Disclosures About Impaired Securities

At its 11/25/03 meeting, the Financial Accounting Standards Board (“FASB”) ratified a consensus reached by its Emerging Issues Task Force (“EITF”) at the 11/12-11/13/03 EITF meeting on certain quantitative and qualitative disclosures required under EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The EITF consensus on quantitative and qualitative disclosures about unrealized losses on certain debt and marketable equity securities is effective for fiscal years ending after 12/15/03. Comparative information for earlier periods presented is not required.

**Background.** The overall issue addressed by the EITF is to determine the meaning of *other-than-temporary impairment* and its application to investments classified as either available-for-sale or held-to-maturity under Statement of Financial Accounting Standards (“SFAS” or “Statement” or “FAS”) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, (including individual securities and investments in mutual funds) and investments accounted for under the cost method or the equity method. The impairment methodology for various types of investments accounted for in accordance with the provisions of Accounting Principles Board (“APB”) Opinion No. 18, *The Equity Method for Accounting for Investments in Common Stock*, and SFAS No. 115 is predicated on the notion of *other-than-temporary*. According to the EITF, some believe that the authoritative literature discussing the notion of other-than-temporary is ambiguous and has led to inconsistent application.

At its 7/31/03 meeting, the EITF discussed separate impairment models proposed by the FASB staff for each of the following categories of investments: (a) SFAS No. 115 and SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, equity securities; (b) SFAS No. 115 and SFAS No. 124 debt securities; (c) cost method investments (*i.e.*, equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method); and (d) equity method investments. The models were generally consistent with the three-step approach proposed by an EITF working group at the 3/20/03 EITF meeting with some exceptions. The final step of the approach is to recognize an impairment loss equal to the difference between the investment’s carrying amount...
and its fair value (measured as of the balance sheet date).

11/12-11/13/03 EITF Meeting. The EITF did not reach a consensus on accounting guidance regarding determination of what constitutes an other-than-temporary impairment pending further consideration at a future EITF meeting. However, the EITF reached a consensus that certain quantitative and qualitative disclosures would be required for debt and marketable equity securities classified as available-for-sale or held-to-maturity under SFAS No. 115 and SFAS No. 124 that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. For those investments with unrealized losses that have not been recognized as other-than-temporary impairments, the investor would disclose:

- Quantitative information, aggregated by each category of investments that the investor discloses in accordance with SFAS No. 115 and SFAS No. 124, in tabular form:
  - The aggregate amount of unrealized losses (i.e., the amount by which cost or amortized cost exceeds fair value); and
  - The aggregate related fair value of investments with unrealized losses.

The above disclosures would be segregated by investments that have been in a continuous unrealized loss position for less than 12 months and investments that have been in a continuous unrealized loss position for 12 months or longer (based on certain specified balance sheet reference dates). The EITF consensus includes a tabular example of the quantitative disclosures set forth above.

- Additional information, in narrative form, that provides sufficient information to allow financial statement users to understand the quantitative disclosures and the information that the investor considered (both positive and negative) in reaching the conclusion that the impairments are not other-than-temporary including:
  - The nature of the investment(s);
  - The cause(s) of the impairment(s);
  - The number of investment positions that are in an unrealized loss position;
  - The severity and duration of the impairment(s); and
  - Other evidence considered by the investor in reaching its conclusion that the investment(s) is not other-than-temporarily impaired (e.g., industry analyst reports, sector credit ratings, volatility of the security’s market price, and/or any other information that the investor considers relevant).

The EITF concluded that securities subject to EITF Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interest in Securitized Financial Assets, are not subject to the consensus on EITF Issue No. 03-1 related to disclosures.

Foreclosed Assets

On 11/11/03, the FASB staff issued FASB Staff Position (“FSP”) No. FAS 144-1, Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. A detailed example is provided in FSP FAS 144-1 that illustrates the application of FSP FAS 144-1 to a lender’s real estate loan receivable.

Background. FSP FAS 144-1 addresses the question of should a valuation allowance for a loan collateralized by a long-lived asset be carried over as a separate element of the cost basis for purposes of accounting for the long-lived assets under SFAS No. 144 subsequent to foreclosure?

FSP FAS 144-1. Upon foreclosure, the lender must measure the long-lived asset received in full satisfaction of a receivable at fair value less cost to sell as prescribed under ¶28 of SFAS No. 15. ¶29 of SFAS No. 15 states: “After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.” Therefore, application of SFAS No. 15 results in the
measurement of a new cost basis for the long-lived asset received in full satisfaction of a receivable. That is, the valuation allowance should not be carried over as a separate element of the cost basis for purposes of accounting for the long-lived asset under SFAS No. 144 subsequent to foreclosure.

¶37 of SFAS No. 144 states: “A loss shall be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain shall be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell).” Accordingly, ¶37 limits gain recognition to the extent that cumulative losses have been recognized and measured while the assets were accounted for as long-lived assets under SFAS No. 144. In other words, SFAS No. 144 does not allow the lender to “look-back” to lending impairments measured and recognized under SFAS No. 5, Accounting for Contingencies, SFAS No. 15, or SFAS No. 114, Accounting by Creditors for Impairment of a Loan, for purposes of measuring the cumulative loss previously recognized.

Transition. The guidance in FSP FAS 144-1 is effective immediately upon posting of the final FSP to the FASB website [11/11/03]. If applying the FSP results in changes to previously reported information, the cumulative effect of the accounting change would be reported as of the beginning of the first period ending after the final FSP is posted to the FASB website. The requirements of the FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

Liabilities and Equity
During the month of November 2003, there were a number of developments concerning SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, that was issued by the FASB on 5/15/03. SFAS No. 150 provides new rules on the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. SFAS No. 150 requires that those instruments (i.e., generally: (a) mandatorily redeemable shares; (b) put options and forward purchase contracts on the issuer’s equity shares; and (c) certain obligations that the issuer must or may settle with a variable number of its equity shares) be classified as liabilities in statements of financial position.

Background. SFAS No. 150, as issued, was effective for financial instruments entered into or modified after 5/31/03, and otherwise was effective at the beginning of the first interim period beginning after 6/15/03, except for mandatorily redeemable financial instruments of nonpublic entities (for which the effective date was for the first fiscal period beginning after 12/15/03). It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still existing at the beginning of the interim period of adoption. Restatement is not permitted. As originally issued, for nonpublic entities, mandatorily redeemable financial instruments were subject to the provisions of SFAS No. 150 for the first fiscal period beginning after 12/15/03.

¶9 of SFAS No. 150 requires that: “A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.” (emphasis added) However, the “only upon liquidation” exception in ¶9 does not apply to financial instruments issued by subsidiaries in the consolidated financial statements of a parent of that entity.

FSP FAS 150-3. On 11/7/03, the FASB staff issued FSP FAS 150-3, Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150. FSP FAS 150-3 defers the effective date for applying the provisions of SFAS 150 for: (a) mandatorily redeemable financial instruments of certain nonpublic entities; and (b) certain mandatorily redeemable noncontrolling interests.

- **Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities.** FSP FAS 150-3 defers the effective date of SFAS No. 150 for mandatorily redeemable financial instruments issued by nonpublic entities that are not Securities and
Exchange Commission ("SEC") registrants, as follows:

- For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of SFAS No. 150 are effective for fiscal periods beginning after 12/15/04; and

- For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of SFAS No. 150 are deferred indefinitely pending further FASB action.

Mandatorily redeemable financial instruments issued by SEC registrants are not eligible for either of the above deferrals, even if the entity meets the definition of a nonpublic entity in SFAS No. 150. Those entities must follow the effective dates required by SFAS No. 150 and related guidance, including the deferral for certain mandatorily redeemable noncontrolling interests in the second part of FSP FAS 150-3 [below], as appropriate.

