Tribunal (FSMT) published its decision in *Davidson and Tatham v the FSA*, clearing both Davidson and Tatham and criticizing the FSA. After a high profile investigation and a highly publicized case against the pair, the FSA had fined Davidson £750,000 and Tatham £100,000 for market abuse. These were the facts of the case: Cyprotex was to be listed on the Alternative Investment Market (AIM). Take-up of shares in the share placing was slow, the idea emerged that if a spread bet were placed then the spread betting broker with which it was placed would be almost certain to hedge the bet through a contract for differences with a counterparty who would in turn hedge the contract for differences by purchasing Cypotex shares in the placing thus completing it.

The FSMT concluded that there was a scheme or arrangement to facilitate the flotation of Cyprotex which was likely to give a false or misleading impression as to the demand for, and the price or value of, the ordinary shares in Cyprotex. However, FSMT also considered that there was no regulatory obligation to disclose the spread bet or the contract for differences in the Prospectus and so any failure to disclose was not market abuse within the meaning of section 118 of the Financial Services and Markets Act 2000 (FSMA). In case they were wrong about that conclusion the FSMT also considered the position of Davidson and Tatham if there were an obligation to disclose. On the assumed basis that Davidson and Tatham were complicit in the scheme, the FSMT concluded that they made all appropriate disclosure to Cyprotex's nominated broker. It was his responsibility to make full disclosure to the Cyprotex's board and to its AIM nominated adviser (NOMAD) so that the Prospectus could disclose the appropriate information to the market. Accordingly, the behavior of Davidson and Tatham did not create a false and misleading impression within the FSMA.

The FSMT criticized the FSA for imposing an unprecedented £750,000 fine on Davidson, ruling that the appropriate penalty under current market abuse rules would have been a published statement not a fine. As to Tatham, clearing him of improper behavior, the FSMT added that "it is a matter of great regret that he has been so adversely affected". -- as a result of the FSA inquiry, he forfeited his bonus and eventually lost his job at broker City Index.

The FSA has declined to make any detailed comment on the FSMT's reversal of its decision stating only that the FSMT had handed down "a long and complicated judgment which is currently being studied by the FSA. If necessary the FSA will comment subsequently on the decision."
http://www.financeandtaxtribunals.gov.uk/decisions/documents/Fin%20serv/davidson_and_tatham.pdf

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Litigation

District Court Finds Generalized Economic Motive Insufficient to Plead Scienter

Plaintiff alleged that defendants violated section 10(b) of the Securities Exchange Act of 1934 through false and misleading statements regarding expected sales and market prospects of a medical product. In dismissing the plaintiff's action, the district court found, among other things, that plaintiff had not properly alleged scienter where it alleged, in conclusory fashion, that defendants were motivated to commit fraud (i) to inflate the company's stock price until a private placement closed and (ii) to preserve their salaries and to keep their jobs. The court noted that since the company intended to use the private placement to repurchase its stock, the company would not have had a strong motive to prop up its stock

price. In addition, the allegations that defendants had a motive to commit fraud to preserve their jobs and salaries were insufficient because such a generalized economic motive common to all for-profit endeavors cannot support a securities law claim. (*In re Thoratec Corp. Securities Litigation*, 2006 WL 1305226 (N.D. Cal. May 11, 2006))

Court Must Explain Grounds for Denial Of Leave to Amend Securities Fraud Complaint

On appeal to the Ninth Circuit, plaintiffs argued that the district court improperly denied them permission to replead their third amended securities fraud complaint without considering the factors set forth by the Supreme Court in *Foman v. Davis* and explaining why permission was denied. Although the district court had previously cautioned the plaintiff that no further opportunities to replead would be granted, the Ninth Circuit found that especially in a securities fraud case, which has heightened pleading requirements, the district court should articulate with particularity why it was denying leave to replead. (*Osher v. JNI Corp.*, 2006 WL 1307902 (9th Cir. May 12, 2006))

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CFTC

CFTC and Committee of European Securities Regulators Create Online Guides to Facilitate Transatlantic Derivative Business

In an effort to facilitate transatlantic derivatives business and allay industry concerns, the United States Commodity Futures Trading Commission and the Committee of European Securities Regulators (CESR) published online guides to answer frequently asked questions related to conducting derivatives business in the U.S. and the European Union. The guides include country-specific information regarding regulation and supervision in the U.S. and in Europe, with information provided by CESR members in Germany, Ireland, Luxembourg, the Netherlands, Poland, Sweden and the UK.

The guides are intended to be practical in nature and are divided into sections for exchanges, investment services and end-users. Additionally, the guides provide links to detailed information (including rules) applicable in the U.S. and in CESR member countries, as well as general information about the regulators, exchanges and clearing organizations in each jurisdiction. The guides may be accessed through the "online guides" link at CESR's website.
http://www.cesr-eu.org/index.php?page=home_details&id=151
http://cftc.gov/opa/press06/opa5182-06.htm

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