

May 25, 2007

SEC Adopts Management Guidance on Internal Controls and Proposes Amendments to Regulation D, Rules 144 and 145, and Other Regulations

On May 23, 2007, the SEC approved interpretive guidance on internal control over financial reporting. In an equally significant move, the SEC proposed a series of noteworthy changes, including changes to Rules 144 and 145, and Regulation D. Among the most important of these proposed changes would be to:

- expand Regulation D exempt offerings by establishing a new Rule 507 registration exemption for sales of securities with limited advertising to a new category of qualified purchasers; amend the definition of “accredited investor” to add a new category of accredited investors based on investments owned; provide for inflation-based adjustments to the definitions of “Rule 507 qualified purchaser” and “accredited investor”; shorten the integration safe harbor from six months to 90 days; extend the disqualification provisions of Rule 505(b)(2)(iii) to all offerings made in accordance with Regulation D; and institute an interactive electronic filing system to replace the paper filing system for Form D;
- liberalize the resale of restricted securities under Rule 144 by shortening the holding period for resales by non-affiliates of reporting companies from one year to six months (subject to a proposed tolling provision), and, with the exception of the current information requirement, eliminating other Rule 144 resale limitations; toll the holding period for restricted securities under Rule 144(d) while a securityholder has a short position or has entered into a put equivalent position with respect to the restricted security, except that tolling would not apply if the restricted security has been held for one year or more, regardless of hedging activity; eliminate the manner of sale requirements for affiliate resales of debt securities; and increase Form 144 filing thresholds for affiliate resales and impose the filing requirements only on affiliates of the issuer;
- create new exemptions from registration under Section 12(g) of the Exchange Act for compensatory employee stock options issued by both reporting and non-reporting companies;
- eliminate Rule 145’s presumed underwriter provisions except for transactions involving blank check or shell companies and revise the Rule 145(d) resale restrictions to conform to certain of the proposed amendments to Rule 144; and

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- create a new category of issuers called “smaller reporting companies,” which would include most companies with a public float below \$75 million; integrate the provisions of Regulation S-B into Regulation S-K; and amend Forms S-3 and F-3 to allow companies with a public float below \$75 million to take advantage of shelf registration on these forms, as long as (a) they meet all other eligibility requirements for use of the forms, (b) they are not shell companies and have not been shell companies for at least one year, and (c) they do not sell more than 20% of their public float in public offerings on Form S-3 or F-3 in any year.

The final interpretive guidance on management’s implementation of internal controls is effective 30 days after its publication in the *Federal Register*. The proposed changes to Rules 144 and 145, Regulation D, and regulations governing capital formation are subject to a 60-day comment period.

I. Interpretive Guidance for Management’s Evaluation of Internal Control Over Financial Reporting and PCAOB Revised Accounting Standard

The SEC adopted its interpretive guidance on internal controls in substantially the same format as was proposed in December 2006, which we described in a memo entitled “*SEC Proposes Interpretive Guidance for Management Regarding its Evaluation of Internal Control Over Financial Reporting*” available at <http://www.paulweiss.com/resources/pubs/>. As anticipated, the guidance uses a top-down, risk-based approach that permits the exercise of judgment by management in its evaluation of internal controls, providing a type of safe harbor for managers that rely on the interpretive guidance in conducting their evaluations. Based on the comments received, the SEC staff recommended proposing a definition of “significant deficiency” that does not include a probability threshold.

The SEC declined to provide additional illustrative examples in the guidance, stating that such examples may become inadvertent bright line tests. It also decided to provide guidance to foreign private issuers in a separate FAQ, which the Staff is preparing. Finally, non-accelerated filers will not receive any more postponements in implementing internal controls. Smaller companies will be required to comply with internal control requirements in their 2008 audit cycle.

On a related note, the PCAOB held its Open Meeting on May 24, 2007 and adopted new Auditing Standard No. 5 on auditing internal control over financial reporting, as well as a related independence rule. As adopted, AS No. 5 will supersede the PCAOB’s existing AS No. 2 and is aligned closely with the SEC’s guidance. AS No. 5 will still need to be reviewed and approved by the SEC before it becomes effective.

II. Regulation D

The SEC proposed a number of significant amendments to Regulation D:

- The SEC proposed to add to Regulation D an additional Securities Act registration exemption, new Rule 507. Rule 507 would allow issuers to sell securities without registration to “Rule 507 qualified purchasers,” which would include (a) individuals who own at least \$2.5 million in investments or have individual annual income of \$400,000 or combined annual income with their spouse of \$600,000; (b) institutional investors who

own at least \$10 million in investments; and (c) directors, executive officers, or general partners of the issuer, without regard to any financial threshold. Issuers would be permitted to engage in limited advertising in connection with Rule 507 offerings.

