

## Contents

### 1 **Sarbanes-Oxley 404: Moving Beyond the First Round**

By Henry Ristuccia and Chuck Saia

After the first Section 404 reports are complete, public companies can take a breather—but just a short one. Then it's time to analyze what they did well and what they need to change.

### 9 **Revenue-Sharing Disclosure by Broker-Dealers**

By Frank G. Zarb, Jr.

What exactly is "revenue-sharing," and what changes are proposed for the rules that address the practice?

### 14 **Continuous Reporting and Auditing: Opportunities and Challenges**

By Michael Alles, Alexander Kogan, and Miklos Vasarhelyi

Thanks to evolving technology, the Sarbanes-Oxley mandate for "rapid and current" reporting may revolutionize auditing and assurance practices.

### 21 **SEC Update: CEO Certification, Ban on Road Show Participation, and Voting Client Proxies**

By Mark J. Dorsey, Christopher M. Salter, and Tony Regenstreif

## Sarbanes-Oxley 404: Moving Beyond the First Round

by Henry Ristuccia and Chuck Saia\*

Section 404 is the most time consuming and publicly visible aspect of Sarbanes-Oxley. Most firms are just finalizing their first round of Section 404 activities. The question is, will public companies get the 404 reporting one-hundred-percent right their first time out? In fact, many public accountants, financial managers, and senior leaders view this first round of 404 filings as something akin to a pass-fail test. The pass-fail aspect allows CEOs, CFOs, and public accountants to conclude that internal controls over financial reporting are well designed and operating effectively and that the company has a supporting process to evaluate controls. But it also clearly provides the opportunity—and the need—to reconsider and refine what corporate America has done in this first round.

From the start, firms know they will have to meet a certain standard. But there also is an understanding that, in future rounds, they will be expected to fine-tune the process of documenting and testing internal controls. In this

(continued on page 3)


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## Letter From the Editors

Regulators and ten major investment banks agreed in principle to the famous (or infamous) Global Settlement almost two years ago; the formal settlement terms became final in April 2003. The Global Settlement imposed monetary penalties; required banks to offer enhanced disclosure about possible conflicts of interest and about rating methods; and required banks to contract for, and offer to their customers, independent research. But the most significant change wrought by the Global Settlement was the structural reforms it imposed. Analysts and investment bankers were to be completely separated: they could not share physical space, legal or compliance staff, or budgets; they could not communicate with each other without a legal or compliance chaperone; and bankers could not have any input into decisions about analysts' compensation.

The NASD is determined to spread these requirements beyond the firms that are subject to the Global Settlement. This month's SEC Update column describes a proposed NASD rule amendment that would prohibit analysts from participating in road shows and restrict various types of communication between analysts and investment bankers.

The goal of the structural reforms, and of the NASD's proposed amendment, is to free analysts to give candid, unbiased opinions without fear of career-destabilizing (or financial) retribution from investment banking colleagues and higher-ups. Notably, a recent study by business professors at Washington University concludes there has been progress toward that goal. The professors determined that before the Global Settlement, analysts affiliated with an issuer's investment bankers were 21% more positive in their recommendations than unaffiliated analysts. After April 2003, that number dropped to 13%. The professors argue that at least some of that 13% is due to issuers selecting banks that employ analysts the issuers think will rate them favorably, and not to biased analysis.

And while we are on the subject of the Global Settlement, on November 2, the Commission released extensive guidance (available at <[www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm](http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm)>) on its restrictions. The guidance includes responses to 29 specific questions, as well as requested clarifications, on issues such as coverage, analyst participation in pitch meetings and conferences, and analyst compensation. 

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## **Sarbanes–Oxley . . .**

*(continued from page 1)*

sense, internal controls are like accounting and auditing: frameworks and standards are in place but the implementation of these reference points is an art. As in art, the beauty of it—in this case the effectiveness of internal controls—is in the eye of the beholder. The beholders here are the CEOs and CFOs of public companies and their external auditors.

### ***Firms ... should benefit from the lessons learned from the first 404 filings.***

In this evolving process, the general counsel, as a member of the firm's executive team, can play a pivotal role by helping refine the internal control and governance processes. Typically, general counsel are well placed to lead their organizations through the most critical aspect of internal controls over financial reporting: the control environment. In our opinion, the control environment is the most fundamental of the five major components of COSO, the SEC's recommended internal-control framework.<sup>1</sup> It sets the "tone-at-the-top" for corporate governance. The general counsel of public companies are partly, if not predominantly, the stewards of corporate governance administration.

Firms also should benefit from the lessons learned from the first 404 filings. Management will need to capture and analyze these experiences, adapting and applying relevant lessons to fine-tune their future filings. In addition, firms should use these experiences to help them improve what institutional investors, audit committees, stock markets, employees, and legislators value the most now—corporate governance effectiveness.

Based on our consulting experience, most firms have spent the greatest percentage of their 404 preparation time documenting and testing internal controls at very detailed business process levels. While this is necessary and appropriate, firms also must continuously evaluate how detailed level controls connect to and support the broader corporate governance elements of a control framework. We believe that in the second round of Section 404 compliance, companies can deliver superior corporate governance. To

achieve this advanced level of compliance, we suggest a two-pronged approach that focuses on both strategy and tactics. The strategic prong emphasizes a comprehensive, big-picture assessment of the overall compliance effort. The tactical prong focuses on a detailed post-event analysis to determine which actions worked, which didn't, and why.

## **Starting With a Strategic Mindset**

Because general counsel engages in the senior management aspects of corporate governance administration, the best place to begin is with the consideration of strategic elements; the strategy inevitably informs and drives the tactics. That is why COSO considers the tone-at-the-top to be the foundation of internal controls and governance.

Public companies have invested substantial time, effort, and dollars into complying with the Sarbanes-Oxley regulations and, as suggested, at that detailed business process level. The fundamental questions management might ask now are: Did we simply aim to comply with the letter of the law? Or did we go further and respond to the spirit of the legislation? In other words, did we try to demonstrate strong governance through superior internal controls over financial reporting? To answer these questions, senior management must measure the effectiveness of the detailed business process controls and their supportive relationship to the corporate governance aspects of internal controls. In short, the CEO, CFO, and external auditors must measure the company's Financial Reporting IQ.

What is a Financial Reporting IQ exactly? It is an emerging and useful business standard measured by four elements:

- 1. Transparency.** With investors demanding more and better information and access, firms must know how to create, capture, and analyze information that presents a compelling picture of how the business is doing.
- 2. Timeliness.** With investors insisting on current information, firms are doing more than just closing their books in record time; they are letting investors know how changing markets and other business conditions will impact performance.

3. **Accuracy.** With investors punishing companies that issue earnings restatements, it is critical that firms invest in the policies, systems, processes, and controls required to get the numbers right.
4. **Reliability.** With investors becoming accustomed to the market's volatility, they understand that earnings go up and down. This makes stockholders more accepting of bad news, especially when there's a strategy in place to reverse the situation.

These concepts are how institutional and sophisticated stakeholders evaluate financial reporting. In the Sarbanes-Oxley-fueled governance environment, the quality of a firm's financial information has a strong and direct impact on the level of trust investors have in an organization. To compete for investor trust—and dollars—smart firms recognize that a robust Financial Reporting IQ contributes as much to shareholder value as earnings and P/E ratio. They are working hard to build a high Financial Reporting IQ and the strategic advantage it supports. Remember too that the criteria for Financial Reporting IQ also should be the basis for determining the scope and approach for Sarbanes-Oxley compliance.

### **Developing a Positive Environment**

A strong Financial Reporting IQ grows out of a corporate culture that consistently champions integrity and honesty. Again, the emphasis on setting the appropriate tone-at-the-top is linked to two key components of the COSO framework: the control environment, and the company's ability to monitor its performance in terms of these governance concepts.

Executive teams at the benchmark firms seek to build the ideal environment by underlining their commitment to strong governance, ethical behavior, and accurate information. They articulate the values and principles that guide people on how to work with each other as well as with external businesses, consumers, governments, local communities, shareholders, and other stakeholders. Leaders formulate codes of ethics and conduct that guide good people to make good decisions—even in the most difficult situations. They put a whistleblower system in place and punish misconduct.

Day-to-day practices support prescribed policies and procedures. Managers insist that promises be kept. They make sure that business plans are reviewed, budgets are maintained, and deadlines are met. Straight talk and candidness are encouraged throughout the organization. Leaders demand competence from people at all levels. And they are resolute about business being conducted in an ethical manner.

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### ***The good news is that superior governance pays off.***

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Organizational processes and practices also are aligned with core ethical values. For example, the honesty and openness of managers can be assessed during their individual performance reviews. Companies can set up 24-hour hotlines for employees to report questionable business conduct. And management can make certain that all reports of misconduct are investigated thoroughly and promptly.

### **Getting Governance Right**

Sarbanes-Oxley has attempted to make corporate governance more visible, more objective, and more measurable. But are there reliable models for good governance? To start, consider the aggregate practices of exemplary firms.

