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Corporate and Financial Weekly Digest

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SEC/Corporate

Preliminary Views Issued on Auditing of Internal Controls of Smaller Public Companies

On October 17, the Public Company Accounting Oversight Board (PCAOB) issued its preliminary views and requested public comment regarding the application of provisions of Auditing Standard No. 5 to audits of the internal controls of smaller public companies. In its release, the PCAOB identified several key areas that present unique challenges in connection with the audit of internal controls of smaller, less complex companies.

The PCAOB release stressed the importance of scaling the internal control audit to the size and needs of the particular client. For instance, while smaller companies may have less complex operations, with fewer business lines and less complex business processes and financial reporting systems, senior management of smaller public companies is more likely to be involved in the day-to-day operation of the business, thus increasing the risk of management override. Smaller companies with limited staffing may be incapable of segregating incompatible duties. On the other hand, fewer transactions, less complexity and centralization of function may allow the auditor's obtaining a substantial amount of evidence about the effectiveness of internal control by simply testing entry-level controls. Generally, auditors with smaller clients were urged to contemplate each such factor when assessing overall effectiveness of internal controls.

The PCAOB will accept public comments on its preliminary views of on the auditing of internal controls of smaller public companies until December 17.

http://www.pcaobus.org/Standards/Standards_and_Related_Rules/AS5/Guidance.pdf

Standards and Best Practices for Executive Compensation Disclosure

In light of the new executive compensation disclosure rules for public companies that went into effect in early 2007, the letters sent by the Staff of the Securities and Exchange Commission to 350 corporations that critiqued compliance with those rules, and the SEC's October 9 report on such compliance, as described in the October 12, 2007 edition of *Corporate and Financial Weekly Digest*, RiskMetrics Group (formerly ISS) has published a study designed to promote best practices in compensation disclosure and to stimulate further thought and discussion. The report focuses on various aspects of disclosure.

As it relates to style and readability, the report stressed that the key audiences of investors, corporate directors and executives should be kept in mind; writing should be in plain English, executive summaries should be included in

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disclosure with an emphasis on material information; text should be well organized with subtitles; and formatting should be designed to convey information in a meaningful way.

With respect to content, analysis is the key component for compensation disclosure and it is essential for the companies to illustrate the connection between a company's business strategy and its compensation incentives, and to include analyses of performance links to compensation, target pay levels, the reasons for the pay mix, and CEO performance as it relates to predetermined targets.

All disclosure should be put together in a "holistic" manner so all key elements are included; missing information raises unwanted questions including whether certain omissions were deliberate. According to RiskMetrics, better disclosure should lead to better compensation practices within the company which in turn leads to better long-term corporate and stock performance. (RiskMetrics Group, *Proposed Best Practices In Executive Compensation Disclosure*, October 2007).

http://www.riskmetrics.com/pdf/ExecCompBestPractices.pdf

Broker Dealer

NASDAQ to Establish New Options Market

NASDAQ has filed a proposal to establish a new equity and index options market named the NASDAQ Options Market (NOM). NOM would be operated by a wholly owned subsidiary and "facility" of NASDAQ and, as such, NASDAQ would have regulatory responsibility for the activities of NOM. Membership in NASDAQ would be a prerequisite to participation in NOM options trading. NASDAQ submitted a separate rule proposal in April to establish rules relating to listing, membership and trading on NOM (SR-NASDAQ-2007-004). NASDAQ anticipates launching NOM in December.

http://www.sec.gov/rules/sro/nasdaq/2007/34-56604.pdf

NYSE Membership Rule Changes Related to FINRA Consolidation

A recent New York Stock Exchange rule filing would require all current NYSE-only member firms to become members of the Financial Industry Regulatory Authority (FINRA) and would amend NYSE rules to require FINRA membership as a condition of NYSE membership for future applicants. The filing is related to the recent consolidation of the NASD and NYSE Regulation. In a separate, related filing, NASD (now FINRA) proposed to establish a "waive-in" process to enable the approximately 95 NYSE member organizations that were not also members of NASD on July 25, 2007 to automatically become members of FINRA. Qualifying firms would be required to submit a special application to FINRA to effect the "waive-in." FINRA will become the Designated Examining Authority for all NYSE member organizations.