FSP FAS 150-3 also provides deferral guidance concerning situations where some entities have issued shares that are required to be redeemed under related agreements.

• **Certain Mandatorily Redeemable Noncontrolling Interests.** FSP FAS 150-3 defers the effective date of SFAS No. 150 for certain mandatorily redeemable noncontrolling interests of all entities, public and nonpublic, as follows:

  - For mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the “only upon liquidation” exception in ¶9 of SFAS No. 150, but would be classified as liabilities by the parent in consolidated financial statements, the classification and measurement provisions of SFAS No. 150 are deferred indefinitely pending further FASB action.

  - For other mandatorily redeemable noncontrolling interests that were issued before 11/5/03, the measurement provisions of SFAS No. 150 are deferred indefinitely, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest, pending further FASB action. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other literature (e.g., in EITF Abstracts, Topic No. D-98, Classification and Measurement of Redeemable Securities) continues to apply during the deferral period. However, the classification provisions are not deferred [see below].

  - During the deferral period, all public entities as well as nonpublic entities that are SEC registrants are required to follow the disclosure requirements in ¶¶26 and 27 of SFAS No. 150 as well as the disclosures required by other applicable guidance.

• **Transition.** For mandatorily redeemable financial instruments that were created before the effective date designated by SFAS No. 150 (or in FSP FAS 150-3) for the instruments and that still exist at the beginning of the period in which SFAS No. 150 is adopted for the instruments, transition is achieved by reporting the cumulative effect of a change in an accounting principle by initially measuring the financial instruments at fair value or other measurement attribute required by SFAS No. 150. ¶A30 of SFAS No. 150 provides more information about the initial measurement and cumulative effect entries upon transition.

Early adoption of the provisions of SFAS No. 150 for instruments within the scope of the indefinite deferrals established by FSP FAS No. 150-3 is precluded during the deferral period. Entities that already have adopted SFAS No. 150 for instruments within the scope of the indefinite deferral must reverse the effects of that adoption (including both the initial cumulative effect upon adoption and the subsequent recognition of related interest costs).
Detailed guidance is provided on the reporting of the reversal.

**11/12-11/13/03 EITF Meeting.** At this meeting, the SEC Observer clarified that SEC registrants with instruments that qualify for the FSP FAS 150-3 deferral should refer to Topic D-98 for guidance related to classification and/or measurement, as applicable, for those securities that, for the time being, will not be accounted for in accordance with SFAS No. 150.

**FSP FAS 150-4.** On 11/7/03, the FASB staff issued FSP FAS 150-4, *Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150.* FSP FAS 150-4 concludes that employee stock option plan (“ESOP”) shares that are mandatorily redeemable or freestanding agreements to repurchase those shares are not within the scope of SFAS No. 150, because the shares are accounted for under American Institute of Certified Public Accountants (“AICPA”) SOP 93-6, *Employers' Accounting for Employee Stock Option Plans,* or its related guidance through the point of redemption. However, ESOP shares that are mandatorily redeemable or freestanding agreements to repurchase the shares continue to be subject to other applicable guidance related to SOP 93-6, (e.g., EITF Issue No. 89-11, *Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*). As discussed in Issue No. 89-11, SEC registrants are required to comply with SEC Accounting Series Release (“ASR”) No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks,”* which requires certain amounts to be classified outside of permanent equity.

The guidance in FSP FAS 150-4 is effective for financial statements issued after the final FSP is posted to the FASB website [11/7/03]. If applying the FSP results in changes to previously reported information, the cumulative effect of the accounting change would be reported as of the beginning of the first period ending after the final FSP is posted to the FASB website.

**Variable Interest Entities**

During the month of November 2003, there were a number of developments concerning FASB Interpretation No. ("FIN") 46, *Consolidation of Variable Interest Entities ["VIEs"]*. FIN 46, issued by the FASB on 1/17/03, clarifies the application of Accounting Research Bulletin ("ARB") No. 51, *Consolidated Financial Statements,* to certain entities in which equity investment at risk does not have the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support. For those entities, a controlling financial interest cannot be identified based on an evaluation of voting interests. The objective of FIN 46 is to improve financial reporting by companies involved with VIEs by requiring that a VIE be consolidated by the company that is subject to a majority of the economic risks and/or rewards related to that entity.

**Background.** FIN 46 provides that an enterprise that consolidates a VIE is the primary beneficiary of the VIE. The primary beneficiary of a VIE is the party that absorbs a majority of the entity’s expected losses (a defined term, based on probability-weighted scenarios), receives a majority of its expected residual returns (a defined term that, in general, is the opposite of expected losses), or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests in an entity. The ability to make decisions is not a variable interest, but it is an indication that the decision maker should carefully consider whether it holds sufficient variable interests to be the primary beneficiary. An enterprise with a variable interest in a VIE must consider variable interests of related parties and de facto agents as its own in determining whether it is the primary beneficiary of the entity.

FIN 46 applies immediately to VIEs created after 1/31/03 and to VIEs in which an enterprise obtains an interest after that date. As originally issued, FIN 46 applied in the first fiscal year or interim period beginning after 6/15/03 to VIEs in which an enterprise holds a variable interest that it acquired before 2/1/03. Certain of the disclosure requirements apply in all financial statements issued after 1/31/03, regardless of when the VIE was established. FIN 46 applies to public enterprises as of the beginning of the applicable interim or annual period, and it applies to nonpublic enterprises as of the end of the applicable annual period.
On 10/9/03, the FASB staff issued FSP FIN 46-6, *Effective Date of FASB Interpretation No. 46*, which defers to the fourth quarter of 2003 from the third quarter of 2003 the implementation date for FIN 46. This deferral only applies to VIEs, held by public companies, that existed prior to 2/1/03. (A separate deferral applies to certain nonregistered investment companies.) Pursuant to the deferral, public companies must complete their evaluations of VIEs that existed prior to 2/1/03, and the consolidation of those for which they are the primary beneficiary, for financial statements issued for the first interim or annual period ending after 12/15/03. For calendar year public companies, consolidation of previously existing VIEs will be required in their 12/31/03 financial statements.

**FSP FIN 46-7.** On 11/26/03, the FASB staff issued FSP FIN 46-7, *Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FASB Interpretation No. 46*. FSP FIN 46-7 states that the FASB has agreed that the guidance contained therein will be incorporated into a pending amendment to FIN 46 (proposed on 10/31/03) and will be subject to the effective date and transition provisions of that final FIN, when issued.

¶8(c) of FIN 46 requires fees paid to the decision maker (if there is a decision maker) of a VIE to be included in the calculation of the entity’s expected residual returns. FSP FIN 46-7 addresses the question of can a decision maker’s fee ever be excluded from the ¶8(c) component of an entity’s expected residual returns?

FSP FIN 46-7 answers the above question in the affirmative and provides criteria for distinguishing between a decision maker that potentially has a controlling financial interest in a VIE and a decision maker that is only a hired service provider or employee of the entity. A fee paid by a VIE to a decision maker is not subject to the requirement in ¶8(c) and is not considered a variable interest in the entity if all of the characteristics of a hired service provider or an employee relationship identified in the FSP are present in an arrangement. However, a fee with those characteristics would be included in the calculation required by ¶¶8(a) and 8(b) [concerning the expected variability in the entity’s: (a) net income or loss; or (b) fair value of its assets].

