Annual Review of Federal Securities Regulation

By the Subcommittee on Annual Review, Committee on Federal Regulation of Securities, ABA Section of Business Law*

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INTRODUCTION

This Annual Review was prepared by the Subcommittee on Annual Review of the Federal Regulation of Securities Committee of the American Bar Association’s Section of Business Law. The Review covers significant developments in federal securities regulation during 2007. We divide the Review into three sections: regulatory actions, accounting pronouncements, and case law.

The Annual Review is written from the perspective of the practicing corporate and securities lawyer. As a result, it emphasizes significant developments under the federal securities laws as they relate to companies, stockholders, and their counsel. The discussion is limited to those developments believed to be of the greatest interest and importance to a wide range of practitioners.

In general, the Review does not discuss proposed regulations or newly adopted rules that are narrowly focused. The Review also does not discuss cases interesting only because of their factual background rather than the legal concepts involved. In addition, the Subcommittee refrained, for the most part, from editorial comment on the soundness of regulations, rules, or cases. Following is a summary of the federal rulemaking that occurred during the course of 2007; no significant federal securities legislation was enacted during 2007.
Significant 2007 Regulatory Developments

**Revisions to Rules 144 and 145**

On December 6, 2007, the U.S. Securities and Exchange Commission ("SEC" or "Commission") issued its final amendments to Rule 144 and Rule 145.¹ These new rules became effective on February 15, 2008,² and are applicable to resales of securities acquired prior to or after that effective date.³ These amendments are expected to reduce the cost to issuers of raising capital through private placements by making restricted securities more liquid.⁴

**New Rules Shorten Holding Period Requirements**

Rule 144 provides selling security holders with a safe harbor exemption under section 4(1) of the Securities Act of 1933 ("Securities Act" or "33 Act")⁵ for the resale of their securities, so that—if the resale satisfies certain criteria—holders are not deemed to be engaged in a distribution of securities.⁶ As a result, the selling security holder is not classified as an "underwriter" and may sell the securities without registration.⁷ Rule 144 applies to the resale of restricted securities, including securities purchased in a private placement or prior to an issuer’s initial public offering.⁸ In 1997, the SEC amended Rule 144 to reduce the required holding period for both affiliates and non-affiliates before they resell restricted securities under Rule 144(d) from two years to one year, and the SEC reduced the required holding period before non-affiliate holders may resell securities under Rule 144 without restriction from three years to two years.⁹

For non-affiliates that hold restricted securities of reporting companies under the Securities Exchange Act of 1934 ("Exchange Act" or "34 Act"), the SEC has reduced the holding period from one year to six months, provided that the issuer has been subject to the reporting requirements for ninety days prior to the sale.¹⁰

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³. See id.
⁴. Id. at 71549.
⁷. Id.
Following that six-month holding period, a non-affiliate may engage in unlimited resales so long as the issuer has been current in its public filings during the twelve months preceding such sale or for such shorter period of time that the issuer was required to file Exchange Act reports (which must be a minimum of ninety days). After a one-year holding period, non-affiliates may engage in unlimited public resales without complying with any other requirements of Rule 144. 

Affiliates that hold restricted securities of Exchange Act reporting companies may engage in resales following the six-month holding period so long as all of the requirements of Rule 144 are satisfied, including the current information requirement, volume limitations, manner of sale requirements (for equity securities only, as discussed below), and, if applicable, the filing of a Form 144.

The new rules continue to provide for a minimum one-year holding period for non-affiliate security holders if the issuer is not subject to the Exchange Act reporting requirements. Following the one-year holding period, the selling security holder may engage in unlimited public resales without conditions. There is a minimum one-year holding period for affiliates if the issuer is either not subject to the Exchange Act reporting requirements or has not been subject to such reporting requirements for at least ninety days.

REVISED VOLUME LIMITATIONS FOR DEBT SECURITIES

Prior to the recent amendments, sales of both debt and equity securities pursuant to Rule 144 were limited to the greater of 1 percent of the outstanding class or the average weekly trading volume during any three-month period. Under the amendments, the volume limitations for debt securities have been increased to 10 percent of the relevant tranche during any three-month period.

MANNER OF SALE REQUIREMENTS

Rule 144(f) previously required that securities be sold in “brokers' transactions” (as the term is defined in section 4(4) of the Securities Act) or that securities be sold with a “market maker” (as the term is defined in section 3(a)(38) of the Exchange Act). Rule 144(f) also previously prohibited “a selling security holder from: (1) [s]oliciting or arranging for the solicitation of orders to buy the securities in anticipation of, or in connection with, [a] Rule 144 transaction; or (2) making...
any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities."22