Governance-focused organizations typically appoint a diverse group of independent and experienced business people to their executive committee, risk management committee, other internal management organizations, and the audit committee. To help audit committee members be more effective in carrying out oversight responsibilities, they should be encouraged to engage in direct contact with various members of senior management—both inside and outside the boardroom. Management also should invite audit committee members to be proactive in ensuring that the quality, integrity, and transparency of financial reports are monitored. Most important, firms should continuously find ways to improve and refine their governance practices.

Bear in mind that the financial control environment is driven by the people at the top. While a key task of senior leaders and outside directors of the audit committee is to put the internal audit function in place, their responsi-

bilities don't stop there. These senior people also frame the firm's mission statement, define its code of ethics, and develop its code of conduct. And they ensure that employees receive the training necessary to carry out their individual responsibilities for internal control. It is also the people at the top who communicate—through their words and actions—the values and standards all employees are expected to live by. Put simply, they serve as the role models.

The good news is that superior governance pays off. Research shows that the capital markets will pay a premium for companies that demonstrate good governance. After examining the stock returns of 2,100 major global firms during the past three years, GovernanceMetrics International found the stock returns of companies with well-above-average governance ratings outperformed those with below-average ratings.<sup>2</sup>

## Revisiting Business Models and Operations

One far-reaching consequence of Sarbanes-Oxley is that it will compel firms to rethink their business models and day-to-day operations so they can address governance issues such as risk management and fraud detection.

New compliance-related questions about business models will need to be answered. Can your CEO and CFO be confident that the annual 404 filing is accurate when the business is very decentralized and each operating unit prepares its reports independently? Can you obtain the level of accuracy you need through standardization? Is it time to revisit the centralization-decentralization debate?

Companies must rethink their operations as well. For instance, compliance with Section 404 requires a high level of control and oversight on processes such as payroll, accounting, finance, valuation, tax reporting, information technology, new product development, and human resources—operations that are frequently outsourced. This is causing senior leaders to question whether they need to change their outsourcing strategy and contracts, as well as their strategic alliances and suppliers. Errors in recording transactions can force a company to restate its financial results—an action that is considered a control weakness and precludes a favorable Section 404 report.

Put another way, management has to be confident that investment and strategic decisions won't result in a hidden infraction or material error after information has been provided to Wall Street. Investors don't have much confidence in companies that have to release financial restatements. In fact, there is compelling evidence that investors punish those companies. In late 2002, the U.S. General Accounting Office stated that the average market capitalization loss due to a financial restatement is 9.5 percent on the day after the restatement and a hefty 18.2 percent 60 days later.<sup>3</sup> That is a severe penalty.

## Taking a Lead Role

General counsel can play a lead role in the re-evaluation process in several ways: by helping to build and sustain a workplace culture that values integrity and principled action; by balancing business objectives against the demand for accurate and reliable reporting; and by striving constantly to raise the organization's Financial Reporting IQ. Here are some specific actions counsel can take:

- Collaborate with other senior leaders to specify the qualifications and credentials (business experience, education, personal characteristics) of individuals who might be considered as candidates for the Board of Directors;
- Review the firm's code of ethics and code of conduct periodically to ensure that they are current, comprehensive, relevant, and communicated clearly to employees;
- Assess existing contracts with outsourcers, suppliers, and others to make certain they offer the firm adequate control and oversight; and
- Keep abreast of changing legislation and regulations that might impact business operations and advise on appropriate actions to take to be in compliance.

## Improving Sarbanes-Oxley Readiness

Firms have poured significant time and resources into preparing their Section 404 filings. Initially, it was anticipated that a successful job would take about 35,000 staff hours. This estimate was off by half. It turns out that most

large organizations (over \$5 billion of revenue) invested more than 70,000 staff hours in their preparation activities.<sup>4</sup>

In turn, the price tag for compliance is substantial. While it is hard to compute a clear-cut cost for compliance, some firms are suffering sticker shock over the numbers coming out of recent surveys:

- Compliance accounts for a 90 percent increase in the cost of being public for a mid-market company, reports Foley & Lardner;<sup>5</sup>
- Compliance for the typical Fortune 500 company is running between \$3.5 and \$9.5 million, says The Johnsson Group Inc.;<sup>6</sup>
- Compliance expenses are topping out at \$4.6 million for large companies, says Financial Executives International;<sup>7</sup> and
- AMR Research predicts compliance budgets will go up 10% per year after December, according to Baseline Magazine.<sup>8</sup>

Many firms tackled Sarbanes-Oxley readiness by establishing a central project management office (PMO), often headed by the CFO or the controller. Their efforts were complemented by people from the compliance, internal audit, operations, and information technology functions. PMO teams typically followed a three-phase approach to preparing for compliance:

1. **Planning and scoping:** making decisions about disclosure procedures and determining the scope of the internal controls program.
2. **Documenting, assessing, and remediating internal controls:** documenting the control objectives, the design and implementation of control activities, methods for testing activity effectiveness, and assessing and mitigating risks to financial reporting and disclosure.
3. **Building a sustainable process:** supporting management as it assumes ownership of the controls and ongoing assessments by collaborating with general counsel, internal audit, and others to develop practical procedures that satisfy regulations and auditor attestation purposes.

Based on our experience as consultants to the financial services industry and in assisting over 800 firms on Sarbanes-Oxley readiness, Deloitte believes that most PMO teams should work

concurrently on Section 302 certifications of disclosure controls and Section 404 compliance preparations. A dual focus will promote efficiency and establish a process that is risk-based by converging 302 and 404. The processes and documentation developed to address the Section 302 requirements can be building blocks that support the Section 404 reporting requirements. Furthermore, developing a robust 404 program will make the 302 program more accurate and meaningful.

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***In the second year, much can ... be done to improve the elements of the overall control environment.***  
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Deloitte also advises that once firms have filed their first 404 report, they should consider morphing their PMO teams into a permanent organization with ongoing responsibility for compliance. On a literal level, you can accomplish this by simply changing the nameplate on the office—from the Sarbanes-readiness office or PMO to the Sarbanes Compliance Office or SCO. There are many benefits to such a “transformation.”

### **Assessing First-Year Results**

In their efforts to attain reliable financial reporting, PMO teams devote a lot of time to documenting routine transactions. Once the first reports are filed, the SCO organization and senior leaders can take a step back and ask some basic questions: Did we do enough or did we do too much? Can we sharpen compliance effectiveness by working smarter, not harder?

You can do a fine-tuning exercise by assessing the firm’s compliance reporting. Review the routine transactions, double checking that all the key controls are identified. A “key control,” we believe, is one control activity that addresses multiple financial assertions or potential errors and risks.

As companies move into the second year of compliance and seek to improve reporting efforts, the SCO team may revisit the three phases it worked through in the first round, but there will be a significant shift in emphasis from routine to non-routine transactions. These are events and transactions that occur infrequently, including:

- Transactions with special terms, such as derivatives;
- Mergers, acquisitions, and divestitures;
- Whistleblowing and fraud activities;
- Extraordinary accounting items and challenging financial disclosures; and
- Accounting that requires judgments and estimates.

Many firms have difficulty governing and monitoring these *accounting policy* aspects of internal controls. Compounding the challenge is the reality that even competent employees are likely to have minimal experience accounting for complicated transactions that occur only occasionally. Because these are mistake-prone and judgmental events, the general counsel and other senior executives must make sure the SCO team has re-emphasized how critical these issues are. What's more, they need to ensure that the advanced thinking, judgments, and broad governance viewpoint of senior management are brought to bear.

In the second year, much can also be done to improve the elements of the overall control environment. In preparing for the first round of compliance reporting, most organizations simply documented their control environment-related controls. Few questioned how deeply rooted in the organization these controls actually were. Now you need to make sure that control owners both understand and embrace all elements of the control environment, including the whistleblower program, the codes of ethics and conduct, and fraud prevention and detection.

As companies endeavor to increase the effectiveness of their financial reporting, it is crucial for them to focus on issues that might create a material weakness in their reporting. *Materiality* is a term used to describe the significance of financial statement information to investors and other decision-makers. An item of information is considered material if it is probable that its omission or misstatement would influence or change a stakeholder's decision. Remember that materiality is a moving target. You should revisit your materiality calculation annually and even more frequently if conditions and circumstance dictate. Keep in mind that non-numerical disclosures, particularly those in

footnotes to the financial statements, play a large role in influencing investment decisions.

## Managing the Testing of Controls

Testing the controls is a critical element of building a sustainable process. Firms are now struggling with complex questions related to who should do the testing and how.

***[I]t is crucial for [companies] to focus on issues that might create a material weakness in their reporting.***

There are two distinct approaches to testing. One is to have the people who own the controls—the senior leaders—conduct the testing. The CEO, the CFO, the general counsel, and other members of management have a vested interest in recognizing what a control is and in understanding the obligation to have effective controls. By getting involved in a hands-on way, executives gain the knowledge and experience needed to excel at compliance. From our perspective, senior management ownership of the compliance process gets to the essence of what Sarbanes-Oxley is all about: leadership must assume explicit responsibility for managing internal controls in the organization.