All fees paid to a decision maker would be excluded from ¶8(c) and would not be considered variable interests if all of four specified conditions exist (e.g., the fees are compensation for services provided and are commensurate with the level of effort required to provide those services). FSP FIN 46-7: (a) states that determination of whether fees paid to a decision maker represent compensation for services provided commensurate with the level of effort required to provide those services will require judgment based on all relevant facts and circumstances; (b) lists the factors that may indicate that the fees exceed the level of compensation that would be commensurate with the services provided (e.g., the arrangement includes terms, conditions, or amounts that are not customarily present in arrangements for similar services negotiated at arm’s length); and (c) states that an entity may not apply the provisions of FSP FIN 46-7 to exclude some but not all of the fees paid to a decision maker from ¶8(c).

The ability of an investor or another party to remove the decision maker (i.e., kick-out rights) does not affect the status of a decision maker in the application of ¶8(c) unless the rights are substantive. FSP FIN 46-7: (a) states that the determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances; and (b) lists the two characteristics that kick-out rights must have to be substantive; one of which is that the parties holding the kick-out rights have the ability to exercise those rights if they choose to do so (i.e., there are no significant barriers to the exercise of the rights).

**FSP FIN 46-f.** On 11/14/03, the FASB staff issued proposed FSP FIN 46-f, *Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity’s Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46*. Comments are due by 12/14/03. FSP FIN 46-f addresses the questions of: (a) should an entity be subject to consolidation according to ¶5(b)(1) of FIN 46 if, as a group, the holders of the equity investment at risk (the “equity group”) lack the direct or indirect ability to make decisions about an entity’s activities through voting rights or similar rights; and (b) how should variable interest holders evaluate whether the equity group lacks the direct or indirect
ability to make decisions about an entity’s activities through voting rights or similar rights?

FSP FIN 46-f states that the evaluation should be based on the extent to which the total equity investment at risk provides the equity holders as a group the ability to make decisions about an entity’s activities through voting rights or similar rights. The equity group would not lack the characteristic in ¶5(b)(1) of FIN 46 in situations in which the equity group holds all voting rights or similar rights, and, conversely, the equity group would lack the characteristic in situations in which the equity group holds no voting rights or similar rights. Guidance is provided for those situations in which both the equity group and the parties outside the equity group hold voting rights or similar rights such that each has the ability to make or participate in decisions about an entity’s activities.

The guidance in the final FSP would be effective for all arrangements to which FIN 46 has been or will be applied. If the application of the guidance in the FSP results in changes to previously reported information, the cumulative effect of the accounting change would be reported as of the beginning of the quarter in which the final FSP is posted to the FASB website. (The FASB stated that the quarter in which the final FSP is posted is expected to be the quarter beginning 10/1/03, for a calendar-year entity.)

The provisions of the final FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. For enterprises that have not yet applied the provisions of FIN 46 to variable interests in VIEs in accordance with the effective date provisions of ¶127 of FIN 46 or FSP FIN 46-6, the guidance would be applied as a part of their adoption.

FIN 46 Effect on Hedging. At its 11/5/03 meeting, the FASB discussed the comments received on Statement 133 Implementation Issue No. G24, Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Due to Initially Applying FASB Interpretation No. 46. The FASB unanimously agreed to relax the requirements for use of the shortcut method if a change in consolidation practices due to the initial application of FIN 46 causes the consolidated entity to discontinue a preexisting hedging relationship for which effectiveness was being assessed under the shortcut method in ¶68 of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. In those circumstances, if the company contemporaneously designates a new hedging relationship, the new relationship can qualify for the shortcut method if certain criteria are met, even though the fair value of the hedging interest rate swap is not zero at the inception of the new hedging relationship. Implementation Issue G24, which was renumbered as Issue E22 and retitled Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46, was posted on the FASB website on 11/10/03 as cleared guidance.

Fair Value Measurement

At its 11/19/03 meeting, the FASB discussed Phase 1 scope and codification issues relating to existing pronouncements with fair value measurement requirements and reconsidered certain of its decisions in its former project to replace SFAS No. 107, Disclosures about Fair Value of Financial Instruments, which was removed from the FASB technical agenda in July 2003. The issues are now part of the FASB’s broader project to devise a Statement that would provide comprehensive rules on fair value measurement.

Background. The FASB previously decided to exclude from the Phase 1 scope existing pronouncements that relate to leasing and stock-based compensation transactions.

At its 12/19/01 meeting on the SFAS No. 107 project, the FASB decided that if a quoted market price is represented by a bid-asked spread, rather than a single transaction price, and the spread is created by firm offers to buy or sell in an active market, the mid-point of the spread would be used to estimate fair value.

Restricted securities refer to securities for which sale is restricted by governmental or contractual requirements. The securities are issued by entities with freely traded securities identical in all respects except for the restriction. At its 4/9/03 meeting on the SFAS No. 107
project, the FASB decided that the following factors would be among those considered in measuring the fair value of restricted securities: (a) the fair value and volatility of an unrestricted trading unit of the same security; (b) the nature and duration of the restriction; and (c) the risk-free interest rate.

The unit of account describes the asset (or liability) accounted for under a particular pronouncement and the level at which the asset (or liability) would be aggregated (or disaggregated) for purposes of applying all (or some) of the provisions of the pronouncement. For fair value measurements, it describes “what” is being measured. At its 3/5/03 meeting on the SFAS No. 107 project, the FASB decided to prohibit using block discounts in measuring the fair value of a large position of unrestricted securities traded in an active market, thereby affirming the principle in SFAS No. 107 that for financial instruments traded in an active market, the unit of account is the individual trading unit.

11/19/03 FASB Meeting. The FASB reached the following tentative decisions:

- **Additional Scope Exclusions.** The FASB decided to exclude from the Phase 1 scope revenue recognition transactions covered under existing pronouncements that require vendor-specific objective evidence of fair value measurement.

- **Bid-Asked Spread Pricing.** The FASB reconsidered its 12/19/01 decision that for financial instruments traded in active markets in which prices are quoted in terms of bid and asked prices, the fair value measurement would be determined using the midpoint of the bid-asked spread. The FASB decided that the fair value measurement would be determined using bid prices for long positions (assets) and asked prices for short positions (liabilities).

- **Restricted Securities.** The FASB decided that for fair value measurements involving restricted securities, the existing SEC guidance in ASR No. 113 would continue to apply, as supplemented by the proposed guidance discussed by the FASB in April 2003, which refers to factors that would be included among those considered in developing the measurements.

- **Unit of Account.** For financial instruments traded in active markets, the FASB affirmed its 3/5/03 decision to retain the principle in SFAS No. 107 that establishes that the unit of account is the individual trading unit and prohibits a fair value measurement using a block discount. The decision would require conforming changes to the AICPA Industry Guides for broker-dealers and investment companies. For assets and liabilities that are not traded in active markets, the FASB decided not to reconsider the unit-of-account guidance in other existing pronouncements in this project.

**Disclosures about Pensions**

At its 11/26/03 meeting, the FASB finalized its decisions regarding: (a) narrative descriptions of investment policies and strategies; (b) the disclosure of estimated future benefit payments; and (c) the effective dates for disclosures about plan assets and interim period information, as part of its concluding deliberations on the 9/12/03 FASB Exposure Draft of a proposed SFAS, *Employers’ Disclosures about Pensions and Other Postretirement Benefits*. A number of decisions were reached including staff authorization to proceed to a draft of the final Statement.