The SEC’s rule amendments eliminate entirely the manner of sale limitations for debt securities.23 In addition, the new rules revise the manner of sale provisions relating to affiliates’ sales of equity securities. For example, sales of equity securities may be made through “riskless principal transactions in which trades are executed at the same price,” regardless of any “markup or markdown, commission equivalent, or other fee.”24 Similarly, amendments have been made to the definition of brokers’ transactions to permit brokers “to insert bid and ask quotations for [a] security in an alternative trading system.”25

**Adoption of Higher Thresholds for Form 144 Filings**

The SEC amended Rule 144(h)26 to increase the Form 144 filing threshold amount to trades of 5,000 shares or $50,000 within a three-month period.27 Only affiliates of issuers will be required to file this notice when relying on Rule 144; these requirements will no longer apply to non-affiliates.28

**Simplification of Preliminary Note and Codification of Certain SEC Staff Interpretations**

Additionally, the recent amendments to Rule 144:

- **streamline the introductory note to Rule 144 to clarify in “plain English” that “any person who sells restricted securities, and any person who sells restricted securities or other securities on behalf of an affiliate, shall be deemed not to be engaged in a distribution of such securities and therefore shall be deemed not to be an underwriter with respect to [the transaction in which the securities are sold] if the sale in question is made in accordance with all the applicable provisions of [Rule 144]”;**29 and

- **codify certain staff interpretations of the SEC’s Division of Corporation Finance with respect to Rule 144, including, among others, (i) allowing the tacking of holding periods in connection with holding company reorganizations and conversions and exchanges of securities,30 (ii) commencing the holding period for cashless exercises of certain options and warrants (not including options granted under an employee benefit plan) when the option or warrant is issued,31 and (iii) prohibiting reliance on Rule 144 for**

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22. *Id.*
23. *Id.* at 71553.
24. *Id.*
25. *Id.*
28. *Id.*
29. *Id.* at 71548.
30. *Id.* at 71555.
31. *Id.* at 71556.
the resale of securities of a shell company (other than a business combination related shell company) whether or not it is a reporting company.32

REVISIONS TO RULE 145: “PRESUMPTIVE UNDERWRITER” PROVISIONS

Rule 14533 provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations, or transfers of assets that are subject to shareholder vote constitute sales of these securities. Rule 145(c)34 deems a person who is a party to these transactions (other than the issuer or any person who is an affiliate of the issuer when the transaction is submitted for vote or consent) and who publicly offers or sells securities of the issuer acquired in connection with the transaction to be an “underwriter” within the meaning of section 2(11) of the Securities Act.35 Rule 145(d)36 sets forth the restrictions on the resale of securities by persons and parties deemed to be underwriters. The practical effect of these rules is to decrease the liquidity of securities in entities that have been subject to merger transactions.

The SEC determined that the “presumptive underwriter provision in Rule 145 is no longer necessary in most circumstances.”37 However, based on abusive sales of securities that have resulted from business combinations involving shell companies, the SEC “believes there continues to be a need to apply the presumptive underwriter provision to reporting and non-reporting shell companies and their affiliates and promoters.”38 Accordingly, the new rules eliminate the presumed underwriter status provisions in Rule 145(c), except with regard to transactions involving shell companies.39

SMALLER REPORTING COMPANY REGULATORY RELIEF AND SIMPLIFICATION

OVERVIEW

On December 19, 2007, the SEC released its final rules relating to “smaller reporting companies.”40 These new rules, most of which became effective on February 4, 2008:

• adopt qualifying standards for an entity to be treated as a smaller reporting company;41

32. Id. at 71557.
33. 17 C.F.R. § 230.145 (2008). Rule 145(c) and Rule 145(d) are known as the “presumptive underwriter” provisions. See Revisions to Rules 144 and 145, 72 Fed. Reg. at 71556.
34. 17 C.F.R. § 230.145(c) (2008).
38. Id.
39. Id.
41. See id. at 934.
• move scaled disclosure items from Regulation S-B\textsuperscript{42} to Regulation S-K;\textsuperscript{43} 
• eliminate “SB” forms associated with Regulation S-B;\textsuperscript{44} and 
• make changes to the required financial statements for smaller reporting companies,\textsuperscript{45} the required age of financial statements in registration statements for these companies,\textsuperscript{46} and the required financial statements for businesses acquired or to be acquired by these companies.\textsuperscript{47}

In a companion release\textsuperscript{48} issued the same day and effective January 28, 2008, the SEC expanded the availability of Forms S-3\textsuperscript{49} and F-3\textsuperscript{50} so that they can be used by certain domestic and foreign private issuers making primary securities offerings.