Yet, there are drawbacks to having management conduct the testing. Will the essential qualities of independence and objectivity suffer if management is testing its own controls? And what if management faces situations where they don't know how to test the controls? Testing controls requires distinct skills that few business people outside the auditing function possess.

The second approach to testing is to use an entity other than management. The most logical choice here would be an "external" unit that is actually internal—the internal audit function. By definition, the audit function is objective and independent. It generally reports to the Audit Committee. Internal auditors are professionals who understand the required frameworks and standards. They are thoroughly familiar with testing processes, knowing how to both test controls and document the work.

What are the drawbacks to this approach? If internal audit does all the testing, it is unlikely that management will truly learn the value of the

process and the lessons of advanced governance. The testing becomes a third-party event that distances management. This undermines the intent of Sarbanes-Oxley, which mandates that senior-level managers should be actively engaged in understanding and testing controls.

A second disadvantage is rooted in the fact that internal audit's objectivity is as pure as it is because the entity has no line responsibility for day-to-day activities. If internal audit were to assume responsibility for testing, there is some risk that its objectivity might be compromised. People are put in a difficult situation when they are asked to audit their own work and find they have to cannibalize their plans.

Another drawback of this approach, though of lesser concern, is that it would force the internal audit group to substantially increase its staff. One firm we are familiar with had 60 people in its internal audit group before Sarbanes-Oxley. The company has doubled the number of employees in internal audit because the group is now responsible for all testing.

### **Striking a Balance**

After considering the pros and cons of these two testing approaches, a third option seems to offer the most balanced solution, and it best serves the intent of Sarbanes-Oxley. The solution is built on the newly-transitioned SCO team described earlier.

On average, the SCO organization at a large public financial institution might number between 10 and 25 people. This group would have two primary responsibilities. First, it would ensure that the people who are doing the testing—the firm's management—have the necessary understanding and training. It also would provide the tools and support services needed for successful testing. Second, the SCO group would play a quality-assurance role. For example, if management were to conduct 100 percent of the testing, the SCO organization would have the responsibility and capability to re-perform 10 to 15 percent of the testing to validate effectiveness.

Firms that buy into the SCO concept will have to decide which major area of the firm the newly created group will report into. There are several choices: the CFO and Controller division; the General Auditor who directs the inter-

nal audit function; the Compliance Officer (who is sometimes located in the Office of the General Counsel); and the Risk Management organization. We believe the most coherent solution is to have the SCO organization report to the CFO-Controller division. Because the CFO-Controller division is *the* senior management entity responsible for the internal control environment, it is the route that most closely follows the spirit of Sarbanes-Oxley. But there is a caveat to this recommendation. We think the SCO should actually have a dual reporting relationship. SCO can be established as a matrix organization, with solid-line reporting to the CFO-Controller and dotted-line reporting to the General Auditor.

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***[L]eadership must assume explicit responsibility for managing internal controls in the organization.***

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Several reasons recommend a dual-alliance structure for the SCO. By reporting directly to the CFO, the SCO becomes allied with management. This fulfills the essence of Sarbanes-Oxley by putting primary responsibility for internal controls oversight into the hands of management. At the same time, it gives the SCO a channel to the Board of Director's Audit Committee when needed.

However, there is a perception problem. Should SCO report solely to the CFO, it may raise questions about the group's independence and objectivity. This concern is eliminated if SCO has a dotted line to the General Auditor's office. This dual reporting structure also allows SCO to capture the independence, objectivity, and professional know-how of internal audit experts. In addition, it can leverage the work already done by internal audit and reduce the workload SCO would otherwise have to handle.

### **Building a Bridge to Trust**

Investor trust is in short supply today. To restore confidence, firms across all industries will need to do more than simply comply with SEC regulations.

To win confidence, firms have to truly understand that Sarbanes-Oxley is about good business and shareholder value. This insight should trigger in-house initiatives to achieve the

highest standards of governance, to demonstrate the firm's superior Financial Reporting IQ with high-quality financial information, and to align business strategy with the imperatives of effective financial control.

General counsel can and should take a lead role in guiding their firms beyond the requirements of Sarbanes-Oxley and capitalizing on the opportunities it offers. In this way, general counsel can be a force that contributes to compliance by leading the organization to advanced corporate governance. 

<sup>1</sup> See The Committee of Sponsoring Organizations of the Treadway Commission, "Internal Control—Integrated Framework, Executive Summary," available at <[www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm)> (describing the

five "interrelated components" of internal control as control environment, risk assessment, control activities, information and communication, and monitoring).

- 2 GovernanceMetrics International March 2004 GMI Governance and Performance Study is available through links at <[www.gmiratings.com](http://www.gmiratings.com)>.
- 3 United States General Accounting Office, "Financial Statement Restatements, Report to the Chairman, Committee of Banking, Housing and Urban Affairs," October 2002.
- 4 See FEI Special Survey on Sarbanes-Oxley Section 404 Implementation, Executive Summary (July 2004), available at <[www.fei.org/download/SOXSurveyJuly.pdf](http://www.fei.org/download/SOXSurveyJuly.pdf)>.
- 5 See Thomas E. Hartman, "The Cost of Being Public in the Era of Sarbanes-Oxley 2004" (May 19, 2004), available through link at <[www.foley.com/features/feature\\_detail.aspx?featureid=37](http://www.foley.com/features/feature_detail.aspx?featureid=37)>.
- 6 See "New Regulations: Preparing for Unplanned Costs," from the January/February 2003 issue of FINANCIAL EXECUTIVE, available at <<http://demo.thejohnsongroup.com/PDFs/FEIreg.pdf>>.
- 7 See report at <[www.fei.org/news/404\\_survey.cfm](http://www.fei.org/news/404_survey.cfm)>.
- 8 See Kevin Fogarty, "Paying for Sarbanes Oxley" (Sept. 1, 2004), available at <[www.baselinemag.com/article/0,1397,1644466,00.asp](http://www.baselinemag.com/article/0,1397,1644466,00.asp)>.

# Revenue-Sharing Disclosure by Broker-Dealers

by Frank G. Zarb, Jr.\*

The numerous headlines about woes in the mutual fund industry these days have been notable in the use of short-hand references—or buzzwords—to the issues at hand, such as "late trading," "directed brokerage," "compliance procedures," "board independence," and so on. Among them, "revenue-sharing"—a practice in which a mutual fund adviser or affiliated underwriter makes payments out of its own resources to a broker based on factors such as the amount of that mutual fund's shares the broker sells—is probably the least understood.

This is as good a time as any to try to understand "revenue-sharing," including the unstable ground created by current regulatory initiatives, since industry participants may be called upon to begin the transition to a new world order as early as next year.<sup>1</sup> This article provides an aerial view of the regulatory topography, and some predictions of how that topography might evolve.

## Defining the Terms

Before beginning, in order to avoid confusion with other issues currently affecting the

mutual fund industry, a brief word on what "revenue-sharing" is not, and on what it is.

First, what it is not. While some have criticized revenue-sharing, it is a long-standing practice that the principal regulators (the SEC or the NASD) have not prohibited, or even proposed to prohibit. The current regulatory issues seem to be principally focused on requiring additional disclosure.

You no doubt have read about "directed brokerage," a practice in which some mutual funds or their affiliates may have given certain broker-dealers additional brokerage business, with the accompanying commissions—sometimes as part of overall revenue-sharing payments. Although the practice was well-established, this past September the SEC decided to prohibit the use of "directed brokerage" to

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finance mutual fund distribution, based not on any notion that related revenue-sharing arrangements are inappropriate, but rather on considerations about the use of fund assets to pay brokerage commissions and on concerns that the practice might adversely affect the broker's obligation to obtain a "best execution" of the trades.<sup>2</sup>

What *is* "revenue-sharing"? It is one component of the economics of mutual fund distribution and servicing. To understand revenue-sharing, it is easiest to start with other economic components, such as sales loads, which most readers probably understand.

***[R]evenue sharing ... is a long-standing practice that the principal regulators ... have not prohibited, or even proposed to prohibit.***

When a client of a broker-dealer purchases shares in a mutual fund, the client may pay a sales load, which typically is a percentage of the investment that is applied to defray distribution expenses, such as sales commissions. Regardless of whether the fund carries a sales load, fund assets may be used to meet certain distribution expenses through the deduction of "12b-1 fees" (that is, if the fund has adopted a plan that qualifies under Section 12b-1 of the Investment Company Act). Thus, the annual payment of distribution expenses by the fund will reduce the fund's overall net asset value by the same amount.

While sales loads or 12b-1 fees have a direct economic impact on the fund's shareholders (they are deducted from investment proceeds or from the general fund assets), "revenue-sharing" payments do not; they are not subtracted from fund assets. Instead, revenue-sharing payments typically are paid by the fund adviser or its affiliated underwriter out of its own assets, such as the profit the adviser earns from the management fee or from other sources.