**Background.** At its 11/11/03 meeting, the FASB made the following decisions about additional pension and other postretirement benefit disclosures:

- The following disclosures would be required as proposed in the Exposure Draft:
  - The accumulated benefit obligation (“ABO”);
  - The use of a tabular format for disclosure of a number of key assumptions (e.g., the assumed discount rates);
  - Certain information about each major category (equity, debt, real estate, other) of plan assets (e.g., a narrative description of investment strategies); and
  - Certain interim disclosures (e.g., an update of the employer’s expected contributions to be paid during the year, if that expectation changed significantly from the previous annual or interim period disclosure amount).
• The following disclosures would be required concerning provisions of the disclosures that have changed or been eliminated from those proposed in the Exposure Draft:
  – A narrative description of the basis for determining the overall expected long-term rate of return.
  – In all cases, measurement dates used for plans that make up the majority of a sponsor’s plan assets and benefit obligations.
  – Reconciliations of beginning and ending balances of the fair value of plan assets and benefit obligations.
  – The employer’s best estimate, once known, of its contributions to be paid to fund the plan for the next fiscal year beginning after the date of the latest statement of financial position.
  – The projected/expected benefit payments, including employees’ future service, for each of the next five years and thereafter, with a reconciliation back to the projected benefit obligation that would reflect interest, future service accruals, and participant contributions. (This disclosure is subject to reconsideration.)
• The FASB reaffirmed that all requirements would be applied to nonpublic entities, except for exemptions carried forward from SFAS No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefit, and for the interim-period disclosure of the components of net periodic benefit cost.
• Certain information would not be required (e.g., sensitivity information).
• The effective date of the final Statement for nonpublic entities would be for fiscal years ending after 6/15/04.

11/26/03 FASB Meeting. The FASB tentatively agreed as follows:
• A description of investment strategies would be required for all entities and that disclosure would include a description of target asset allocations if they are used.
• Disclosure of benefit payments used in the calculation of the expected benefit obligation (includes estimated future employee service) would be required, and they would be presented separately for years 1–5 and in the aggregate for years 6–10.
• Disclosure of domestic plan asset information would be required for annual periods ending after 12/15/03. The FASB reaffirmed that all new disclosure requirements related to foreign plans (including plan asset information) could be deferred until annual periods ending after 6/15/04.
• For companies that defer disclosure of foreign plan asset information until annual periods ending after 6/15/04, domestic and foreign information would be shown separately in financial statements in which only domestic information is presented. This is a transitional requirement only and it applies to certain information such as the total fair value of plan assets, the projected benefit obligation, and the expected long-term rate of return on assets.
• Disclosure of interim-period information would be required for interim periods beginning after the issuance of the final Statement.

The FASB authorized its staff to proceed to a draft of the final Statement for vote by written ballot. The FASB staff noted that the final Statement will be SFAS No. 132 (revised 2003) rather than SFAS No. 151.

Equity-Based Compensation
At its November 2003 meetings, the FASB discussed a number of issues including the method of transition and effective date for both public and nonpublic enterprises and issues related to certain required disclosures in
connection with a proposed Statement about equity-based compensation ("EBC") arrangements. A number of tentative decisions were reached.

11/11/03 FASB Meeting. The FASB discussed certain issues relating to the measurement basis of EBC arrangements of nonpublic enterprises and the interaction of SFAS No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 150, and made the following tentative decisions:

- Nonpublic enterprises would be permitted the option of measuring EBC arrangements using either a fair value-based method or an intrinsic value based method (each method would have different measurement dates). Nonpublic enterprises would be required to make a one-time policy decision that would apply to all EBC arrangements.
- The FASB expressed support for a proposal that would classify financial instruments given under an EBC arrangement as liabilities if those financial instruments would have been subject to SFAS No. 150, absent the explicit scope exception in ¶17.
- Generally, a freestanding EBC financial instrument accounted for under SFAS No. 123 would become subject to SFAS No. 150 when all employee-service conditions have been met or satisfied.
- Modifications of certain financial instruments that are subject to SFAS No. 150 because all employee-service conditions have been met or satisfied would be accounted for in accordance with the guidance on modifications and settlements set forth in SFAS No. 123, if the modifications or settlements are a result of the holder’s employment status.

11/19/03 FASB Meeting. The FASB decided that temporary differences related to the income tax effects of a cash-settled stock appreciation right would be based on the arrangement’s fair value and amount of compensation cost recognized in the financial statements and made the following decisions that pertain to the income tax effects of EBC awards classified as equity:

- The tax effects of an EBC award classified as equity for which a tax deduction is received for the exercise-date fair value of the award would be calculated using the arrangement’s grant-date fair value and the amount of compensation cost recognized in the financial statements.
- If a deduction reported on a tax return for a stock-based award exceeds the cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction would be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, would be recognized in the income statement.
- If a temporary difference is due to the measurement of compensation cost for financial reporting purposes occurring prior to the measurement of compensation cost for tax purposes, tax benefits related to the excess deduction would pertain to the equity transaction. If a temporary difference is due to any other circumstance, the income tax effects from those differences relate to the compensation transaction and would be accounted for in the income statement.
- A deferred tax asset would be evaluated for future realization and would be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset would not be realized.
- The imputed cash flow effects of excess tax benefits would be accounted for in the financing section of the cash flow statement.

In addition to the decisions pertaining to the accounting for income tax effects of EBC arrangements, the FASB made decisions relating to: (a) convergence issues relating to modifications (e.g., of vesting conditions); (b) reconveyances of an award from the employee to the employer; (c) certain EBC transactions involving related parties; and (d) the definition of share-based payment.

11/26/03 FASB Meeting. The FASB discussed disclosure requirements relating to EBC arrangements and affirmed its previous decisions that enterprises would be required to disclose certain information enabling a financial statement user to understand a number of matters concerning EBC arrangements (e.g., the potential
outcomes from EBC arrangements on the transfer of wealth from shareholders to equity award holders.) The FASB expressed support for certain revised specific disclosure requirements that are expected to be included in the proposed Statement. The FASB also discussed the effective date and method of transition for nonpublic enterprises and reached the following decisions:

- The proposed Statement would be effective for all employee awards granted, modified, or settled after the beginning of the first fiscal year for fiscal years beginning after 12/15/05. Early adoption would be permitted. Enterprises would be required to disclose the effect of the change from SFAS No. 123 to the proposed Statement in the year of adoption.

- The method of transition required for awards that would be classified as equity under the proposed Statement would be described as a “prospective method.” That method would require expense recognition for all employee awards granted, modified, or settled after the beginning of the fiscal year in which the provisions of the Statement are first applied.

- The method of transition required for awards that would be classified as liabilities under the proposed Statement would be described as similar to a cumulative effect of a change in an accounting principle. Under that method, a liability for awards outstanding at the effective date would be recognized at that date in the amount of the fair value or intrinsic value as required by the proposed Statement. The cumulative effect adjustment also would reflect the effect of income taxes associated therewith.

Further, the FASB discussed certain issues related to transition for both public and nonpublic enterprises and reached the following decisions:

- In connection with EBC awards that would have been classified as equity under SFAS 123 or APB Opinion No. 25, Accounting for Stock Issued to Employees, but would be classified as liabilities under the proposed Statement: (a) a cumulative effect of a change in an accounting principle would be recognized by initially measuring the liability at fair value or intrinsic value as required by the proposed Statement; and (b) if any amounts related to those awards have been previously recognized in equity, a liability would be established. Guidance is provided on the method of establishing the liability.

- In connection with certain awards with graded vesting that are not attributed according to FIN 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, (because the enterprise elected to attribute the compensation cost using the straight-line method) and that are unvested as of the effective date of the proposed Statement, the awards would continue to be attributed using the original provisions of SFAS No. 123.