**Definition of Smaller Reporting Company**

For more than fifteen years, reduced SEC disclosure requirements have applied to “small business issuers,” defined as companies with both a public equity float and annual revenues of less than $25 million.\textsuperscript{51} In addition, in response to certain requirements in the Sarbanes-Oxley Act of 2002 (“SOX”),\textsuperscript{52} the SEC added the category of “non-accelerated filer,” meaning companies with a public equity float of less than $75 million.\textsuperscript{53} In late 2007, the SEC expanded the category of companies subject to reduced disclosure requirements by reason of size.\textsuperscript{54} These issuers are referred to as “smaller reporting companies” and are companies that have a public equity float of $75 million and are not investment companies or asset-backed issuers.\textsuperscript{55} “When a company is unable to calculate public float, however, such as if it has no common equity outstanding or no market price for its outstanding common equity exists at the time of the determination, the standard will be less than $50 million in revenue in the last fiscal year…”\textsuperscript{56} A company that qualifies as a smaller reporting company must check the appropriate box on the cover page of most filings with the SEC.\textsuperscript{57} The determination date, other than for initial registration statements, is the last business day of a company’s second fiscal quarter.\textsuperscript{58}

\textsuperscript{42} 17 C.F.R. §§ 228.10–228.703 (2008).
\textsuperscript{44} Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. at 936.
\textsuperscript{45} See id. at 938.
\textsuperscript{46} Id. at 952.
\textsuperscript{47} Id. at 938.
\textsuperscript{49} 17 C.F.R. § 239.13 (2008).
\textsuperscript{50} 17 C.F.R. § 239.33 (2008).
\textsuperscript{51} 17 C.F.R. § 230.405 (2008).
\textsuperscript{53} 17 C.F.R. § 240.12b-2 (2008).
\textsuperscript{54} Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. at 942.
\textsuperscript{55} Id.
\textsuperscript{56} Id. at 935–36.
\textsuperscript{57} Id. at 945.
\textsuperscript{58} Id. at 943.
SCALED DISCLOSURE REQUIREMENTS

Under the new rules, the disclosure items previously applicable to small business issuers, which were set forth in Regulation S-B, have been moved to Regulation S-K.59 Other than for Item 404 regarding the dollar amount of transactions, which has a potentially lower threshold as it applies to smaller reporting companies,60 a smaller reporting company may pick and choose on an item-by-item basis whether to comply with the scaled disclosure items at the smaller reporting company level or at the level applicable to larger companies.61 The disclosure items that may be omitted by smaller reporting companies include selected financial data for the previous five fiscal years,62 quarterly financial data,63 a stock performance graph,64 disclosures about market risk,65 disclosure regarding the ratio of earnings to fixed charges,66 risk factor disclosure in periodic Exchange Act reports,67 and reduced disclosure regarding management’s discussion and analysis68 and executive compensation,69 including no requirement that management provide a compensation discussion and analysis or a compensation committee report.70

ELIMINATION OF CURRENT SB FORMS

Following a transition period, the SEC will eliminate all forms designated with the letters “SB,” such as Form SB-2 and Form 10-KSB.71 Current small business issuers may “file their next annual report for a fiscal year ending on or after December 15, 2007[,] on either Form 10-KSB . . . or Form 10-K.”72 All subsequent reports must be filed on a form that does not have the “SB” designation.73 If a Securities Act registration statement filed before February 4, 2008, is amended after that date, the amendment must be filed on a correct form without an “SB” designation, but the issuer “may continue to use the disclosure format and content based on the ‘SB’ form until [August 4, 2008].”74 The SEC staff issued A Small Entity Compliance Guide in January 2008 to assist smaller reporting companies in transitioning to the new rules.75

60. Id. at 941.
61. Id. at 940.
64. 17 C.F.R. § 229.201 (2008).
67. Id.
72. Id. at 945.
73. See id.
74. Id.
EXPANSION OF AVAILABILITY OF FORM S-3 FOR PRIMARY SECURITIES OFFERINGS

Form S-3 (and Form F-3 for foreign private issuers) is a “short form” registration statement “used by eligible domestic companies to register securities offerings under the Securities Act.”76 In addition to being able to incorporate required information from the company’s Exchange Act reports, Form S-3 enables a registrant to conduct “primary offerings ‘off the shelf’ under Rule 415 of the Securities Act”77 by providing more flexibility in the timing of offerings and responding to changes in the public securities markets.78 Under new General Instruction I.B.6. to Form S-3,79 a company that does not have $75 million in public float may nevertheless register a primary offering of securities on Form S-3, provided it:

- “[m]eet[s] the other registrant eligibility conditions for the use of Form S-3[,]”80 including that it has been a public reporting company and filed all reports required under sections 13, 14, or 15(d) of the Exchange Act81 in a timely manner for at least twelve calendar months immediately prior to filing the Form S-3;82
- has a class of common equity securities listed on a national securities exchange;83
- does not sell an amount of securities equal to more than one-third of its public float (the “one-third cap”) in primary offerings registered on Form S-3 during the preceding twelve calendar months;84 and
- is not a shell company85 and has “not been [a] shell company[y] for at least twelve calendar months before filing” the Form S-3.86

“Eligible registrants will also be able to offer non-investment grade debt on Form S-3.”87 For securities that are convertible into or exercisable for equity shares, the one-third cap is calculated by reference to the aggregate market value of the underlying equity shares.88 That value is based on the maximum number of shares into which the securities sold in the prior twelve months are convertible.