Revenue-sharing payments typically compensate broker-dealers for ensuring that the participating mutual funds receive a higher profile—or better "shelf space" by analogy to the competition for the most visible shelves in a grocery store. For example, funds that enter into

revenue-sharing arrangements may appear on a list of preferred funds, may have greater access to the broker-dealer's financial advisers to provide education and training, or may be invited to participate in conferences and meetings organized by the broker-dealer.<sup>3</sup>

A mutual fund's adviser or affiliated underwriter also may make payments to reimburse the broker for performing shareholder-servicing tasks for the fund that, in the past, may have been performed by the fund or its affiliates. Broker-dealers, for example, may keep track of investor accounts (a practice known as "sub-accounting") and report holdings on a consolidated basis on their own client statements. In their current proposals to amend their rules, both the SEC and the NASD have generated some controversy by defining such expense reimbursements as "revenue-sharing," making no distinction between reimbursements and payments for "shelf space."

### **The Revenue-Sharing "Problem"**

Why are some regulators concerned about revenue-sharing? The objection should not be on economic grounds. The adviser or affiliated underwriter generally makes revenue-sharing payments from its own assets, so there is no reduction of the fund's resources. Rather, some argue that the payments could be the basis for a conflict of interest between the broker-dealer and its customer. The theory is that, when recommending funds to a customer, a broker might favor a fund from which it receives such payments over another fund from which it does not.

The traditional approach of the SEC and the NASD to potential conflicts of interest is to require disclosure of the related circumstances. That indeed has been the primary approach of both agencies to revenue-sharing,<sup>4</sup> but exactly what broker-dealers are required to disclose has been unclear. The fee table included in the fund's prospectus does not reflect revenue-sharing payments because such payments are not incurred by the investor, although funds historically have disclosed elsewhere in the prospectus or SAI that their advisers or affiliated underwriters make revenue-sharing payments.

For the requirements relating to the disclosure of revenue-sharing arrangements, one must look to the NASD's Conduct Rule 2830(1)(4),

and the SEC's Rule 10b-10 under the Securities Exchange Act of 1934. The disclosure of potential conflicts of interest is the principal underlying policy of both rules, and, as explained below, both rules are in flux; both the SEC and NASD have proposed amendments. On top of these considerations are the general anti-fraud provisions: Section 17(a)(2) of the Securities Act of 1933 and Rule 10b-5 under the Exchange Act.

### **NASD Conduct Rule 2830(l)(4)**

Rule 2830(l)(4) bars a broker from accepting "cash compensation" from a third party unless the fund's prospectus or SAI<sup>5</sup> describes the compensation.<sup>6</sup> The applicability of Rule 2830(l)(4) to revenue-sharing arrangements has been unclear and generated uncertainty—a point the NASD appears to implicitly acknowledge in its pending proposed rule amendments, which would address revenue-sharing explicitly.<sup>7</sup>

If adopted, the amended rule would supplement the definition of "cash compensation" to include "any cash payment received as a condition for inclusion of the investment company on a preferred or select sales list; in any other sales program; or as an expense reimbursement." The proposed amendments also would require the broker-dealer to provide a client with additional disclosures at the time the customer establishes an account, or if no account is established, at the "point of sale," which is the time the customer first purchases fund securities. Such additional disclosures also would have to identify the broker-dealers with which the fund has had revenue-sharing arrangements, in order of the magnitude of the payments involved.

The SEC's proposed amendments to Rule 10b-10, discussed below, followed the NASD's proposed revisions to Rule 2830(l)(4). The NASD likely will hold its proposals in abeyance until the SEC adopts final rules.

### **SEC Rule 10b-10**

Rule 10b-10(i)(D) under the Exchange Act requires disclosure in the confirmation of sale of, among other things, the "source and amount of any *other remuneration* received, or to be received by the broker in connection with the transaction." This language generally is viewed as calling for disclosure of revenue-sharing payments, although the phrase "other remunera-

tion" does not specifically implicate those payments. The SEC has consistently stated that such disclosure can be included in the fund prospectus in lieu of the confirmation.

While the NASD has interpreted Rule 2830(l)(4) to not require any quantification of revenue-sharing payments,<sup>8</sup> the SEC has indicated that some quantification may be required under Rule 10b-10. In an *amicus* brief submitted in a Second Circuit case decided in 2000,<sup>9</sup> the SEC opined (and the court agreed) that the defendant's disclosure to the effect that "significant amounts" of revenue-sharing fees were paid was sufficient to satisfy Rule 10b-10 and Rule 10b-5 in the circumstances presented. The SEC explained that "[t]his language does more than disclose the mere existence of a conflict and gives some idea of the dimensions of the conflict."<sup>10</sup>

.....  
***[S]ome argue that [revenue sharing] payments could be the basis for a conflict of interest between the broker-dealer and its customer.***  
.....

In formulating its position in the *Quick* case, the SEC likely deliberately shied away from seeking more detailed quantification of revenue-sharing payments in an enforcement proceeding. As reflected in some of the public comments on the quantification aspects of the pending proposals to amend Rule 10b-10, the complexities of formulating an approach to quantification are better addressed in the policy-making process.

The SEC's proposed amendments to Rule 10b-10 were released in January, and took the form of proposed new Rule 15c2-2 (addressing broker-dealers' disclosure obligations when they send written confirmations of sales) and new Rule 15c2-3 (which would require new "point of sale" disclosures).<sup>11</sup> The proposed definition of "revenue-sharing" would include both the expense reimbursement component of such payments and the "shelf space" component.

As proposed, at point of sale the broker-dealer would merely indicate whether it receives revenue-sharing payments from the fund complex in question. The proposed confirmation disclosure, by contrast, would have detailed quantification of revenue-sharing amounts.

Specifically, a broker-dealer would be required to disclose revenue-sharing payments as a percentage of net asset value of covered securities issued by the fund complex that are sold by the broker-dealer in the four most recent calendar quarters. This percentage would have to be compared to a range of industry norms. The disclosure also would have to include a number that results from multiplying the dollar amount of the individual investment in question by the percentage noted above, which may or may not represent the amount of revenue-sharing payments the broker-dealer will receive as a result of the transaction.

Some commenters argued that the proposed approach to quantification disclosure would be misleading for a number of reasons. First, it would not distinguish between true revenue-sharing payments and reimbursement for costs such as for servicing fund shareholders. Second, it would not distinguish between fees based on net asset value and fixed fees. Finally, since the calculation of the percentage of revenue-sharing payments compared to net asset value of shares sold by the broker-dealer is based on the fee arrangements of all funds in the fund complex, that percentage may be misleading as reported to a customer of a single fund.<sup>12</sup>

The proposals also were sharply criticized for the magnitude of implementation costs. For example, the Securities Industry Association estimated total implementation costs to the industry of \$5.4 billion, and additional billions in ongoing annual expenses.<sup>13</sup>

### **The Anti-Fraud Provisions: Securities Act Section 17(a)(2) and Rule 10b-5**

Because of the possibility of Monday morning quarterbacking by regulators or private litigants, the ambiguous application of the anti-fraud rules in this context creates the most uncertainty. The good news is that, as a practical matter, if the SEC adopts amendments to Rule 10b-10, the SEC's Enforcement Division is unlikely to contend that information outside the scope of the updated rule is material. In other words, the rules, if adopted, should effectively eliminate the potential for enforcement actions.

That said, the preliminary note to Rule 10b-10 does provide that "[t]he requirements under

this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions." Similarly, in its release proposing amendments to Rule 10b-10, the SEC reaffirmed its position that "even if a confirmation rule specifically addresses a particular practice, a broker, dealer, or municipal securities dealer could provide enough disclosure to satisfy the rule, but nonetheless violate the antifraud provisions . . . through its omission of material information to its customer in a particular transaction or under particular arrangements."<sup>14</sup>


The SEC's antifraud enforcement arsenal includes Section 17(a)(2) of the Securities Act,<sup>15</sup> which does not require the SEC to show scienter (intent to defraud), and Rule 10b-5 under the Exchange Act, which does require scienter. The SEC already has demonstrated a willingness to rely on these provisions in addition to its disclosure rules in pursuing actions based on revenue-sharing arrangements.<sup>16</sup>

### **What Does the Future Hold?**

While the SEC and the NASD maintain that their pending rule proposals are not overlapping or inconsistent, most believe the NASD will wait to see what the SEC does before proceeding with its proposals. Due to the nature of the comments the SEC received, it seems likely the SEC will reformulate its proposals somewhat before adopting final rules; this reformulation could involve a re-proposing release with a new comment period if the modifications are significant.

The SEC eventually will pursue amended rules. These rules probably will require some generalized point-of-sale disclosure, although it is unclear whether and to what extent they will require quantification of the revenue-sharing payments. Most likely, the SEC will require some form of generalized or omnibus quantification, such as a ranking of broker-dealers in order of magnitude of revenue-sharing payments, and steer away from the more detailed disclosure that it had proposed. While the Enforcement Division might maintain its interest in revenue-sharing disclosure practices, the SEC probably realizes that enforcement proceedings are not the best way to make law or provide guidance in this area. For one thing, using enforcement proceed-

ings in an area of the law that lacks clear guidance creates more uncertainty. Furthermore, it is impossible to adopt detailed policies in the context of such proceedings. For instance, a settlement cannot create a uniform formula for quantifying revenue-sharing payments.