Regulatory Update

Nominating Committees and Communications with Directors

On 11/28/03, the SEC adopted amendments to Item 401 of Regulation S-B and Item 401 of Regulation S-K under the Securities Act of 1933 (the “Securities Act”), Items 7 and 22 of Schedule 14A under the Securities Exchange Act of 1934 (the “Exchange Act”), Rule 30a-2 under the Investment Company Act of 1940 (the “Investment Company Act”), Forms 10-Q and 10-QSB under the Exchange Act, and Form N-CSR under the Exchange Act and the Investment Company Act. Even though the SEC did not adopt amendments to Schedule 14C under the Exchange Act, the amendments will affect the disclosure provided in Schedule 14C, as Schedule 14C requires disclosure of some items of Schedule 14A. Similarly, even though the SEC did not adopt amendments to Forms 10-K and 10-KSB under the Exchange Act, the amendments to Item 401 of Regulations S-B and S-K will affect the disclosure under Forms 10-K and 10-KSB, as those forms require disclosure of the information required by Item 401 of Regulations S-K and S-B.

Specifically, the SEC adopted enhancements to existing disclosure requirements regarding the operations of board nominating committees and a new disclosure requirement concerning the means, if any, by which
security holders may communicate with directors. The rules require registrants to comply with the disclosure requirements in proxy or information statements that are first sent or given to security holders on or after 1/1/04, and in Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, and Form N-CSR for the first reporting period ending after 1/1/04. The rules allow registrants to comply voluntarily with the disclosure requirements before the compliance date. The SEC noted that comments regarding the “collection of information” requirements, within the meaning of the Paperwork Reduction Act of 1995, of Regulations S-B and S-K, and Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, and Form N-CSR should be received by 1/1/04.

The SEC adopted rules that will improve disclosure to investors regarding the nominating committee processes of public companies and the ways by which security holders may communicate with directors at the companies in which they invest. These rules implement recommendations made by the Division of Corporation Finance to the SEC in its 7/15/03 Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors. The SEC noted that the disclosure requirements will enhance significantly the transparency of the nominations and communications processes of public companies and are the next step in the implementation of the recommendations in the Staff Report.

The new disclosure standards require companies to disclose important additional information regarding a company’s process of nominating directors, including:

- Whether a company has a separate nominating committee and, if not, the reasons why it does not and who determines nominees for director;
- Whether members of the nominating committee satisfy independence requirements;
- A company’s process for identifying and evaluating candidates to be nominated as directors;
- Whether a company pays any third party a fee to assist in the process of identifying and evaluating candidates;
- Minimum qualifications and standards that a company seeks for director nominees;
- Whether a company considers candidates for director nominees put forward by shareholders and, if so, its process for considering such candidates; and
- Whether a company has rejected candidates put forward by large, long-term security holders or groups of security holders.

The new disclosure standards also require companies to disclose significant, new information regarding shareholder communications with directors, including:

- Whether a company has a process for communications by shareholders to directors and, if not, the reasons why it does not;
- The procedures for communications by shareholders with directors;
- Whether such communications are screened and, if so, by what process; and
- The company’s policy regarding director attendance at annual meetings and the number of directors that attended the prior year’s annual meeting.

**Strengthening of Corporate Governance for Listed Companies**

On 11/4/03, the SEC approved new rules proposed and adopted by the New York Stock Exchange, Inc. ("NYSE") and the Nasdaq Stock Market ("Nasdaq"), which the self regulatory organizations ("SROs") noted are designed to require widespread strengthening of corporate governance standards for listed companies. The new rules establish a stricter, more detailed definition of independence for directors and require the majority of members on listed companies’ boards to satisfy the new standard. In addition, the rule changes include a number of provisions that require and facilitate independent director oversight of processes relating to corporate governance, auditing, director nominations, and compensation.

**NYSE Rule Changes.** The NYSE stated that its Corporate Governance rule change is designed to further the ability of honest and well-intentioned directors, officers, and employees of listed issuers to perform their functions effectively. The NYSE also stated that the rule change will allow shareholders to more easily and
efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior. The rule change, which is contained in NYSE §303A of the NYSE Manual, addresses:

- Independence of majority of board members;
- Definition of independent director;
- Separate meetings for board members;
- Nominating/corporate governance committee;
- Compensation committee;
- Audit committee, including its composition, charter and responsibilities;
- Internal audit function;
- Corporate governance guidelines;
- Code of business conduct and ethics;
- CEO certification;
- Public reprimand letter;
- Exceptions to the NYSE corporate governance proposals;
- Application to foreign private issuers; and
- Implementation of new requirements.

Nasdaq Rule Changes. The Nasdaq noted that the purpose of its Independent Director rule change is to provide greater transparency regarding certain relationships that would preclude a board of directors from finding that an individual can serve as an independent director, and to increase the role of independent directors on board committees. In the Nasdaq's view, the rule change is intended to enhance investor confidence in the companies that list on the Nasdaq.

According to the Nasdaq, its Going Concern rule change is to bring notice of a going concern qualification to investors and potential investors; the purpose of the Nasdaq Related Party Transactions rule change is to improve investor protection; the purpose of the Nasdaq Issuer Applicability rule change is to alert investors to the exemptions that may be granted to foreign issuers; and the purpose of the Nasdaq Code of Conduct rule change is to provide further assurance to investors, regulators, and the Nasdaq that each of the Nasdaq’s issuers has in place a system to focus attention throughout the company on the obligation of ethical conduct, encourage reporting of potential violations, and deal fairly and promptly with questionable behavior. The rule change, which is contained in NASD Rule 4200 and Rule 4350, addresses:

- Independence of majority of board members;
- Separate meetings for board members;
- Compensation of officers;
- Nomination of directors;
- Controlled companies exempt;
- Audit committee charter and responsibilities;
- Audit committee composition;
- Cure periods;
- Notification of noncompliance;
- Code of business conduct and ethics;
- Public announcement of audit opinions with going concern qualifications;
- Related party transactions;
- Application to foreign issuers and certain other issuers; and
- Implementation of new requirements.

Rules of Practice and Related Provisions

The SEC proposed amendments to its Rules of Practice (“Rules”) and related provisions in light of the Sarbanes-Oxley Act of 2002 (“SOA”). The SOA, among other things, authorized the SEC to review disciplinary actions of the Public Company Accounting Oversight Board (“PCAOB”) and to create “Fair Funds” in SEC administrative proceedings. The SEC also proposed for comment amendments to other provisions of the Rules as a result of its experience with those rules and to correct certain citations. The SEC noted that the proposed amendments are intended to enhance the transparency and facilitate parties’ understanding of the applicability of the review process to PCAOB.
proceedings, and to make practice under the Rules easier and more efficient.

**Proposed Amendments as a Result of the SOA.**

§107(c) of the SOA authorizes the SEC to review disciplinary actions imposed by the PCAOB and actions that result in the disapproval of registration of a public accounting firm. §105(d) and §107(c) of the SOA require the PCAOB to give the SEC notice if it disapproves the registration of a public accounting firm or if it disciplines a registered public accounting firm or a person associated with a registered public accounting firm.

In creating its framework for SEC review of PCAOB actions, §107(c) specifies that §19(d)(2) and §19(e)(1) of the Exchange Act, which govern SEC review of SRO disciplinary proceedings, will govern SEC review of final disciplinary sanctions imposed by the PCAOB as fully as if the PCAOB were an SRO and the SEC were the appropriate regulatory agency for that SRO. Thus, the administrative structure currently used by the SEC in reviewing SRO disciplinary proceedings, including relevant provisions of the Rules, is applicable to persons seeking review of PCAOB actions.

The SEC proposed amendments to certain of its rules to enhance the transparency and facilitate parties’ understanding of the applicability of the review process to PCAOB proceedings. Specifically, the proposed rules would address: (a) disapproval of registration; (b) review of disciplinary sanctions; (c) stay of PCAOB action; (d) summary action and expedition; (e) review on motion of the SEC; and (f) amendments to the SEC existing Rules of Practice with respect to the review proceedings and its ex parte rule.