77. Id. at 73535; 17 C.F.R. § 230.415 (2008).
84. Id.
85. A “shell company” is defined as a registrant, other than an asset-backed issuer, that has no or nominal operations and either no or nominal assets, assets consisting solely of cash or cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets. 17 C.F.R. § 230.405 (2008).
87. Id. at 73540.
88. Id.
as of a date within sixty days prior to the date of sale.\textsuperscript{89} The amount an issuer may sell will increase or decrease as its public float moves up and down, and the one-third cap will be removed if the issuer’s public float increases above $75 million (but will be reimposed if the public float has fallen below $75 million at the time the issuer files its next Form 10-K).\textsuperscript{90}

The SEC did not revise the rules relating to foreign private issuers in connection with the recent amendments, although the new rules give all foreign private issuers, regardless of size, the option to report as smaller reporting companies.\textsuperscript{91}

\textbf{REVISIONS TO FINANCIAL STATEMENT REQUIREMENTS}

In conjunction with the changes in scaled disclosure requirements for smaller reporting companies, the SEC has changed the financial statement requirements in several respects, including:

- The SEC has moved the financial statement rules for smaller reporting companies from Item 310 of Regulation S-B to a new Article 8 of Regulation S-X;\textsuperscript{92}
- The SEC will require smaller reporting companies to furnish two years (up from one year) of audited balance sheets, income statements, and statements of cash flows;\textsuperscript{93}
- At the time of the initial filing of a registration statement, the financial statements that the SEC will require a smaller reporting company to include need only be as recent as those required to be included in the most recent annual or quarterly report that it would otherwise be required to file with the SEC as of the filing date;\textsuperscript{94}
- “[I]f the audited financial statements for the most recently completed fiscal year are available or become available before effectiveness or mailing, [the SEC requires that] they . . . be included in the filing”,\textsuperscript{95} and
- If the acquirer is a smaller reporting company, the SEC requires that only a maximum of two years of audited financial statements of the target be filed if the revenues of the target in the most recent fiscal year were less than $50 million.\textsuperscript{96}

\textsuperscript{89} Id.

\textsuperscript{90} Id. at 73541.

\textsuperscript{91} Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. at 936. To do so, foreign issuers must prepare their financial statements in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"). See id.

\textsuperscript{92} See id. at 938.

\textsuperscript{93} Id.

\textsuperscript{94} Id. at 955.

\textsuperscript{95} Id.

\textsuperscript{96} 17 C.F.R. § 240.9-04(c)(1) (2008); Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. at 938.
SHORT SELLING IN CONNECTION WITH A PUBLIC OFFERING

On August 6, 2007, the SEC amended Rule 105 of Regulation M. The amendments became effective October 9, 2007, and are designed to protect the soundness of raising capital by assuring investors and issuers that offering prices are based solely on supply and demand and not on potentially manipulative short selling practices that occur prior to pricing. Historically, these practices have created offering prices that have been lower than expected, thereby lowering investor confidence and creating “artificially depressed market prices.”

Former Rule 105 prohibited the act of “covering,” which is simply the act of buying back the shares that were sold short within the applicable Rule 105 restricted period. It did not prohibit the simple purchase of the offered securities. Prior to the amendments, the SEC became aware of transactions that resulted in the equivalent of economic activity that former Rule 105 was designed to prevent. As a result, the SEC changed the prohibited activity from covering the short sale with offered securities to actual purchase of the offered securities during the restricted period, unless an exception applies. Under amended Rule 105, the purchase takes place when the investor agrees orally or in writing to buy the offered securities, “not [on] the date that a confirmation is sent or received or payment is made.” While amended Rule 105 prohibits the purchase of the offered securities, the amended rule provides three exceptions to the rule’s application: (1) the bona fide purchase exception, (2) the separate account exception, and (3) the investment company exception.

98. See id. at 45094.
100. See Short Selling Final Release, supra note 97, 72 Fed. Reg. at 45094.
101. Id. Former Rule 105(a) stated:
   It shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the shorter of: (1) the period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) the period with the initial filing of such registration statement of notification on Form 1-A and ending with the pricing.
102. See id.
104. Id. at 45096.
105. Id. at 45102 n.88 (internal quotation marks and citation omitted).
THE BONA FIDE PURCHASE EXCEPTION

The bona fide purchase exception allows a “restricted period short seller” to purchase the offered securities if a bona fide purchase of the same securities is made in equal quantity during regular trading hours, is “reported to an effective transaction reporting plan,” and is “effected after the last Rule 105 restricted period short sale, but no later than the business day prior to pricing.” In addition, the person “may not [conduct a] restricted period short sale [later than] 30 minutes before the close of regular trading hours on the business day prior to the day of pricing.” In essence, the rule requires the investor to take a position, long or short, and complete the position. If the purchaser does not sell short, the rule does not prohibit the purchaser from buying the offered security during the restricted period. However, if the purchaser has sold short during the restricted period, that purchaser is limited to purchasing the same quantity that he or she sold short after his or her last short sale during regular trading hours.