What should a broker-dealer be doing? At minimum, it should review the relevant disclosures, including prospectus and SAI, for any funds it offers, as well as confirmation disclosure, to determine whether these disclosures are likely to pass muster under current rules, and to assess what it will take to comply with new requirements when they are adopted. 

- 1 See, e.g., “Brokerage Firms Lift the Veil on Pacts with Mutual Funds,” *THE WALL STREET JOURNAL* (Oct. 1, 2004).
- 2 See SEC Release No. IC-26591 (Sept. 2, 2004), available at <[www.sec.gov/rules/final/ic-26591.htm](http://www.sec.gov/rules/final/ic-26591.htm)>.
- 3 Payments by mutual funds, or by their advisers or distributors, to broker-dealers to fund educational and training seminars are permitted as non-cash compensation under NASD Rule 2830, subject to a number of conditions.
- 4 Of course, broker-dealers also are subject to substantive requirements that should mitigate or eliminate any potential conflict, such as the mandate to have reasonable grounds for believing a recommended mutual fund is suitable for the customer. See NASD Conduct Rule 2310.
- 5 While the rule states that the disclosure must be included in the prospectus, the NASD has by interpretation permitted the disclosure to be included in the Statement of Additional Information, or “SAI.” See Notice to Members 3-54, at 568 (Sept. 2003), available at <[www.nasdr.com/pdf-text/0354ntm.txt](http://www.nasdr.com/pdf-text/0354ntm.txt)>.

- 6 The rule also bars a broker from entering into a “special cash compensation arrangement” that is “not made available on the same terms to all members who distribute the investment company securities” unless the name of the broker and “the details of the arrangements” are disclosed in the prospectus or SAI. The scope of this language also becomes an issue in the context of revenue-sharing arrangements. The NASD’s pending amendments unfortunately would not clarify the relationship between “revenue-sharing” arrangements and “special cash compensation arrangements”—a term that would be redefined as “special sales charge or service fee arrangements.”
- 7 See Notice to Members 3-54, *supra* note 5, at 572.
- 8 See Notice to Members 3-54, *supra* note 5, at 567.
- 9 *Press v. Quick & Reilly, Inc.*, 218 F.3d 121 (2d Cir. 2000).
- 10 Brief of the Securities and Exchange Commission, Amicus Curiae, February 14, 2000.
- 11 See SEC Release No. 33-8358 (Jan. 29, 2004), available at <[www.sec.gov/rules/proposed/33-8358.htm](http://www.sec.gov/rules/proposed/33-8358.htm)>.
- 12 See, e.g., Securities Industry Association, File No. S7-06-04, April 12, 2004, available at <[www.sec.gov/rules/proposed/s70604/sia041204.pdf](http://www.sec.gov/rules/proposed/s70604/sia041204.pdf)>; Merrill Lynch, File No. S7-06-04, April 12, 2004, available at <[www.sec.gov/rules/proposed/s70604/merrilllynch041204.pdf](http://www.sec.gov/rules/proposed/s70604/merrilllynch041204.pdf)>.
- 13 SAI Comment Letter, *supra* note 12. Several of the broker-dealer commenters suggested that the new disclosures instead be included in a plain-English brochure and/or be made available on a Web site in order to avoid excessive implementation costs.
- 14 SEC Release No. 33-8358, *supra* note 11, at n. 55.
- 15 Rule 17(a)(2) is generally viewed as unavailable to private litigants.
- 16 Last November, for instance, the SEC settled an action against one major broker-dealer based on a “Preferred Partners” program through which the firm conducted revenue-sharing arrangements with numerous funds. The SEC claimed the firm violated Section 17(a)(2) and Rule 10b-10, alleging, among other things, that the firm did not “provide sufficient facts about the preferred programs for investors to appreciate the dimension of the conflicts of interest inherent in them.” SEC Release No. 33-8339 (Nov. 17, 2003), available at <[www.sec.gov/litigation/admin/33-8339.htm](http://www.sec.gov/litigation/admin/33-8339.htm)>, at ¶ 25. While the SEC acknowledged the presence of some disclosure about revenue-sharing payments, it took the position that the firm should have disclosed more, such as “the various marketing advantages provided through the programs.”

# Continuous Reporting and Auditing: Opportunities and Challenges

by Michael Alles, Alexander Kogan, and Miklos Vasarhelyi\*

Section 409 of the Sarbanes-Oxley Act begins a process that will lead to continuous reporting, but real-time disclosure will lack credibility without the assurance that investors have taken for granted with current mandatory reports. Continuous Assurance (CA) takes advantage of the information technology (IT) systems that define the modern, digital corporation to produce the real-time assurance that stakeholders in today's fast-paced information economy demand. This intersection of technology and the post Sarbanes-Oxley demand for more timely and comprehensive information makes the evolution of auditing to CA seem inevitable. But the emergence of continuous reporting and auditing also poses legal, regulatory, and business challenges—and opportunities—that require further thought.

## Continuous Reporting

The Sarbanes-Oxley Act fundamentally changes all aspects of the financial and auditing environment. Most attention currently is focused on the Section 404 requirements concerning financial reporting controls. As a result, the spotlight is off another provision that could be equally momentous in its long run impact: the requirement built into Section 409 to move toward a system of real-time or continuous reporting. Specifically, Section 409 provides:

“Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.”

Thus far, the Securities and Exchange Commission has invoked Section 409 only to mandate faster reporting on several disclosure forms. But accelerating the filing deadline for 10-Q's by ten days is a far cry from disclosure on a “rapid and current basis.”

***[R]eal time disclosure will lack credibility without the assurance that investors have taken for granted with current mandatory reports.***

We interpret Section 409 as the first official recognition of the dramatic changes in business technology and in the speed at which modern financial markets operate; together these changes make the 19th Century model of annual and quarterly financial reporting obsolete. Computer technology, such as Enterprise Resource Planning (ERP) systems (for example, SAP™), which tie together all the data and processes of a firm in one IT system, and the emergence of computer languages designed to support the exchange of financial and other information (such as XBRL and XBRL-GL), increasingly are facilitating cost-efficient online real-time systems. *[Editor's note: A sidebar to this article explains XBRL and its potential to transform how investors obtain, analyze, manipulate, and communicate financial information.]* These systems could include financial statements published on the Web that are complete up to the last recorded corporate transactions, contracts, and commitments—even before they are realized in traditional accounting. That would fulfill the Section 409 requirements much better than the

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preliminary steps taken by the SEC thus far, which tend to take processes as given rather than rethinking and reengineering them.

Inevitably, the needs of the modern information marketplace will bring about real-time reporting and disclosure. The assumption is that corporations with real-time monitoring and control systems will be more transparent, and that transparency will confer a competitive advantage. Consequently, regardless of how Section 409 is officially interpreted, internal reporting processes will progressively be real-time. Once that transformation occurs, the incremental cost of using real-time controls for external reporting will be small—especially when all accounting systems are XBRL-enabled.

***[D]ramatic changes in business technology and in the speed at which modern financial markets operate ... make the 19th Century model of annual and quarterly financial reporting obsolete.***

We predict that, over time, Section 409 will lead to the adoption of reporting at times dictated by the needs of users of financial information and not by the constraints of the calendar. However, more frequent and timely reports will lack much of their power if users are not assured of their accuracy and dependability. By way of example, note that while quarterly financial statements are only required to be reviewed by the outside auditor (rather than attested to), a private survey conducted by accounting firm KPMG found that over 50% of financial analysts actually believe that 10-Qs are audited. Clearly investors take it for granted that all financial statements released by a firm have assurance attached to them, even though in reality only the annual income statement and balance sheet has to be audited. As more “Section 409” reporting emerges, the market will insist that assurance be provided before those reports are relied on for decision making.<sup>1</sup> As one authority recently argued, “The advantages of electronic business reporting will provide a market for—indeed, the necessity of—continuous assurance.<sup>2</sup> Moreover, “Investors need real-time, rich information. IT permits it; therefore it will happen.”<sup>3</sup>

Right now audit methodologies are based upon an audit that is mandated, issued only annually, and with no real-time content or constraint. Matching the time cycle of continuous reporting requires the development of a new type of audit methodology: Continuous Auditing. Thus the impact of Section 409 will extend beyond reporting to bring about fundamental changes in the assurance industry.

### **Continuous Auditing**

“A continuous audit is a methodology that enables independent auditors to provide written assurance on a subject matter, for which an entity’s management is responsible, using a series of auditors’ reports issued virtually simultaneously with, or a short period of time after, the occurrence of events underlying the subject matter.”<sup>4</sup>

Even before the advent of Section 409 and its boost to continuous reporting, the acceleration of information flows and the availability of online real-time enterprise systems had prompted the accounting profession to reconsider what an audit means and how it is carried out. It is now widely believed that the “archival audit”—where the auditor comes in at the end of the year, examines statements, and issues ex-post opinions—is a relic of an age with fewer informational demands by stakeholders. The shortcomings in the financial reporting and auditing system exposed by recent scandals have illustrated the importance of effective auditing to a well functioning economy, and exacerbated concerns that the way auditing is carried out has to be upgraded to match the complexity of today’s global companies.