http://www.sec.gov/rules/sro/nyse/2007/34-56654.pdf

http://www.sec.gov/rules/sro/nasd/2007/34-56653.pdf

Proposed Rule Change Relating to Member Firm Use of FINRA Name

The Financial Industry Regulatory Authority (FINRA) is proposing to amend NASD Interpretative Material 2210-4 (IM-2210-4) to limit the use of FINRA's name (and any other corporate name owned by FINRA) and require members that refer to FINRA membership on a web site to provide a hyperlink to

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www.finra.org. On November 9, 2006, the Securities and Exchange Commission approved an amendment to IM-2210-4 establishing a requirement for member firms and persons associated with a member that refer to their membership in NASD on a web site to hyperlink to NASD's home page, www.nasd.com.

On January 8, 2007, NASD published Notice to Members 07-02, which announced the SEC's approval of the hyperlink requirement and established July 7, 2007, as its implementation date. To reflect NASD's consolidation with NYSE Regulation, NASD changed its corporate name and internet domain and delayed the implementation of the hyperlink requirement until its new corporate name and internet domain could be established. FINRA submitted the proposed rule change to amend IM-2210-4 to reflect the new corporate identity.

http://www.sec.gov/rules/sro/finra/2007/34-56615.pdf

Banking

Order Issued Finding that Certain Pension Activities are "Financial in Nature"

On October 12, the Board of Governors of the Federal Reserve System (the Federal Reserve) issued an order to a financial holding company (FHC) determining that the FHC's acquisition, management and operation of defined benefit pension plans in the United Kingdom established and maintained by unaffiliated third-parties was permissible (with certain restrictions) under Section 4(k) of the Bank Holding Company Act of 1956, as amended, because such activity is "financial in nature."

The activity proposed by the FHC was broader than pension plan activities currently permitted to FHCs and involved the acquisition of pension plans that were "hard-frozen" (*e.g.,* no additional beneficiaries could be added to the plan and existing beneficiaries could not accrue additional benefits under the plan) and were and fully funded by the selling sponsor based upon the plan's assets and projected liabilities (using appropriate actuarial assumptions).

In reaching its determination, the Federal Reserve found that the proposed activity, at its core, involves "the types of investment advisory and investment management skills that are routinely exercised by banking organizations and the types of operational and investment risks that banking organizations routinely incur and manage." In furtherance of its determination, the Federal Reserve also noted that the FHC could perform such activities with respect to the pension funds because it would assume "essentially the same financial obligations and risks through the acquisition of a third-party U.K. pension plan as an insurance company performs and assumes in connection with the issuance of fixed annuities," thus making such activities financial in nature. Notably, in order to find that the activity was permissible, the Federal Reserve was required to notify the Secretary of the US Treasury. The Secretary concurred with the Federal Reserve's determination and analysis of the activity.

http://www.federalreserve.gov/newsevents/press/orders/orders20071012a1.pdf

Financial Markets

GAO Releases Report on Federal Regulation of the Financial Services Industry

The Government Accountability Office (GAO) has released a report regarding the increasing regulatory challenges facing the financial services industry,

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resulting from increased globalization, product convergence, and consolidation among industry participants. The GAO report focuses on three areas: (i) the difficulties of accurately measuring and weighing the burdens of regulation against its benefits, (ii) the challenges posed by the fact that numerous regulators are organized along functional lines but industry participants increasingly participate in businesses that cross multiple functional (and therefore, jurisdictional) lines, and (iii) the various options that have been suggested to enhance the efficiency and effectiveness of the financial regulatory system. The GAO report contains no new recommendations, but notes a variety of recommendations received from industry participants, as well as the GAO's own prior recommendations on these subjects.