THE SEPARATE ACCOUNT EXCEPTION

The separate account exception allows a person to purchase the offered security in Account A when the person sold short during the Rule 105 restricted period in Account B. The transaction decisions related to each account must also be “made separately and without coordination of trading or cooperation among or between the accounts.”

THE INVESTMENT COMPANY EXCEPTION

Last, the investment company exception allows “an individual fund within a fund complex, or a series of a fund [to purchase] the offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period.” The SEC noted that “provisions of the Investment

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114. Id.
115. 17 C.F.R. § 242.105(b)(2) (2008). Additionally, according to the SEC: [Accounts are separate if:] (1) The accounts have separate and distinct investment and trading strategies and objectives; (2) Personnel for each account do not coordinate trading among or between the accounts; (3) Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts; (4) Each account maintains a separate profit and loss statement; (5) There is no allocation of securities between or among accounts; and (6) Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decisions for the accounts.

116. See id. at 45100. See also 17 C.F.R. § 242.105(b)(3) (2008).
Company Act generally prohibit concerted action between funds in a complex and between different series of the same fund" and that “[a]n arrangement by which one fund sells a security short while another affiliated fund intentionally goes long to cover that position would generally be the type of joint arrangement that is prohibited by [those provisions].”

EXEMPTION OF COMPENSATORY EMPLOYEE STOCK OPTIONS FROM REGISTRATION UNDER SECTION 12(g) OF THE EXCHANGE ACT

On December 3, 2007, the SEC adopted two new exemptions from the registration requirements of section 12(g) of the Exchange Act for compensatory employee stock options, one for non-reporting issuers and the other for reporting issuers. Several private, non-reporting issuers previously fell under the 12(g) registration requirement, and the exemption for non-reporting issuers builds upon a series of no-action letters issued by the SEC to companies exempting them from registration.

The private, non-reporting issuer exemption is limited in several respects. First, it only applies to those issuers who do not have a class of equity securities registered under section 12 of the Exchange Act and who are not subject to reporting requirements under section 15(d). In addition, the “compensatory employee stock options must be issued under a written compensatory stock option plan that is limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.” The optionholder may not pledge, hypothecate, or transfer the option except by gift to a family member. Consistent with the underlying rationale for registration and reporting—that is, full disclosure—this exemption requires that the issuer provide the optionholder with information about the risks associated with the investment in the securities and financial statements required under a Regulation A Offering Statement.

The second new exemption under Rule 12h-1 for reporting or registered issuers also requires a written compensatory employee stock option plan that is limited to employees, directors, consultants and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents. However, this

120. Id. at 69554 n.7. Those companies included VG Holding Corporation, Headstrong Corporation, AMIS Holdings, Inc., Mitchell International Holding, Inc., Kinko’s, Inc., and Starbucks Corporation. Id.
122. Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934, 72 Fed. Reg. at 69556 (emphasis added).
125. Id.
exemption differs from the exemption for private non-reporting issuers in three important respects: (1) the issuer of the equity security underlying the stock option must either have a registered class of securities under section 12 of the Exchange Act or be required to file reports under section 15(d) of the Exchange Act;127 (2) there is no requirement that the issuer provide the optionholder with certain information or financial statements;128 and (3) an insignificant deviation from the rule’s limitations on who may hold stock options does not preclude reliance on the exemption as long as the issuer has made a good faith and reasonable effort to comply.129

SHAREHOLDER PROPOSALS RELATING TO THE ELECTION OF DIRECTORS

On December 6, 2007, the SEC amended the “election exclusion rule” contained in Rule 14a-8(i)(8) under the Exchange Act.130 The amendment became effective January 10, 2008,131 and is designed to codify the Commission’s longstanding interpretation of Rule 14a-8(i)(8) regarding shareholder proposals.132

Rule 14a-8 provides a procedure for a shareholder, who has continuously owned a specified amount of a company’s securities and is eligible to vote,133 “to place certain proposals in a company’s proxy materials for a vote at an annual or special meeting of shareholders.”134

The amended language of the election exclusion rule relates only to shareholder proposals “that would result in a contested election either in the year in which the proposal is submitted or in any subsequent year.”135 Rule 14a-8(i)(8), as amended, permits the exclusion of any shareholder proposal that “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.”136 The Commission’s longstanding interpretation of the election exclusion rule regarding corporate elections is that subsection (i)(8) “is not the proper means for conducting campaigns for effecting reforms in elections of that nature, since other proxy rules” are applicable to those situations.137 The SEC stated that the adoption of the amendment “codifies the agency’s longstanding interpretation.”138

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128. Id. at 69561.
131. See id. at 70450.
132. Id. at 70452.
133. Id. at 70454.
134. Id. at 70450.
135. Id. at 70454.
138. Id. at 70453.
COVERED SECURITIES PURSUANT TO SECTION 18
OF THE SECURITIES ACT

Effective May 24, 2007, the SEC adopted two amendments to Rule 146(b) under section 18(b)(1)(B) of the Securities Act. The first amendment exempts from state registration requirements securities listed on the Nasdaq Capital Market ("NCM").

