



## SEC Votes to Propose Interpretive Guidance for Management Assessment of Financial Controls, Hedge Fund Private Offering Rule

### Interpretive Guidance Regarding Financial Controls Assessment

The SEC has voted to propose, for public comment, interpretive guidance for management in assessing the adequacy of a company's internal controls for financial reporting. Compliance with the guidelines, which are intended to prevent excessive testing of controls and documentation of controls and testing, would constitute compliance with the SEC's financial control rules, but a company also would be allowed to use other methods that satisfy the rules.

The guidance describes a four-step procedure:

1. Use a risk-based approach to determine areas that both are material and pose a risk to reliable financial reporting, and identify the controls addressing the risk, including the risk of fraud.
2. Gather and analyze evidence about the operation of those controls. Assessment of other controls would be unnecessary.
3. Decide if any control deficiencies identified are material weaknesses. The proposed guidance provides management with a framework, outside of the auditing literature, for making these judgments.
4. The proposed guidance explains the nature and extent of documentation that management must maintain to support its assessment, noting that the documentation may take a variety of forms.

The SEC also is proposing amendments to accounting rules to coordinate an expected parallel auditing standard to be

proposed by the Public Company Accounting Oversight Board.

The significant additional expense imposed by the financial controls rules, adopted under the Sarbanes-Oxley Act of 2002, is believed especially burdensome to smaller companies, preventing them from seeking financing in U.S. public markets. The SEC believes that smaller companies especially should benefit from the flexibility and scale the guidance is intended to afford and that it will restore some of the competitiveness of U.S. capital markets.

### Hedge Fund Private Offering Rule

The SEC also proposes to define a new category of accredited investor that would apply to offers and sales of securities issued by hedge funds and other private investment pools to natural persons. The proposed definition would include any natural person who (a) meets either the current net \$1,000,000 net worth test or \$200,000 income test and (b) owns at least \$2.5 million in investments. Currently, an individual meeting only the former criteria could invest in hedge fund securities without their registration. The new rule adds a significant second wealth test.

For more information on the content of this alert, please contact David C. Fischer at 212.407.4827 or [dfischer@loeb.com](mailto:dfischer@loeb.com).

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