



PHOTO Downtown Vancouver

## INTERNAL CONTROLS

### **ALERT:** **SOX Rule 404 Management Reports now Required for Small Business Issuers**

New disclosure requirements are in effect under Rule 404 of the Sarbanes-Oxley Act of 2002 for small business reporting issuers in the United States with year-ends on or after December 15, 2007. Foreign small business issuers who file their annual reports on Form 20-F are subject to the rules for year-ends on or after June 30, 2008.

Reporting issuers are required to have internal controls over all aspects of their business that materially impact financial reporting line items. Management must also document the design and implementation processes of these internal controls.

Small business issuers with year-ends on or after December 15, 2007 will need to include results of management reports on internal controls in their next Form 10-K filing.

Rule 404 requires management to assess and report on the testing of and the effectiveness of an issuer's internal controls at preventing or uncovering a material misstatement in its financial reports. The conclusion of the management report must be included as part of the issuer's annual filing on Form 10-K (or Form 20-F) with the United States Securities and Exchange Commission. If the company finds that its controls are not effective, reasons as to why that is the case must be provided.

In 2009, the real test of these controls is scheduled to occur. Auditors will need to conduct an audit of each issuer's internal controls as part of their year-end audit and reach their own conclusions, independent of the conclusion of management, as to whether the small business issuer's internal controls are effective at uncovering or preventing a material misstatement in its financial reports. The audit requirements take effect for U.S. small business issuers with year-ends on or after December 15, 2008, and for foreign small business issuers with year-ends on or after June 30, 2009.

### Internal Controls Procedures

- Develop a control environment
- Assess the risk of occurrence of a material misstatement
- Develop controls, policies and procedures to mitigate the risk
- Communicate controls to employees and professional advisors
- Monitor and assess the effectiveness of controls and revise them as needed

Twelve to thirteen percent of accelerated filers who have been filing SOX 404 management reports since 2004 had internal controls that were found to be ineffective by their auditors. If an issuer doesn't test and file a report on its internal controls, it could face disciplinary action by the SEC.

Companies should contact their auditors as soon as possible to discuss the effectiveness of their internal controls. Many auditors will want to vet the company's internal controls and the company's management report before its results are filed. Contacting the auditors now and involving them in the process will hopefully minimize the impact of the audit next year.

We can advise you on how to improve your internal controls and procedures so that they are tailored to respond to your company's specific financial statement risks. We can also assist you in preparing management's report on effectiveness. Please contact Jenna Virk at 604.632.1282 to set up an initial consultation.

## SEC Reduces Rule 144 Hold Period and Clarifies Availability of Rule 144 to Shell Companies

On February 15, 2008 changes to United States Rule 144 became effective. This rule provides a safe harbor for the resale of securities under the Section 4(1) exemption of the Securities Act of 1933. The following is a breakdown of the major Rule 144 changes:

### Reporting Issuers

(subject to Exchange Act disclosure obligations)

- reduction of the hold period from one year to six months

### Non-affiliates:

- no more requirements to file Form 144, sell through a broker or market maker, or limit the volume of shares sold

### Affiliates:

- still required to abide by all Rule 144 requirements including volume restrictions, manner of sale and Form 144 filing

### Definition of "Affiliate"

An affiliate of an issuer is a person who controls, is controlled by, or is under common control with the issuer. Control means the power to direct (or cause the direction of) the management and policies of the issuer, whether through the ownership of voting securities, by contract, or otherwise.

Under the safe harbor definition of "affiliate" in Rule 10A-3(e)(1) of the Exchange Act, a person who is not an executive officer or a shareholder owning 10% or more of any class of voting equity securities of an issuer is deemed not to be an affiliate. However, there is no presumption that a person who exceeds this ownership requirement will be deemed to be an affiliate, and it will be necessary in this situation to undertake a facts and circumstances analysis of control. Importantly, outside directors usually do not meet the definition of an affiliate.

**Non-Reporting Issuers** (not subject to Exchange Act disclosure obligations)

- hold period continues to be one year

*Non-affiliates:*

- no more requirements to file Form 144, sell through a broker or market maker, or limit the volume of shares sold, but the issuer must have disclosure information publicly available

*Affiliates:*

- still required to abide by all Rule 144 requirements including volume restrictions, manner of sale and Form 144 filing

### Meaning of “subject to Exchange Act disclosure obligations”

An issuer will be deemed to be subject to Exchange Act disclosure obligations if it has registered a class of securities under Section 12(b) or 12(g) of the Securities Exchange Act of 1934 or has filed a Securities Act registration statement. The obligation to file Exchange Act disclosure for issuers who have filed a Securities Act registration statement expires at the end of the fiscal year in which the registration statement is filed, unless the issuer has 300 or more shareholders of record. Once these obligations expire, the issuer is considered a voluntary filer and the issuer’s securities are not eligible for the shortened six month hold period.

### Shell Companies

The SEC staff has also taken this opportunity to clarify some of the interpretive issues which have arisen since the last amendment to this rule in 1997, including the availability of Rule 144 to securities issued by shell companies.