The SEC determined that the listing standards for securities listed on the NCM are substantially similar to listing standards adopted by other markets specified in section 18(b), including the New York Stock Exchange, the American Stock Exchange, and the Nasdaq Global Market (formerly the National Market System of the Nasdaq Stock Market). Accordingly, securities listed on the NCM are now "covered securities" exempt from state registration requirements.

Section 18 of the Securities Act defines "covered securities" as securities "listed, or authorized for listing" on the securities exchanges named in section 18 or on other exchanges that the SEC has deemed to have listing standards substantially similar to those listed in the statute. Rule 146(b), however, previously defined "covered securities" as only securities "listed" and omitted the language "authorized for listing." The discrepancy in language between Rule 146(b) and section 18 of the Securities Act had generated concern that securities authorized for listing, but not yet listed on an exchange identified in Rule 146(b), would not clearly be exempt from state qualification or registration requirements. The second amendment revises Rule 146(b) to include securities "authorized for listing" on a market named in Rule 146(b).

COMMISSION GUIDANCE REGARDING MANAGEMENT’S REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

On June 20, 2007, the SEC issued interpretive guidance for entities with regard to management's evaluation and assessment of internal control over financial reporting (the “Guidance”). The purpose of the Guidance was to provide management with an approach for conducting a “top-down, risk-based evaluation of

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141 See id. at 20410.
142 See id.
143 See id.
146 See id.
147 See id. (emphasis added).
internal control over financial reporting” that would also satisfy the evaluation requirements of Rules 13a-15(c) and 15d-15(c) of the Exchange Act.149

**INTRODUCTION**

The rules adopted to implement section 404 of the Sarbanes-Oxley Act of 2002150 require management to evaluate on an annual basis whether its internal control over financial reporting (“ICFR”) effectively provides reasonable assurance regarding the reliability of its financial reporting and the preparation of its financial statements in accordance with GAAP and to disclose its assessment to investors.151 Management is required to maintain evidence and documentation providing reasonable support of its assessment and to allow third parties, including external auditors, to consider such work.152

The Guidance: (1) explains how to vary evaluation approaches for gathering risk assessment evidence; (2) discusses the evidentiary use of ongoing monitoring activities such as “daily interaction” and self-assessment; (3) explains the purpose of documentation and management’s flexibility in documenting support for its assessment; (4) provides management with significant flexibility regarding what constitutes adequate evidence in low-risk areas; and (5) allows different testing approaches for management and auditors.153

The Commission structured its Guidance according to two principles. First, management should evaluate whether the implemented controls adequately address the risk that “a material misstatement of the financial statements would not be prevented or detected in a timely manner.”154 The “top-down” risk-based approach in the Guidance is intended to promote efficiency “by allowing management to focus on those controls that are needed to adequately assess the risk of a material misstatement of its financial statements.”155 Second, management’s evaluation of evidence regarding the operation “of its controls should be based on [management’s] assessment of risk” so that management “align[s] the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate).”156 The SEC hopes that the risk and control identification process will allow management to test only those controls that are needed to provide reasonable assurance regarding the reliability of financial statements and to obtain evidence about those processes most efficiently.157

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149. See id.
152. See id.
153. Id.
154. Id.
155. Id.
156. Id. at 35235.
157. Id.
THE EVALUATION PROCESS: IDENTIFYING FINANCIAL REPORTING RISKS AND CONTROLS

The evaluation of the ICFR provides management with a reasonable basis for its annual assessment regarding the existence of any material weaknesses in the ICFR at the end of the relevant fiscal year.\(^{158}\) Management must identify the risks to reliable reporting, evaluate whether the controls address the risks, and evaluate evidence concerning how the controls operate.\(^ {159}\)

Identifying Financial Reporting Risks

According to the Guidance, an entity begins to identify its risks in financial reporting with an evaluation of how GAAP requirements apply to the company's business including its organization, operations, and processes.\(^ {160}\) Using this knowledge, management should then consider any sources and the likelihood of misstatements in financial reporting.\(^ {161}\) To identify such sources and the likelihood of misstatement, management may want to consider “what could go wrong” with a reporting element.\(^ {162}\) The method for identifying any risks will depend on the characteristics of the individual company including size, complexity, organizational structure, and processes.\(^ {163}\) Additionally, any evaluation of a risk of misstatement should include a “consideration of the vulnerability of the entity to fraudulent activity . . . and whether any such exposure could result in a material misstatement.”\(^ {164}\)

Identifying Controls

Once management has identified the likely risks, it must then determine whether it has controls (policies, procedures, etc.) in place that adequately address the risks to financial reporting.\(^ {165}\) An entity’s decision regarding the ability of a single control or combination of controls to address reporting risks will involve a judgment regarding whether the control(s) “can effectively prevent or detect misstatements that could result in material misstatements in the financial statements.”\(^ {166}\) If a determination is made that an ICFR deficiency\(^ {167}\) exists, then it must be evaluated to determine whether it will result in a material weakness.\(^ {168}\)

\(^{158}\) Id. at 35326.