http://www.gao.gov/new.items/d0832.pdf

United Kingdom Developments

UK Treasury Publishes Discussion Paper on Offshore Funds

On October 9, the UK Treasury published a discussion paper setting out its plans to modernize the UK tax regime for offshore funds and strengthen the existing UK anti-avoidance rules. The proposals introduce a new framework for offshore funds and the tax treatment of UK investors based on funds being classified as "Reporting Funds" rather than "Distributing Funds" as they are currently termed. The proposals includes: (i) changing the definition of offshore funds so as to be based on the characteristics of the fund, (ii) enabling funds to apply in advance for treatment as "Reporting Funds" instead of the current regime where an application to be a "Distributing Fund" must be made at the end of each year, (iii) the removal of percentage investment restrictions and limits on the number of layers into which a "Reporting Fund" may invest.

The deadline for comments is January 9, 2008.

www.hm-treasury.gov.uk/media/2/E/pbr_csr07_offshore402.pdf

UK Government Publishes Discussion Paper on Depositor Protection

On October 11, the UK Treasury, the Financial Services Authority and the Bank of England published a joint discussion paper on depositor protection and proposed improvements to the framework for dealing with banks in financial difficulties.

The paper seeks comments on proposed reforms to the current depositor compensation system and approaches that the UK Government should take to preserve key UK banking functions where there is a risk of a bank failure.

The deadline for comments on the paper is December 5.

www.hm-treasury.gov.uk/media/6/3/consult_bankingreform111007.pdf

Litigation

District Court Dismisses Securities Fraud Lawsuit

Granting defendants' motion to dismiss plaintiffs' class action securities fraud claims, a California federal district court held that plaintiffs did not meet the heightened pleading standards of the Private Securities Litigation Reform Act because they failed to allege specific facts demonstrating that defendants acted with scienter, i.e., either intentionally or recklessly making materially false statements. Plaintiffs attempted to bolster their scienter allegations on grounds that defendants, who purportedly misrepresented their company's

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financial condition during the class period, sold shares of company stock at the same time they were misleading investors. Rejecting this argument, the Court found, among other things, that the stock sales did not raise a strong inference of scienter because (i) defendants sold a relatively low percentage of their stocks, (ii) one defendant sold more stock during the months prior to the alleged fraud which reflected that his sales during the class period were not "dramatically out of line with" his prior trading practices, and (iii) no facts of any stock sales were alleged with respect to other individual defendants and corporate insiders. (*In re Ditech Communications Corp. Securities Litigation*, 2007 WL 2990532 (N.D.Cal. Oct. 11, 2007))

District Court Dismisses Antitrust Claim

Granting defendant company's motion to dismiss plaintiff's antitrust claim under Section 2 of the Sherman Act, a California federal direct court held that plaintiff lacked standing to bring its claims. The Court explained that a plaintiff has no standing to assert that he paid inflated prices for a product as a result of the defendants' monopoly activities in violation of Section 2 of the Sherman Act, unless (i) he purchased the product directly from the defendants, or (ii) one of the limited exceptions to the so-called "direct purchaser" rule applied. Here, plaintiff admitted that it was not a direct purchaser from defendant but argued that it should have standing based on a purported conspiracy between the defendants. The Court rejected this argument. After questioning whether a "conspiracy exception" to the direct purchaser rule should be recognized as a valid means to establish standing, the Court ruled that the plaintiff's inability to sue *all* of the alleged co-conspirators – as required by prior decisions recognizing a "conspiracy exception" – would, in any event render the exception unavailable. (*In re XL Ditropan XI Antitrust Litigation.*, 2007 WL 2978329 (N.D.Cal. Oct. 11, 2007))

CIRCULAR 230 DISCLOSURE: Pursuant to Regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer.

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