As a consequence, we expect the standard audit to be supplemented, if not replaced, by a timelier, closer to the event, semi-supervisory function, where independent assurors will work with both third party stakeholders and firms to provide new forms of assurance products. As one expert states: “On-line reporting based on databases updated in real time will be less wedded to current protocols for periodicity, creating a parallel evolution toward continuous auditing. Continuous auditing may lead to continuous reporting that supplements and eventually replaces the annual audit report.”<sup>5</sup>

## Continuous Assurance

Continuance assurance, or CA, is technology-enabled auditing that produces audit results simultaneously with, or a short time after, the occurrence of relevant events. Compared with the traditional financial statement audit, CA is more timely, more comprehensive, more accurate, and less costly.

CA is the product of a fundamental transformation in business operations and control. The digitization of companies through the widespread use of ERP systems, bar coding, the forthcoming radio ID (RFID) chips, and automated transaction recording makes it cheaper and easier to gather data at an unprecedented level of detail and with very little time lag following the transaction. In particular, the unique and unprecedented characteristic of ERP systems is that they seamlessly integrate and automate business processes to achieve real-time information flows.

***[W]e expect the standard audit to be supplemented, if not replaced, by a timelier, closer to the event, semi-supervisory function.***

Since CA is progressively being built upon a firm's underlying ERP system, CA inherits these characteristics. However, CA only achieves its full power when it takes complete advantage of this ability to automate business processes and integrate information flows to develop new real-time analytic procedures far more sophisticated and all-encompassing than anything in use currently.

The full scope of the capability that automation and integration provides CA has yet to be fully appreciated and utilized. But once it is, auditors will have the unprecedented ability to transform auditing into a system for the continuous analytic monitoring of business processes. Moreover, utilizing the power of online IT systems, CA also offers the potential to produce a wider set of assurance reports encompassing more variables, alarms, and analytic procedures than the standard audit opinion on the annual financial statement. Those capabilities will facilitate the development of a full-fledged continuous reporting environment as contemplated by Section 409.

Clearly CA is much more than a technological tool, or even a simple evolution in auditing methodology. CA can fundamentally change not just the way auditing is carried out, but its role in the operation of the firm and the relationship of the auditor with the firm. But such a change will necessitate equally fundamental changes in the regulatory and legal environment within which auditing is undertaken.

## Drivers of Continuance Assurance

Essentially, the development of CA decreases the gap between audit and management operations. In the past, managers had access to data that was far more detailed and obviously timelier than the auditor, who came into the picture only at the year's end. But the technology underlying CA, especially ERP systems, allows auditors to see the same data as managers and at the same time—or even earlier, given their expertise in process monitoring. This has profound implications for whether auditing remains a device for ex-post verification or becomes a means of real-time monitoring. In any event, CA will give auditors access to streams of data that they never could obtain cost-effectively before. Audit methodologies will have to adapt to this explosion in the magnitude, level of disaggregated detail, and timeliness of data.

***[With continuous auditing,] auditors will have the unprecedented ability to transform auditing into a system for the continuous analytic monitoring of business processes.***

CA extends the analytical methods of traditional auditing by examining continuous flows of data against models of system behavior. Monitoring the content of a firm's data flow focuses on examining both exceptional transactions and exceptional outcomes of expected transactions. CA software continuously monitors company transactions, comparing their generic characteristics to observed or expected benchmarks, thus identifying anomalous situations. When significant discrepancies occur, alarms are triggered to alert the appropriate stakeholders.<sup>6</sup>

While the "electronization" of business processes has been actively pursued for several decades, and the implementation of modern ERP systems for over a decade, auditing has been

slow to adapt to these environmental changes.<sup>7</sup> First, the electronization of business processes was simply ignored with “auditing around the computer”: whatever information was needed was extracted on paper—an approach still in use to a surprising extent. Then the auditors started utilizing the new information technology by “auditing through the computer.” However, this practice at best automates standard audit processes and procedures by using computer productivity tools (such as MS Office) and computer-assisted audit techniques (known as “CAAT”) that are basically data analysis software. This approach is limited because it does not take advantage of the new technological possibility to automate and integrate audit processes and procedures; nor does it provide sufficient response to the challenges of auditing a modern digitized corporation.

.....  
***[O]nce [continuous auditing] reaches a critical mass, the technology will begin to drive audit methodologies, leading to a true reengineering of audit processes.***  
.....

There is a direct analogy between the automation and integration of business processes and the deployment of ERP systems on the one hand, and the automation and integration of audit processes and the deployment of continuous auditing systems on the other. The relationship between ERP and CA extends to lessons on their implementation. Implementing ERP has been dogged by cost and complexity, which reflects the fact that it is much more than a technology. Integration of information flows can only proceed when the underlying business processes also are automated and integrated and have achieved a consistency in purpose and operational practices.<sup>8</sup> But ERP goes one step further, by forcing businesses to adapt their processes to the needs of the ERP system rather than following a “clean sheet” approach where business processes first are reengineered and then the enabling technology is obtained. It turned out to be simply too costly to develop fully customized ERP systems for different firms, so ERP became “one-size fits most.”

It is likely that similar issues will arise with CA systems, both with regard to the need for customization, and more importantly, about how

it will force auditors to analyze and reengineer their audit processes. This has profound implications for the way auditing is carried out and the impact that CA will have on audit practice. CA first will be used to reduce the cost of current audit procedures or to assure processes that cannot easily be assured by traditional methods. But the ERP analogy suggests that it will take time before the investment in implementing CA will start paying off. However, once CA reaches a critical mass, the technology will begin to drive audit methodologies, leading to a true reengineering of audit processes. This will have a transformational effect, especially given that much audit practice has not been subject to formalization and process analysis, let alone reengineering, thus far.

### **Levels of Assurance Under Continuance Assurance**

The basic objective of the traditional audit is to provide assurance about the accuracy of the financial statement. In the past, tradeoffs between the benefits of this assurance and the limits of existing information technology led to the development of a materiality threshold of acceptable error. The modern audit, with great improvements in information technology, has changed these tradeoffs in the direction of a much finer and timely assurance effort. Eventually, with the distribution of data at ever finer levels of detail (as opposed to reporting only at the aggregate level, as in the current system of annual financial statements) through the use XBRL tagged elements, data level assurance will become necessary. The continuous audit will aim to provide prompter and more accurate assurance on more disaggregate data for a much wider set of financial and non-financial variables.

The audit objectives—the specific assertions whose verification is the focus of the audit tasks—range from well-defined issues such as transaction verification to tasks that are much more complex and rely extensively on human judgment, such as the estimation of contingent liabilities. Tasks that are routine and mechanical in nature can readily be transferred from a manual to a CA system and done more comprehensively and cost effectively taking advantage of the automation and integration of the firm’s ERP systems. The question is whether the

effectiveness of CA declines correspondingly from one end of the audit objective continuum to the other as the audit objective moves from mechanical data verification to assessment of managerial judgments. If so, then the impact of CA on auditing and its ability to create a new audit environment also declines, as it essentially does not do much more than automate existing audit methods. CA still adds a great deal of value by freeing auditors from mechanical tasks that are better handled by automated systems, giving them more time to focus on matters that require pure human judgment. But that is still a second rather than first order effect on the audit process.

Understanding the ultimate impact of CA on audit methodology requires distinguishing among four levels on the audit objective continuum. These four levels are hard to define in mutually exclusive or exhaustive ways, but they do serve to illustrate the necessary functional dependence of CA on the audit objective:

**Level 1:** Verifying atomic elements of transactions (e.g., movement of money, information, at the data level).

**Level 2:** Assuring the appropriateness of the measurement rules used in transaction processing (i.e., GAAP).

**Level 3:** Verifying the adequacy of estimates and their assumptions, as well as the consistency of high-level measurements.

**Level 4:** Auditing and questioning high-level judgments and facts about the organization.

While the automation of the first level seems sufficiently straightforward, the really surprising effect of the CA methodology is in its applicability to the higher levels. While CA applies less as the audit objective becomes more complex, we argue that certain audit procedures still can be applied, sometimes formalized, and automated even at the high end of the continuum. The key is to undertake formal process mapping, analysis, and reengineering of audit processes. Like the reengineering preceding ERP, it is likely that a good number of audit tasks currently thought to be matters of pure human judgment can in fact be systematized to some extent. The first step toward bringing these tasks within the capability of automated CA systems is for auditors to explicitly state the assumptions underlying their estimates and judgments.

To illustrate the possible application of CA to these four levels, consider an example from pension disclosures. The problems around measurement, reporting, and auditing of pensions are well known and have troubled standard setters, pension managers, and pensioners for decades. Auditors can use CA methodology to provide several assurance services.

**Level 1:** Flag and extract all transactions that pass resources between the company and its pension fund, extract all transactions that affect pension-related ledger accounts, and vouch for these transactions.

**Level 2:** GAAP specifies maximum and minimum contributions to pension plans as well as ways to account for pension obligations and other pension-related items. This level would create a logical template evaluating compliance with the rules of ERISA and GAAP.