\(^{159}\) Id.

\(^{160}\) Id. at 35327.

\(^{161}\) Id.

\(^{162}\) Id.

\(^{163}\) Id.

\(^{164}\) Id.

\(^{165}\) Id.

\(^{166}\) Id.

\(^{167}\) "A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed.” Id. n.29.

\(^{168}\) Id.
Entities can identify preventative or detective controls and more than one control can address a reporting risk.\textsuperscript{169} However, not all controls need to be identified, including redundant controls, unless they are necessary to address the reporting risk.\textsuperscript{170} Management may also wish to consider how to evaluate a particular control’s evidence of usefulness in identifying adequate controls.\textsuperscript{171} Where multiple controls exist, the ease of obtaining the evaluation evidence may also be a factor in control selection.\textsuperscript{172}

Entity-level controls and other elements of the ICFR may be necessary for a successful internal control system. These include how controls relate to the control environment, controls over management override, entity-level risk assessment, controls over periodic reporting, and adequate significant business control and risk management practices.\textsuperscript{173} The characteristics of the controls should allow management to make judgments as to whether the controls will operate properly.\textsuperscript{174}

### Entity-Level Controls

Management should also consider entity-level controls and their relationship to financial reporting as such controls may affect financial reporting or other controls that management has identified as necessary to address reporting risks.\textsuperscript{175}

### Role of Information Technology (“IT”)

Financial risk controls may be automated and management should consider the “design and operation of the automated or IT dependent application controls and the relevant IT general controls over the applications providing the IT functionality.”\textsuperscript{176} While the proper and consistent operation of financial reporting controls may depend on IT general controls and their evaluation is an integral part of the top-down, risk-based approach, general IT controls by themselves are ordinarily inadequate to address financial reporting risks.\textsuperscript{177}

### Supporting Evidence

Management must maintain reasonable documentation for its evaluation of the ICFR.\textsuperscript{178} Documentation may take several forms, including policy manuals, process models, flowcharts, job descriptions, etc., and “should be focused on those controls that management concludes are adequate to address the financial reporting risks.”\textsuperscript{179} Documentation should also support the overall objectives of an effective ICFR system.
by serving as evidence of the identification of ICFR controls and demonstrating that such controls “are capable of being communicated . . . and . . . monitored.”

THE EVALUATION PROCESS: EVALUATION OF EVIDENCE OF EFFECTIVENESS

Management should also evaluate “whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to operate the control effectively.” The evaluation procedure for gathering evidence should be tailored to management’s assessment of the risk and should focus on high risk areas.

Characteristics of Evidence Needed to Support Assessment

An entity may obtain evidence for evaluation from “direct testing of controls and on-going monitoring activities” and the nature of the evaluation procedures are dependent on the nature of the relevant ICFR risk. The entity should consider qualitative and quantitative characteristics of the evidence in determining whether it is sufficient. The greater the risk of a misstatement in financial reporting or the higher the risk of the control failing, the greater the amount of evidence, qualitative and quantitative, that the entity needs to support management’s assessment of the control. Additionally, “[a]s the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statement, management’s assessment of misstatement risk[] for the financial reporting element generally would correspondingly increase.” Moreover, reporting elements that involve critical transactions, e.g., related party transactions, critical accounting policies, and critical accounting estimates, also have a greater misstatement risk especially if the related controls are subject to a risk of management override.

REPORTING CONSIDERATIONS

Evaluation of Deficiencies

Management must evaluate the severity of each control deficiency to determine whether a control deficiency or combination thereof is a material weakness. Deficiencies determined to be a material weakness “must be disclosed in
management’s annual report on its assessment of the effectiveness of ICFR.” Exchange Act Rule 13a-14 requires that management report significant deficiencies to the company’s audit committee and external auditors. Management may not disclose ICFR as effective if it identifies one or more deficiencies in ICFR as a material weakness.

The severity of an ICFR deficiency does not depend on the occurrence of an actual misstatement. Rather, deficiency depends on “whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of a financial statement amount or disclosure.” Risk factors include:

- “[t]he nature of the financial reporting elements involved”;
- “[t]he susceptibility of the related asset or liability to loss or fraud”;
- “[s]ubjectivity, complexity, or extent of judgment required to determine the amount involved”;
- “[t]he interaction or relationship of the control with other controls”; and
- “[t]he interaction of the deficiencies”; and
- “[t]he possible future consequences of the deficiency.”