**Fair Funds and Disgorgement.** §308(a) of the SOA provides that, in a SEC administrative proceeding where the SEC or a hearing officer enters an order requiring disgorgement from a respondent for a violation of the securities laws, the respondent agrees in settlement to payment of such disgorgement, any civil penalty also ordered against that respondent may be added to the disgorgement funds to create a “Fair Fund” to be disbursed by the SEC for the benefit of the victims of such violation. §308(b) of the SOA authorizes the SEC to accept gifts or bequests to the United States of real and personal property for deposit in a Fair Fund.

Administration of, and distribution to investors under, Fair Funds and disgorgement plans, occurs after the conclusion of the principal action against a respondent. The functions involved are administrative, and are not subject to provisions such as Rule 120 of the Rules of Practice, and the ex parte communication rule in subpart D of the Rules of Practice. The SEC proposed to remove from subpart D of the Rules of Practice Rules 610 through 620, which relate to the development, submission, approval, and administration of orders of disgorgement, and to the right to challenge orders of disgorgement, and to include them in a new subpart F.

Proposed Rule 1100 would state that the SEC is authorized to create a Fair Fund in any administrative proceeding in which a final order is entered against a respondent requiring disgorgement and payment of a civil money penalty. The SEC may also create a Fair Fund if it approves a settlement of an administrative proceeding that provides for a respondent’s payment of disgorgement and a civil money penalty. The proposed Rule would also explain that the SEC may add to the Fair Fund any property received in accordance with §308(b) of the SOA.

Certain requirements for Fair Funds would suggest that the SEC’s Rules should make some distinctions between Fair Funds and disgorgement funds (e.g., Fair Funds must be disbursed to the investors harmed by the securities law violations at issue). The SEC can order a wrong-doer to disgorge ill-gotten gains whether or not investors suffered any damages as a result of the violation. Where there are no identifiable victims of a violation, the SEC proposed to permit that the disgorgement and civil money penalty amounts be paid to the United States Treasury.

The SEC stated that the requirements for Fair Funds and disgorgement funds should be similar. In some cases, the SEC may conclude that it is in the public interest to impose a civil money penalty and order disgorgement even though the relative value of the ill-gotten gains and the number of potential claimants would result in high administrative costs and de minimis distributions to individual investors. Under such circumstances, the SEC would continue its practice of ordering that the disgorgement and civil penalty amount be paid directly to the United States Treasury.
Married Put Transactions

On 11/21/03, the SEC issued interpretive guidance on calculating a “net long” position under the Exchange Act when using married put transactions as a part of certain trading strategies. A seller of securities is required to aggregate all of its positions in that security to determine the seller’s “net long” position. Determining security ownership is an essential component to aggregating security positions under the Exchange Act. The SEC issued guidance clarifies the determination of security ownership when married puts transactions are used.

The SEC noted that a seller of securities must determine whether a sale is “long” or “short” because of special provisions applying to short sales. That determination depends in significant measure on whether the seller owns the security to be sold and the seller’s net position in the security. Rule 3b-3 under the Exchange Act provides, in part, that a person owns a security if he or his agent has title to a security or he has purchased or has entered into an unconditional contract to purchase it but has not yet received it.

The seller’s net position must be determined with reference to Rule 3b-3 that requires a seller of an equity security to aggregate all of its positions in that security. If the seller has a “net long” position in the security after this aggregation process, then the sale may be effected as a “long” sale to the extent of the “net long” position. If the aggregation process results in a “flat” or “net short” position, the sale must be effected as a “short” sale. All sell orders in any security registered on or admitted to unlisted trading privileges on a national securities exchange must be marked either “long” or “short.” A short sale of an exchange-listed security must comply with Rule 10a-1 under the Exchange Act. A sale of a “long” position is not subject to the price test of Rule 10a-1.

The SEC noted that the calculation of a seller’s net position is also necessary for compliance with Rule 105 of Regulation M. Rule 105 prohibits covering a short sale with offering securities obtained from an underwriter or dealer if the short sale occurred during the period 5 days prior to pricing until pricing or the period from filing the registration until pricing, whichever is shorter. Thus, a seller needs to know if any sales during the 5-day period prior to certain repeat or secondary offerings are short sales for which offering shares may not be used to cover such sales.

The interpretive guidance discusses the operation of Rule 3b-3 with respect to sellers who may claim to have a position in a security by virtue of having entered into a “married put” transaction. A married put is the purchase of an option to sell (i.e., a put option) a certain number of securities at a particular price by a specified time, bought contemporaneously with the same number of underlying securities. When used as a hedging vehicle, the married put is designed to provide protection to the holder of the stock against losses (i.e., if the price of the stock goes up, the put will not be exercised and will expire worthless, and if the price of the stock goes down, the put may be exercised by the holder to sell the underlying stock at the strike price).

The SEC issued the guidance to address married puts that are used as part of an attempt to create a “long” position for the purpose of circumventing Rules 10a-1 and 105. Such transactions usually have some or all of the following characteristics (or a variation of them):

- The purchase of an at- or in-the-money non-standardized put option with a brief (1 to 5 day) expiration period;
- The contemporaneous purchase of an equivalent number of shares of the same security;
- The contemporaneous sale of the stock acquired with a married put, in essence divorcing the stock position from the put option;
- The repeated use of a “facilitator” that sells both the puts and the “long” position (often by selling the stock short to the counterparty);
- The “netting out” of the transaction between the facilitator and the counterparty, often at the end of the day the married put was purchased; and
- The payment of a standardized fee, not calculated in accordance with a standard options pricing model, to the facilitator for the transaction.

The SEC stated that the net result of those transactions is that there is minimal or no economic risk to the married put purchaser or the party facilitating the married put. The married puts are distinguishable from other paired
positions of stock and options where each component is intended to offset the risk of the other. In those cases, both sides of the position are held for a period of time, and the stock and options are priced at market levels. The married put transactions have been used in connection with various trading strategies, including, but not limited to, the following:

- Contemporaneously with or shortly after the purchase of a married put, stock sales are made without regard to the “tick test” as part of a day trading strategy dependent on trading without short sale price test execution delays in order to profit from rapid intra-day trades to take advantage of small price movements in stocks;
- Contemporaneously with or shortly after the purchase of a married put, aggressive, rapid stock sales on successive minus or zero-minus ticks as part of a short-term momentum play in which a trader’s strategy is aligned with a downward movement of the stock’s price; or
- Contemporaneously with or shortly after the purchase of a married put, aggressive stock sales are made during the 5-day period prior to the pricing of a secondary or repeat offering where the trader’s strategy is aligned with a downward movement of the stock’s price in an effort to profit from the difference between the sales prices and the offering price.

The SEC issued the interpretative release as a means of providing all market participants with guidance regarding the use of married put transactions when determining their net positions under Rule 3b-3. The SEC stated that married puts with the characteristics described above are sham transactions that do not give rise to security ownership under Rule 3b-3. Therefore, sellers who use those types of married puts may violate Rule 10a-1 and Rule 105. Moreover, if sham married puts are used as part of a fraudulent or manipulative scheme, the conduct may also violate the SEC’s anti-fraud and anti-manipulation provisions, including, but not limited to, §§9(a) and 10(b) of the Exchange Act.