- The SEC proposed to amend the existing definition of “accredited investor” in Regulation D to add a new category of accredited investors who own \$750,000 in investments and institutions that own \$5 million in investments. Under the proposed amendment, the SEC would adjust the financial thresholds set forth in the definitions of “Rule 507 qualified purchaser” and “accredited investor” for inflation on a going-forward basis, beginning on September 1, 2012.
- The proposed amendments would shorten the period during which Regulation D offers and sales would be integrated under the integration safe harbor set forth in Rule 502. Rule 502 would provide that offers and sales that are made more than 90 days before the start of a Regulation D offering or more than 90 days after the completion of a Regulation D offering would not be integrated with a current Regulation D offering, as long as there are no offers or sales of securities of the same or similar class by or for the issuer during those 90 day periods.
- The proposed amendments would extend the disqualification provisions of Rule 505(b)(2)(iii) to all offerings made in accordance with Regulation D, rather than just offerings made in accordance with Rule 505. The disqualification provisions would render an issuer ineligible to rely on Regulation D if it, any of its affiliated persons, or any underwriter participating in the offering is the subject of a securities law-related conviction, injunction, or other order in the preceding five years.
- The SEC proposed an interactive electronic filing system to replace the paper filing system for Form D, which it believes will be simpler for filers to administer and more easily searchable by regulators and members of the public.

III. Rule 144

The SEC proposed a number of significant amendments to Rule 144:

- The proposed amendments would shorten the Rule 144(d) holding period for resales of restricted securities by non-affiliates from one year to six months, where the issuer is subject to Exchange Act reporting obligations and has been for at least 90 days before the sale of the restricted securities. Non-affiliate holders of restricted securities of a reporting company could therefore resell freely after meeting the six-month holding period (subject to a proposed tolling provision described below) as long as current information regarding the issuer is publicly available, as required by Rule 144(c). Non-affiliate holders of restricted securities of non-reporting companies would continue to be required to hold their securities for one year before any public resale, but freely resell after the one-year holding period is met. Manner-of-sale and volume limitation restrictions would be eliminated for both reporting and non-reporting companies.
- The SEC reintroduced a proposed tolling provision that would toll the holding period for restricted securities under Rule 144(d) while a securityholder has a short position or has

entered into a put equivalent position with respect to the restricted security. Tolling would not apply if the restricted security has been held for one year or more, regardless of hedging activity.

- The proposed amendments would eliminate the manner of sale requirements set forth in Rule 144(f) with respect to affiliate resales of debt securities.
- The SEC proposed to amend the Form 144 filing requirement in Rule 144(h) to raise the number of share and aggregate sale price thresholds for such filing and impose the filing requirement only on affiliates of the issuer.
- The SEC will solicit comment on whether to coordinate the Form 144 filing requirement under Rule 144(h) with Form 4 filing requirements under Section 16(a) of the Exchange Act.

IV. Section 12(g) of the Exchange Act

For several years, a number of pre-IPO companies that have large stock option plans have faced the possibility of having to register under Section 12(g) of the Exchange Act as a result of having more than 500 optionees. After having provided relief on an ad hoc basis through no-action letters, the SEC has now proposed two new exemptions from registration under Section 12(g) of the Exchange Act for compensatory employee stock options. Under the proposed rules, non-reporting companies would be eligible for an exemption from registration of compensatory employee stock options issued under a written compensatory stock option plan as long as (a) eligible option holders are limited to employees, directors, consultants, and advisors, (b) transferability of the shares received on exercise of the options and shares of the same class is restricted, and (c) risk factors and financial information are provided to option holders and holders of the shares received on exercise of the options that is of the type that would be required under Rule 701 under the Securities Act if securities sold in reliance on Rule 701 exceeded \$5 million in any 12 month period. In addition, the SEC proposed a separate exemption for compensatory employee stock options of reporting companies that have registered under Section 12 of the Exchange Act the class of securities underlying the compensatory stock options, as option holders would have access to the company's publicly filed Exchange Act reports, including disclosure available under Sections 14 and 16 of the Exchange Act.

V. Rule 145

The SEC proposed to eliminate Rule 145's presumed underwriter provisions except for transactions involving blank check or shell companies. Under the proposed amendments, only a party to a Rule 145(a) business combination transaction involving blank check or shell companies (other than business combination related shell companies) and such party's affiliates would be presumed an underwriter subject to the resale restrictions of Rule 145(d). The SEC would also revise the Rule 145(d) resale restrictions to conform to certain of the proposed amendments to Rule 144 discussed above.

VI. Smaller Reporting Companies

The SEC proposed amendments to its disclosure and reporting regimes under both the Securities Act and the Exchange Act to increase the number of companies that are eligible to

comply with the scaled disclosure and reporting requirements currently in place for small business issuers. The amendments would create a new category of issuers called “smaller reporting companies,” which would include most companies with a public float below \$75 million. In addition, the SEC proposes to eliminate Regulation S-B and the associated forms currently used by small business issuers in connection with the registration of their securities and periodic reporting, including Forms SB-1, SB-2, 10-KSB, and 10-QSB, and integrate the provisions of Regulation S-B into Regulation S-K.

The SEC proposed to amend Forms S-3 and F-3 to allow companies with a public float below \$75 million to take advantage of shelf registration on these forms, as long as they meet all other eligibility requirements for use of the forms. Smaller public companies that wish to take advantage of shelf registration of their securities on Form S-3 or F-3 must not be a shell company, must not have been a shell company for at least one year, and must not sell more than 20% of their public float in public offerings on Form S-3 or F-3 in any year.

VII. Other Matters Discussed

The SEC also adopted rules to implement provisions of the Credit Rating Agency Reform Act of 2006.

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We note that the foregoing is based on oral discussions at the SEC’s open meeting and the SEC’s summary statements on the matters, and the specific language of the SEC rules, proposals, and guidance will not be known until the relevant releases are published.

This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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