Misstatement magnitude factors include:

- “[t]he financial statement amounts or total of transactions exposed to the deficiency”; and
- “[t]he volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.”

Management should be aware that “the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger.” Additionally, compensating controls should also be considered to determine whether there is a mitigating effect on whether a control deficiency is material.

Management should consider the following when determining whether a deficiency in an ICFR exists and whether such deficiency is a material weakness:

- identification of fraud on the part of senior management;
- “[r]estatement of previously issued financial statements to reflect the correction of a material misstatement”;

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189. Id.
192. Id.
193. Id.
194. Id. at 35332–33.
195. Id. at 35333.
196. Id.
197. Id. Compensating controls are “controls that serve to accomplish the objective of another control that did not function property, [reducing] risk to an acceptable level.” Id. n.49.
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- “[i]dentification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company’s ICFR”; and
- “[i]neffective oversight of company’s external financial reporting and internal control over financial reporting by the company’s audit committee.”

Finally, management should treat a deficiency or combination of deficiencies as an indicator of material weakness if it determines that the deficiency or combination would “prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with GAAP.”

DISCLOSURES OF MATERIAL WEAKNESSES

So that disclosures surrounding material weaknesses are not misleading, companies should also consider including the following with regard to their disclosures:

- “[t]he nature of any material weakness”;
- impact of a material weakness on the company’s financial reporting and its ICFR; and
- current plans, if any, or actions already taken to remediate the material weakness.

IMPACT OF RESTATMENTS ON PREVIOUSLY ISSUED FINANCIAL STATEMENTS

A company is required to restate previous financial statements when it discovers a material misstatement in those statements. When this occurs, management should evaluate whether it needs to modify its original disclosures, the effectiveness of disclosure controls, and procedures so that the disclosures are not misleading.

AMENDMENTS TO RULES REGARDING MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

In a companion release to the Guidance, the SEC adopted Amendments to Rules Regarding Management’s Report on Internal Control over Financial Reporting. The

198. Id.
199. Id.
200. Id.
201. Id. at 35333–34.
201. Id. at 35334.
201. Id.
202. Id.
Commission has amended Rules 13a-15(c) and 15d-15(c) of the Exchange Act to include the following:

Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.204

**Amendment to Rules 1-02, 2-02, and 2-02T of Regulation S-X**

Under the prior rules regarding the auditor’s attestation to management’s assessment of internal control over financial reporting, the auditor was required to attest to management’s conclusion about the effectiveness of the company’s ICFR and not to the efficacy of the process followed by management.205 In light of the Guidance with regard to management’s evaluation of ICFR, the Commission has revised Rule 1-02 to require the auditor to express a single opinion directly on the effectiveness of the ICFR.206 Thus, the new rules regarding the attestation requirement are as follows:

The term *attestation report on internal control over financial reporting* means a report in which a registered public accounting firm expresses an opinion, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting. . . .207

Rules 2-02 and 2-02T were also amended to reflect the new attestation requirement.208 The Commission believes the modifications describe more clearly an auditor’s responsibilities to management with regard to the auditor’s attestation to management’s assessment of ICFR and conveys whether the assessment is fairly stated and is in conformity with management’s obligations under sections 404 and 103 of SOX.209

**Amendment to Rule 12b-2 and 1-02 of Regulation S-X—Definition of Material Weakness**

In its Guidance, the Commission provided for a definition of material weakness with regard to deficiencies in an entity’s ICFR. According to the Commission, the term “material weakness” is an integral term associated with SOX and the rules implemented by the Commission thereunder.210 Thus, the Commission believed

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204. 17 C.F.R. §§ 240.13a-15(c), 240.15d-15(c) (2008).
205. Id. at 35311.
206. Id.
210. Id. at 35313.
it was appropriate for Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to include a definition of material weakness because “[m]anagement’s disclosure requirements with respect to ICFR are predicated upon the existence of a material weakness.” The new definition of material weakness is as follows:

Material weakness means a deficiency, or a combination of deficiencies, in internal control over financial reporting . . . such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis.

DEFINITION OF THE TERM SIGNIFICANT DEFICIENCY

In connection with the Guidance, the Commission wished to propose a definition of significant deficiency as SOX requires a company’s “senior management to certify that [it has] communicated significant deficiencies to the audit committee and external auditors.” To amend Rule 12b-2 and 1-02 of Regulation S-X, the Commission adopted a definition of significant deficiency as follows:

[A significant deficiency is 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 will allow auditors and management to use their judgment in determining those deficiencies that are important enough to merit the attention of persons responsible for oversight based on the individual facts and circumstances of the company’s situation.

211. Id.
212. Id. at 35313–14 (emphasis added).