**Ethics Code**

On 11/14/03, the SEC approved an Ethics Code (“EC”) that governs the conduct of PCAOB members, employees, and certain contractors and consultants. §101(g)(3) of the SOA requires the PCAOB to establish ethics rules and standards of conduct for members and staff of the PCAOB. The EC consists of 14 sections (EC 1 through EC 14) that establish rules governing the conduct of PCAOB members, employees and certain contractors and consultants. Among other things, the EC:

- Adopts a set of basic principles;
- Clarifies who is covered by which provisions;
- Establishes permitted and prohibited financial and employment interests;
- Requires certain financial disclosures;
- Restricts certain outside activities;
- Limits the gifts that may be received by members and employees;
- Employs a reasonable person standard for analyzing disqualification issues;
- Maintains a permanent ban on the release of non-public information;
- Establishes the position of an Ethics Officer to counsel and provide interpretations of the EC;
- Addresses the conflict-of-interest issues relating to seeking other employment;
- Imposes a post-employment restriction on former members and staff with respect to practicing before the PCAOB (or the SEC with respect to PCAOB-related matters) with respect to particular matters involving specific parties that the former member or staff person had worked on at the PCAOB,
- Provides that waivers of the EC will be made public (subject to the protection of certain information on privacy grounds), and
- Requires an annual certification of compliance with the EC’s provisions.
Disapproved Registration Applications
On 11/17/03, the SEC granted accelerated approval to temporary hearing rules of the PCAOB relating to disapproved registration applications. On 9/29/03, the PCAOB adopted rules on investigations and adjudications (the “Enforcement Rules”). The temporary hearing rules are limited to a subset of the Enforcement Rules. The subset consists of rules that would govern hearings that the PCAOB may hold concerning possible disapproval of applications for registration. The Temporary Hearing Rules include 41 rules and nine definitions, all of which are designated as temporary by appending a “T” to the rule number.

§102 of the SOA prohibits accounting firms that are not registered with the PCAOB from preparing or issuing, or playing a substantial role in the preparation or furnishing of, an audit report with respect to any issuer. Under PCAOB rules previously approved by the SEC, the PCAOB will not disapprove an application for registration without first giving the applicant an opportunity for a hearing. The purpose of the temporary rules is to supply fair procedures and rules to govern the conduct of any such hearing. The rules address the following:

- Rule 5500T, Commencement of Hearing on Disapproval of a Registration Application, and Rule 5501T, Procedures for a Hearing on Disapproval of a Registration Application

Audit Documentation
On 11/12/03, the PCAOB proposed an auditing standard, Audit Documentation, to establish general requirements for documentation the auditor should prepare and retain in connection with any public company audit. §103 (a)(2)(A)(i) of the SOA expressly directs the PCAOB to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation in sufficient detail to support the conclusions reached in the auditor’s report. Among other changes, the proposed standard would:

- Establish general requirements for documentation the auditor should prepare and retain in connection with any engagement conducted in accordance with auditing and related professional practice standards.
- Set a new requirement that audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, who performed it, when it was
completed, and the conclusions reached. The experienced auditor also must be able to determine who reviewed the work and the date of such review.

- Create a rebuttable presumption that audit documentation must exist to establish the fact that audit work was performed.
- Require audit documentation to include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor’s final conclusions.
- Implement the seven-year retention requirement of the SOA and add a requirement that the documentation be assembled for retention within a reasonable period of time (not to exceed 45 days) after the auditors’ report is released.
- Add a requirement that any changes to the working papers after completion of the engagement be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, by whom it was added, and the reasons for adding it.
- Require documentation of work performed by others to be retained by the office issuing the auditor’s report.

The PCAOB also proposed related amendments to the interim auditing standards. The proposed standard and amendments would apply to engagements completed on or after 6/15/04. The PCAOB will accept comments for 60 days.

Audit Reports
On 11/12/03, the PCAOB proposed an auditing standard to require registered public accounting firms to expressly state in each public company audit report that the audit was conducted in accordance with “the standards of the Public Company Accounting Oversight Board.” The proposed standard would apply to auditors’ reports dated on or after the later of 1/1/04, or the 10th day after final approval of the auditing standard.

Exempt Commercial Markets
On 11/25/03, the Commodity Futures Trading Commission (“CFTC”) proposed two actions relating to electronic trading facilities that operate in reliance on the exemption in §2(h)(3) of the Commodity Exchange Act (“CEAct”). The CFTC requested that all comments on its proposals be received by 1/26/04. The CFTC proposed to:

- Amend Rule 36.3(b), which governs CFTC access to information regarding transactions on such trading facilities, to provide for access to more relevant and useful information from all such markets; and.
- Require those electronic trading facilities that operate in reliance on the exemption in §2(h)(3) and that perform a significant price discovery function for transactions in the underlying cash market to publicly disseminate certain specified trading data.

Under the amended rules, an electronic trading facility filing a notification with the CFTC under Rule 36.3 would be required, initially and on an ongoing basis, to: (a) provide the CFTC with access to the facility’s trading protocols, either electronically or in hard copy form; (b) identify those transactions conducted on the facility with respect to which it intends to rely on the exemption in §2(h)(3); and (c) inform the CFTC whether it intends to satisfy the information access requirement of §2(h)(5)(B)(i) of the CEAct with respect to such transactions through the electronic access option provided in ¶36.3(b)(1)(ii)(B), or the reporting option provided in ¶36.3(b)(1)(ii)(A).

Trading facilities electing to provide information under the reporting option would be required to file weekly reports containing information that could be useful to the CFTC in enforcing its antifraud and anti-manipulation authority with respect to those trading facilities. The reports would include, in a form and manner approved by the CFTC, a report for each business day, showing for each transaction executed on the facility in reliance on the exemption set forth in §2(h)(3) the following information: the commodity, the location, the maturity date, whether it is a financially settled or physically delivered instrument, the date of execution, the time of execution, the price, the quantity, and such other information as the CFTC may determine, and for an option instrument, the type of option (call or put) and
the strike price. Each such report would be required to be electronically transmitted weekly, within such time period as is acceptable to the CFTC following the end of the week to which the data applies.

Trading facilities wishing to provide information pursuant to the electronic access option (Rule 36.3(b)(1)(ii)(B)) would be required, initially and on an ongoing basis, to provide the CFTC with electronic access to those transactions conducted on the facility in reliance on the exemption in §2(h)(3). The access must be structured so as to permit the CFTC to capture in permanent form a continuing record of trades on the facility so that the CFTC would be able to reconstruct and compile the same information regarding transactions on the trading facility that would otherwise be provided by the trading facility under the reporting option (Rule 36.3(b)(1)(ii)(A)).

Proposed Rule 36.3(b)(1)(iii) would require a trading facility to maintain a record of allegations or complaints concerning instances of suspected fraud or manipulation. The record would be required to include the name of the complainant, if provided, the date of the complaint, the market instrument, the substance of the allegations, and the name of the person at the trading facility who received the complaint. Proposed Rule 36.3(b)(1)(iv) would require a trading facility to provide to the CFTC a copy of the record of each substantive complaint no later than three days after the complaint is received.

The CFTC also requested comments on a requirement that an exempt commercial market ("ECM") serving a price discovery function publicly disseminate the following information on a daily basis:

- Contextual information, including: (a) contract terms and conditions or product descriptions; and (b) trading conventions, mechanisms, and practices.
- Trading activity information, including: (a) trading volume; and (b) open interest, if available.
- Price information, including: (a) opening and closing prices or price ranges; (b) high and low prices; (c) a volume-weighted average price; or (d) any other price information approved by the CFTC.

The CFTC proposed to add specificity to its price discovery rules in the following ways. First, the CFTC proposed to adopt two criteria that the CFTC will use to determine whether a ECM performs a significant price discovery function for the underlying cash market. Second, the CFTC proposed to specify the information that must be disseminated by ECMs that serve such a significant price discovery function. Third, the CFTC proposed certain amendments to its procedures for making a price discovery determination.