**Level 3:** On a more analytical level, the continuous assessor can examine the formally disclosed rules relative to pensions that allow for the organization's actuarial estimates. Accounting standards require the disclosure and usage of an interest rate in the assumptions about pension estimates, but the standards do not require a relationship between the historical returns of the fund and the future return assumptions. The current spate of pension failures will increase pressure for corporate judgments regarding pension fund returns to be verified against external benchmarks and for greater assurance about possibly self-serving forecasts about the state of pension obligations.

**Level 4:** At the judgment assurance level the auditor could make assertions about the appropriateness of pension plan funding, the quality of the management of the fund, the quality of the assets held by the fund, or the cost incurred in managing the pension portfolio. Some of these judgments may eventually be relevant for a wider set of assurance and management services.

### **Implications for Auditor Independence**

Full deployment of CA will require more than technology implementation. It will require auditors to examine their processes in way they have resisted thus far to see if they are susceptible to process mapping and reengineering. This is particularly important if CA is to achieve its

full potential by being progressively extended to higher levels of audit objects, rather than being restricted to the most mechanical of audit tasks at the transaction level.

**[I]ntegration of auditing with monitoring systems has the potential to contravene Section 201 [of Sarbanes-Oxley].**

Systematizing processes once thought to be exclusively in the pure human judgment domain will require auditors to change their thinking. At the same time, continuous analytic monitoring will intrude into the internal control arena, especially since it is built on the firm's own ERP systems. This will create concerns with independence and the relationship between internal and external auditing (similar to the current debate on the boundary between auditing and consulting), and sets up a potential conflict with Section 201 of the Sarbanes-Oxley Act, which restricts the non-audit services that can be provided to a firm by its auditor.<sup>9</sup>

While a CA system does not have to be configured to send real-time notifications to the client management about any anomalies it detects, withholding such notifications is problematic for legal, business, and ethical reasons. Acting upon the real-time CA notifications and correcting the identified problems will be a function of managerial control; managers who do not act upon the notifications and correct the identified problems may face legal liability if there is a perception that high quality information with operational implications is being ignored. Therefore, the widespread deployment of CA will likely result in the effective integration of the CA system with the managerial control system.

Such integration of auditing with monitoring systems has the potential to contravene Section 201. Under CA, the distinction between auditing and consulting may effectively be eliminated because in many ways, the reason that auditing is not intertwined with managerial control right now is that it is so far removed in time from the actual transaction. As the audit latency—the time between the transaction and the assurance of that transaction—is reduced, it becomes even more evident that auditing is inherently a dynamic

information generating process; separating the information from the ability to act upon it wastes both information and effort. Thus, either Section 201 of Sarbanes-Oxley will have to be changed, or the development of CA technologies will be severely constrained.

## Conclusion

Until recently, the assumption was that the major constraint on the adoption of continuous reporting and auditing was not the supply of the necessary technology, but rather, whether there would be any demand for more comprehensive and timely reporting and assurance. With the post-Enron endorsement of real-time reporting by the Sarbanes-Oxley Act, the AICPA, and the SEC, and the market's need for matching assurance, interest in continuous reporting and assurance has finally reached critical mass. While the development of new technologies and business institutions are difficult to predict, we expect that either technology-enabled timeliness will become the essential characteristic of reporting and auditing, or accounting reports and auditing will lose their role as the primary means of providing assurance to those who use financial information. **W**

- 1 Of course, we suspect the real constraint on the deployment of continuous reporting is not technology, but managers' fears over increased litigation risks—in this case over non-mandated disclosures. The interests of better informed investors may require the SEC to create some form of safe harbor for real-time reports.
- 2 R. Elliott, "21st Century Assurance," *AUDITING: A JOURNAL OF PRACTICE & THEORY*, Spring 2002, at 141.
- 3 R. Elliott, "The Accounting Profession Post Enron," Presentation to Rutgers Business School, May 2, 2002.
- 4 CICA/AICPA Research Study on Continuous Auditing, 1999.
- 5 R. Elliott, "Assurance Service Opportunities: Implications for Academia," *ACCOUNTING HORIZONS* 11 (4), 61-74, at 64 (1997).
- 6 An example of innovative banking regulation using CA is the provision of real-time audit facilities by the Italian bank, BIPOP, to the Italian Central Bank.
- 7 See M.A. Vasarhelyi and M. L. Greenstein, "Underlying Principles of the Electronization of Business: A Research Agenda," *INT'L JOURNAL OF ACCOUNTING INFORMATION SYSTEMS*, 49 (2003) pp. 1-25.
- 8 See M. Hammer, "Reengineering Work: Don't Automate, Obliterate!" *HARVARD BUS. REV.* (1990) (arguing that the full benefit of technology only comes about when it is used to completely rethink processes, rather than simply being used to automate what was previously done manually).
- 9 See M.A. Alles, A. Kogan, and M.A. Vasarhelyi, "Implications of Section 201 of the Sarbanes-Oxley Act: The Role of the Audit Committee in Managing the Informational Costs of the Restriction on Auditors Engaging in Consulting," *INT'L J. OF DISCLOSURE AND GOVERNANCE* (2004, forthcoming).

## Technological Facilitators of Real-Time Reporting

The mandate for real-time reporting in Section 409 comes on the heels of the technology that makes such reporting cost-efficient. The Internet created the potential for users to communicate at low cost with no regard for distance or location. The World Wide Web revolutionized the Internet by establishing a universal standard and making it easy to publish large amounts of information in an accessible and compelling graphical user interface.

The first generation of WWW tools relied heavily on HTML (Hypertext Markup Language) to create document images. However, HTML only describes the *presentation* format of information and not its content. This makes it harder, if not impossible, to extract data intelligently from a Web page, or to compare information across databases.

XML (Extensible Markup language) represents the second generation of WWW tools and allows the Internet to reach a new and unprecedented level of functionality. In its essence, XML adds information on *content* to data tags, allowing intelligent agents to distinguish one piece of information from another on a Web page, data bank, or any other XML-enabled document.

XML is a meta-language, which means that sub-languages have to be created to describe the particular needs of a user group. Unlike its predecessors, XML is easy to use and is designed to allow sub-languages to be readily created. XML provides an alphabet and a basic set of grammar rules from which a specific set of vocabularies can be derived to suit particular purposes.

XML derivative languages—the next generation of computer languages for putting information on, and moving it through, the Internet—expand the scope of computer system interoperability and introduce the prospect of data being freely transmitted between systems and applications, carrying with it tagged meta information that will facilitate comprehension and usability. There are innumerable groups developing XML extension languages.

XBRL (Extensible Business Reporting Language), the work of a consortium originating from an AICPA initiative, has set itself the task of creating a language to describe business reporting information.<sup>1</sup> XBRL is designed to make it easier to prepare, publish, exchange, acquire, and analyze accounting and business-related information. It makes it easier to transfer financial reporting information between software applications, thus greatly multiplying the usefulness of that information.

XBRL eliminates the need to re-key data presented in un-standardized, context-free (and thus difficult-to-use) formats such as HTML documents or downloadable Excel or Adobe Acrobat files. Keying in the data from these formats is labor intensive and creates a substantial risk of both interpretation and transcription errors.

The adoption of XBRL as the de-facto language of financial reporting for the information economy was greatly enhanced by Microsoft's decision to build XBRL into its ubiquitous Excel spreadsheet program in the Office 2003 program suite. And Microsoft became one of the first companies to release its own financial statements in a fully functional XBRL format. The biggest indicator, though, that XBRL will become the de-facto language of business was the SEC's decision to endorse its use—initially through a voluntary process of accepting 10-K's in a XBRL-enabled format.<sup>2</sup> Clearly this technology is only at the beginning stage of its impact on the reporting environment, and only when its use is more widespread will its full power be utilized—probably in ways we cannot fully anticipate.

The growth in related XML sublanguages will help. The most directly relevant is XBRL-GL, which extends the role of XBRL from financial reporting—the output of the reporting process—to the general ledger entries that are its inputs. Direct links to transactions enable a wide variety of specialized and customized accounting queries to be answered in real time. These could include financial statements published on the Web that are complete up to the last recorded corporate transaction, contract, and commitment in process—even before those items are realized in traditional accounting—and fulfill the Section 409 requirements much better than preliminary steps taken by the SEC thus far.

<sup>1</sup> You can learn more about XBRL at <[www.xbrl.org](http://www.xbrl.org)>.

<sup>2</sup> See SEC Release No. 33-8497 (Sept. 27, 2004), available at <[www.sec.gov/rules/concept/33-8497.htm](http://www.sec.gov/rules/concept/33-8497.htm)>.

# CEO Certification, Ban on Road Show Participation, and Voting Client Proxies

by Mark J. Dorsey, Christopher M. Salter, and Tony Regenstreif\*

## **NASD Requires Members' Chief Executive Officers to Certify Compliance Processes**

On September 10, 2004, the SEC approved new NASD Rule 3013 and Interpretive Material ("IM") 3013.<sup>1</sup> Rule 3013 requires members' Chief Executive Officers to certify their firms' compliance processes and requires members to designate a Chief Compliance Officer ("CCO"). IM-3013 prescribes the language for the certification and provides additional guidance concerning the new requirements.<sup>2</sup>

The NASD published a Notice to Members regarding new Rule 3013 and IM-3013 on November 1.<sup>3</sup> The rules will go into effect on December 1, by which time firms must have designated a CCO. CEOs must certify to their firm's compliance processes on or before December 1, 2005. The date a member firm initially certifies becomes the date by which the firm is required to certify annually thereafter.