Since the Worm/Wulff letters of 1999 and 2000, the SEC staff’s interpretation of Rule 144 has been that it cannot be relied on for the resale of securities issued by a blank check, or shell, company. Despite this restriction, many practitioners assumed investors buying into former shells could rely on Rule 144. The SEC has codified the Worm/Wulff interpretations with these latest Rule

144 amendments to make it clear that Rule 144 is not available for shell companies. What this means for investors is that shares they own in companies which are, or formerly were, shell companies, will not be eligible for resale until they are registered on a registration statement or until all of the following conditions are met:

- the company is no longer a shell company
- one year has passed since the company has filed Form 10 level disclosure (either through a “Form 8-K” or otherwise)
- the company is “subject to Exchange Act disclosure obligations” (see above)
- the company has filed all reports required to be filed for the past 12 months.

## Legal Team

Contact us for information on how we can assist you in going public, completing acquisitions or financings, or meeting your continuous disclosure obligations.



**Penny Green** BA, LLB  
Called in B.C. and Washington State  
T 604.632.1280  
E pgreen@bacchuscorplaw.com



**Robert Galletti**, BMus, LLB  
Called in British Columbia  
T 604.632.1284  
E rgalletti@bacchuscorplaw.com



**Faiyaz Dean**, BA, JD  
Called in Washington State  
Articled Student in B.C.  
T 604.632.1281  
E fdean@bacchuscorplaw.com



**Jenna Virk**, BBA, LLB  
Called in British Columbia  
T 604.632.1282  
E jvirk@bacchuscorplaw.com



**Konrad Malik**, BA, LLB  
Articled Student in B.C.  
T 604.632.1283  
E kmalik@bacchuscorplaw.com



**Rofi Zhou**, LLB, LLM  
Called in New York State  
(not called in B.C.)  
T 604.960.1671  
E rzhou@bacchuscorplaw.com

## REMINDER

### Director and Officer Loans Prohibited

The Sarbanes-Oxley Act of 2002 contains a prohibition against public companies providing personal loans to their directors and executive officers. An important investor protection mechanism, the enactment of Section 402 was prompted by concern over the use of company funds to provide questionable financing to insiders, but the provision's lack of official guidance is unfortunate given its substantial ambiguities and limited legislative history.

#### Issuers Affected:

All companies required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, and companies that have filed a registration statement in the United States seeking to become public companies.

#### Persons Affected:

In general, Section 402 applies to all company directors and executive officers. Rule 3b-7 defines "executive officer" to include a company's president, a vice president in charge of a principal business unit, and any officer with policy making functions, potentially including executive officers of subsidiaries.

### Violations of Section 402 may subject an issuer to civil and criminal penalties.

The breadth of Section 402 prohibits any credit arrangement that exists primarily for the benefit of the employee and not the issuer; examples of these include sign-on loans, salary advances, relocation loans, loans for the exercise of stock options, loans to purchase restricted stock and personal use of a corporate credit card. Specific exemptions are available, yet their scope and terms are severely limited. Potential items not covered by the provision include indemnification advances and a variety of payments and uses subject to reimbursement.

Apart from a 2005 SEC administrative proceeding, in which a reporting issuer was held liable for the actions of two senior executives who authorized interest-free loans to themselves from the issuer, the absence of legislative or regulatory guidance on Section 402 means that companies should pay close attention to the structure of their compensation and benefit plans covering directors and executive officers.

Violations of Section 402 may subject an issuer to civil and criminal penalties. For assistance in developing corporate compliance policies, contact Robert Galletti at 604.632.1700.

### New Location

Bacchus is pleased to announce that we have moved to a new location, conveniently located in downtown Vancouver in Cathedral Place at 925 West Georgia Street, just across from Hotel Vancouver at the corner of West Georgia and Hornby. We encourage you to visit us at our new office, so please feel free to schedule an appointment or drop by.



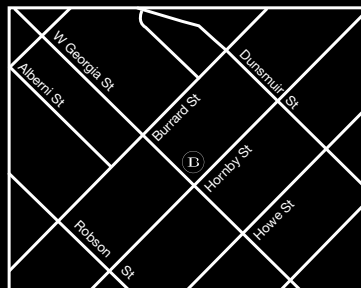
## CONTACT US

#### VANCOUVER OFFICE

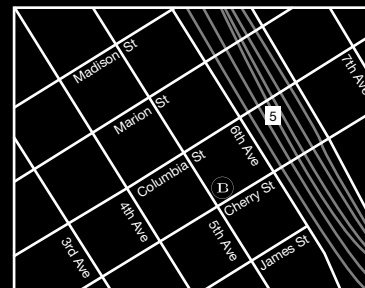
Suite 1820 Cathedral Place  
925 West Georgia Street  
Vancouver, British Columbia  
Canada V6C 3L2  
T 604.632.1700 / 1.877.632.1701  
F 604.632.1730  
www.bacchuscorplaw.com

#### SEATTLE OFFICE

701 Fifth Avenue, Suite 4200  
Seattle, Washington  
United States 98104  
T 206.262.7310  
F 206.262.8001  
www.bacchuscorplaw.com



VANCOUVER



SEATTLE