## **Annual certification of compliance processes**

New Rule 3013 requires CEOs (or an equivalent officer) to annually certify that their firms have compliance processes in place to achieve certain goals. The rule mandates that firms have processes to "establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations."<sup>4</sup>

The required certification language in IM-3013 provides that members have processes to modify their compliance policies and procedures as business, regulatory, and legislative changes and events dictate. Additionally, member firms must certify that they test the effectiveness of compliance policies and procedures regularly. The timing and extent of these tests must be sufficient to

ensure continuing compliance with NASD and MSRB rules and the federal securities laws.

IM-3013 also requires that the CEO (or equivalent officer) certify that he or she has met at least once with the CCO in the preceding 12 months. During this meeting, the CEO and CCO must discuss the matters that are the subject of the certification and address significant compliance problems and plans for emerging business areas. Similarly, the CEO must certify that he or she has consulted with other officers, employees, and outside consultants, as necessary, in order to attest to the statements made in the certification.<sup>5</sup>

In addition to the certification, member firms must prepare a report that describes their compliance processes. The CEO and CCO must review and submit the report to the firm's board of directors and audit committee (or their equivalent if the firm does not have a board of directors or an audit committee).

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IM-3013 requires that the report be prepared before the CEO signs his or her certification, but the report need not contain any conclusions regarding the firm's compliance efforts. The report should discuss how, and how often, compliance processes are conducted and identify the responsible supervisors for those processes. The report may be prepared separately or combined with another report, provided it is clearly titled as responsive to Rule 3013. If the report is combined with another report, the combined report must be presented in its entirety if requested by the NASD.

### **Chief Compliance Officer**

Rule 3013 requires NASD members to designate a principal to serve as CCO and to identify that person on Schedule A of Form BD. IM-3013 clarifies that the CCO may hold other positions within the firm, including CEO, so long as the person can fulfill the required duties of all positions held. The interpretive materials provide that the CCO should have expertise with respect to:

1. "Gaining an understanding of the products, services or line functions that need to be the subject of written compliance policies and written supervisory procedures;
2. Identifying the relevant rules, regulations, laws and standards of conduct pertaining to such products, services or line functions based on experi-

ence and/or consultation with those persons who have technical expertise in such areas of the member's business;

3. Developing, or advising other business persons charged with the obligation to develop, policies and procedures that are reasonably designed to achieve compliance with those relevant rules, regulations, laws and standards of conduct;
4. Evidencing the supervision by the line managers who are responsible for the execution of compliance policies;<sup>6</sup> and
5. Developing programs to test compliance with the member's policies and procedures."

### **NASD Proposes to Prohibit Research Analysts' Participation in Road Shows**

On September 17, 2004, the NASD filed a proposed amendment to NASD Rule 2711 with the SEC.<sup>7</sup> The amended rule would prohibit research analysts from participating in road shows related to investment banking transactions and prevent research analysts from communicating with current or prospective customers about investment banking transactions in the presence of investment banking department personnel or company management. The amendment also would prohibit investment banking department personnel from directing research analysts to

engage in sales or marketing efforts related to investment banking transactions or to communicate with current or prospective customers about such transactions.

### **Rule 2711 safeguards independence**

NASD Rule 2711 is intended to safeguard the primary role of research analysts—providing unbiased analysis—and to increase the objectivity and reliability of the research they produce. In an effort to bolster research analyst independence, the SEC, the NASD, and other SROs have mandated extensive conflict of interest disclosures and prohibited conduct that allowed investment banking interests to influence analysts' reports. The NASD has characterized investment banking influence as "the primary source of biased research."

The proposed amendment would further dissociate investment banking and research by prohibiting analysts from participating in road shows and other investment banking sales efforts. NASD believes that this bar would "reduce the pressure on research analysts to give an overly optimistic assessment of a particular transaction." In addition, if analysts cannot attend, road shows will no longer convey an impression that the analysts endorse all the views expressed by the company or its investment bankers.

NASD stated that the proposed prohibition on

investment banking personnel directing analysts to engage in sales efforts or to communicate with customers about investment banking transactions is “important to eliminate any attempt by investment banking personnel to pressure a research analyst to engage in those communications, thereby further insulating research analysts from influences that could affect their objectivity.”

### **Permitted conduct**

The proposed amendment would permit research analysts to communicate with investors and other member personnel about particular offerings and other transactions. However, this contact must occur outside the presence of the company or investment banking personnel. The NASD explains that this will preserve the analyst’s ability to give a candid assessment of transactions and their risks, while minimizing the pressure from investment banking concerns.

### **Investment Advisers Voting Client Proxies**

On September 15, 2004, the SEC staff issued a letter providing additional guidance to investment advisers on how to use proxy voting recommendations made by third parties who may also advise the issuer on other matters.<sup>8</sup> Under Rule 206(4)-6 of the Investment Advisers Act of 1940, investment advisers must adopt procedures reasonably designed to ensure that they vote clients’ proxies in

the best interests of their clients. One way to accomplish this is for the adviser to vote proxies in accordance with a pre-determined policy and another is for the adviser to vote proxies based on the recommendations of an independent third party.

A proxy voting firm can be one such independent third party. However, if the proxy voting firm receives compensation from issuers for advice on corporate governance or other matters, an investment adviser must determine that the proxy voting firm’s recommendations are impartial and not influenced by the firm’s business relationships with issuers.

The staff concluded that a case-by-case evaluation of the proxy voting firm’s potential conflicts of interest is not the exclusive means by which investment advisers can meet their duty to determine that a recommendation is impartial and independent. The staff suggested that “a thorough review of the proxy voting firm’s conflict procedures and the effectiveness of their implementation” would be one reasonable approach to ensure the independence of a proxy voting firm’s recommendations. Nevertheless, the staff did not conclusively state that an analysis of conflict procedures would always meet the adviser’s duty of care, noting, “relevant facts and circumstances will dictate what steps an investment adviser should take in evaluating a prospective proxy voting firm.”

### **Assessing a proxy voting firm’s conflict procedures**

In order to adequately assess conflict procedures, investment advisers should have a comprehensive understanding of the proxy voting firm’s business and the nature of the conflicts that may arise from it. For example, a proxy voting firm may receive compensation for providing corporate services to issuers, while also making voting recommendations on the issuer’s proxies. An investment adviser must be aware of this business relationship to determine whether the firm’s procedures prevent its business interests from influencing its proxy recommendations.

In this instance, an investment adviser should consider whether the procedures effectively prevent the individuals making voting recommendations from having access to information about the firm’s business relationships with issuers. The adviser also should assess whether those making recommendations are insulated from influence by employees who know of or handle the firm’s relationships with issuers. Finally, the adviser must determine whether the proxy voting firm actually implements its conflict procedures.

Business and conflict procedures can and do change. These changes may affect the investment adviser’s assessment of the proxy voting firm’s conflict procedures. As a result, the staff stated that

*(continued on back cover)*

**SEC Update...** (continued from page 23)

advisers should implement measures “reasonably designed” to identify and address conflicts that may arise on an on-going basis. The staff suggested that advisers should require proxy voting firms to update them regarding any changes in their business or conflict procedures. **W**

- 1 See SEC Release No. 34-50347 (Sept. 10, 2004), available at <www.sec.gov/rules/sro/nasd/34-50347.pdf>.
- 2 The full text of new Rule 3013 and IM 3013 can be found in SEC Release No. 34-50105 (July 28, 2004), which is available at <www.sec.gov/rules/sro/nasd/34-50105.pdf>.

- 3 NASD NTM 04-79 (Nov. 2004), available at <www.nasd.com/stellent/groups/rules\_regs/documents/notice\_to\_members/nasdw\_011955.pdf>.
- 4 The version of Rule 3013 approved by the SEC stands in contrast to the original June 2003 proposal, which would have required CEOs and CCOs to certify to the “adequacy” of a firm’s compliance policies.
- 5 IM-3013 clarifies that by certifying that the required processes are in place, a CEO does not take on responsibility for supervising the firm’s business lines. This is not to say that a CEO could not be found to have line supervisory responsibility in situations where the facts support such a conclusion.
- 6 While it is not entirely clear, we read “evidencing the supervision” to mean that a record of each supervisory review or audit must be made and maintained.

- 7 See File No. SR-NASD-2004-141 (Sept. 17, 2004), available at <www.nasd.com/stellent/groups/rules\_regs/documents/rule\_filing/nasdw\_011625.pdf>.
- 8 See Institutional Shareholder Services, Inc., available at <www.sec.gov/divisions/investment/noaction/iss091504.htm>. The letter elaborates on guidance provided in a May 27, 2004, letter to Egan-Jones Proxy Services concerning the use of third party recommendations to vote proxies. See Egan Jones Proxy Services, available at <www.sec.gov/divisions/investment/noaction/egan052704.htm>.

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