**NYSE Direct+**

On 11/21/03, the SEC granted immediate effectiveness to a NYSE rule change to extend until 12/23/04, the effectiveness of the pilot for NYSE Direct+ ("Pilot"). The Pilot provides for the automatic execution of limit orders of 1099 shares or less ("auto ex" orders) against trading interest reflected in the NYSE’s published quotation. It is not mandatory that all limit orders of 1099 shares be entered as auto ex orders; rather, the member organization entering the order, or its customer if enabled by the member organization, can choose to enter an auto ex order when such member organization (or customer) believes that the speed and certainty of an execution at the NYSE’s published bid or offer price is in its customer’s best interest.

Four filings that impact NYSE Direct+ have been approved by the SEC during the current Pilot and are now part of the Pilot. They include:

- A filing that: (a) amended NYSE Rule 1000 to provide that NYSE Direct+ executions will not be available if the resulting trade would be more than five cents away from the last sale; and (b) provided that during the process for completing NYSE Rule 127 transactions, the specialist should publish a bid and/or offer that is more than five cents away from the last reported transaction price in the subject security on the NYSE.
- A filing that: (a) amended NYSE Rule 13 to provide for a one-year pilot program (also expiring on 12/23/03) to expand Direct+ order size eligibility (for up to 5,000 shares) for Exchange-Traded Funds ("ETFs") and Holding Company Depositary Receipts ("HOLDRs"); (b) amended NYSE Rule 1002 to include ETFs and HOLDRs and provide that ETFs trade until 4:15 p.m.; and (c) amended NYSE Rule 1005 to reflect that the rule applies to ETFs and HOLDRs.
A filing that amended NYSE Rule 1005 to permit entry of limit orders up to 1,099 shares within 30 seconds for an account in which the same person has an interest, provided that the orders are entered from different terminals and that the member or member organization responsible for the entry of the orders to the trading floor has procedures to monitor compliance with the separate terminal requirement.

A filing that amended NYSE Rules 1000 and 1001 in connection with the NYSE LiquidityQuote initiative. In conjunction with autoquoting of bids and offers, NYSE Rule 1000 has been amended to provide that an NYSE Direct+ order equal to or greater than the size of the published bid/offer exhausts the entire bid/offer, rather than decreasing it to 100 shares as was the case initially under the pilot. NYSE Rule 1001(c) provided that if executions of auto ex orders have traded with all trading interest reflected in the NYSE’s published bid or offer, the NYSE will disseminate a bid or offer at that price of 100 shares until the specialist requotes that market. NYSE Rule 1001(c) has been deleted.

The above filings became part of the NYSE Direct+ rules and were incorporated into the Pilot upon their respective approvals by the SEC. The NYSE noted that if the SEC approves the extension of the Pilot for an additional year they are extended as part of the Pilot.

**Fingerprint Processing Fee**

On 11/19/03, the NYSE proposed to amend its 2003 Price List to increase its fingerprinting processing fee. Rule 17f-2 requires the fingerprinting of, among others, every partner, director, officer, and certain specified employees of a national securities exchange member, broker, and dealer. Further, the fingerprints must be submitted to the U.S. Attorney General’s Office or its designee for processing and review. Pursuant to a plan approved by the SEC in accordance with ¶(c) of Rule 17f-2 (“Plan”), the NYSE acts as a processor of fingerprints whereby it forwards fingerprint cards (and attendant payments) to the Federal Bureau of Investigation (“FBI”).

The NYSE performs the service for non-registered employees of members, member organizations, and a limited number of others pursuant to Rule 17f-2 (e.g., transfer agents). Further, the NYSE processes some fingerprint checks on behalf of both prospective NYSE members not associated with a member organization and current members seeking to change firms. In any instance where the NYSE provides FBI fingerprint processing services to a registered person, the results are forwarded to the NASD by the member or member organization for posting to the registered person’s central registration depository (“CRD”) record.

The total fee charged by the NYSE per fingerprint card will be $35.00, which amount consists of a $24.00 processing fee charged by the FBI (of which $2.00 is returned to the NYSE) and a $11.00 processing fee charged by the NYSE. The NYSE noted that the proposed fee increase is directly related to its costs incurred from its transition from a manual to an electronic method of submitting fingerprint cards to the FBI. The transition has resulted in a significant improvement in client service. Upgrades to the NYSE system have reduced processing time per card from an average of three weeks to a current turnaround time of 24 to 48 hours. In addition to recouping consulting and programming expenses incurred during the system upgrade, the increase would offset the cost of maintaining the service.

**Broker Volume**

On 11/26/03, the SEC granted immediate effectiveness to a NYSE rule change to extend the free 30-day trial period for the NYSE Broker Volume Report service, a service that permits subscribers to view Broker Volume Reports of broker share volume information that the NYSE produces from the NYSE Broker Volume Database. The SEC previously approved a rule change (the “Web Service Fee Filing”) by which the NYSE established a monthly $300 fee for a subscriber’s receipt of access to NYSE Broker Volume information that the NYSE makes available via a web-based service (the “NYSE Broker Volume Web Service”). The service enables subscribers to log-on to the NYSE Web site and to receive formatted displays containing aggregate broker-dealer volume rankings in NYSE-traded securities.

In the Web Service Fee filing, the NYSE agreed to waive the NYSE Broker Volume Web Service fee for 30 days.
(the “Free Trial Period”) for any individual that first subscribed to the NYSE Broker Volume Web Service on or prior to 10/1/03. The NYSE stated it has found the Free Trial Period to constitute a successful marketing tool. More than half of all subscribers that subscribe to the NYSE Broker Volume Web Service for the 30-day Free Trial Period continue to subscribe after the Free Trial Period ends. For that reason, the NYSE will extend the application of the 30-day Free Trial Period to subscribers that first subscribe to the NYSE Free Trial Period on or prior to 4/1/04. To avoid a lapse in the application of the Free Trial Period, the NYSE is making the rule change effective retroactively to 10/1/03.

The NYSE will continue to apply the Free Trial Period on a rolling basis, determined by the date on which the NYSE first entitles a new individual subscriber or potential individual subscriber to receive the NYSE Broker Volume Web Service. A specific individual subscriber may only receive the fee waiver one time.

Registered Representative-In-Charge

On 11/17/03, the SEC approved a NYSE rule change that amends the NYSE’s Interpretation Handbook by eliminating, from an existing Interpretation of NYSE Rule 345, a prohibition on persons designated as “Registered-Representative-In-Charge” from associating with members and member organizations as independent contractors. Rule 342 (Offices - Approval, Supervision and Control) requires, in part, that each office of a member or member organization be under the supervision and control of the member or member organization establishing it and of the person delegated such authority and responsibility. Further, the structure and administration of NYSE rules mandate that all employees of members and member organizations, including registered representatives, be subject to the direct and ongoing supervision and control of their member organization employer.

In addition, Rule 342.15 provides that small offices (those with three or fewer registered representatives) may be in the charge of a qualified principal or manager who is either resident or non-resident in that location. Interpretation /02 to Rule 342.15 provides that where a qualified supervisor is not on the premises of a small office, a resident registered representative is to be designated as “in charge.” However, it is still required that all supervisory functions (e.g., approval of accounts, review of account activity and correspondence, etc.) are to be conducted by qualified supervisors.

The NYSE eliminated “registered representative-in-charge” as a category of registered person precluded from being an independent contractor under Interpretation /02 to Rule 345(a). In that regard, the NYSE determined that members and member organizations generally assign administrative as opposed to supervisory functions to persons they designate as registered representatives-in-charge. Pursuant to an existing written interpretation (Rule 342.15/02), primary supervision is carried out by qualified branch managers, (persons who have passed the General Securities Sales Supervisor Qualification Examination, Series 9 and 10) at designated parent branch offices or the main office of the member or member organization in accordance with its overall written plan of supervision.

Accordingly, Interpretation /02 to Rule 345(a) was amended to permit registered representatives-in-charge to associate with members and member organizations as independent contractors provided that the member or member organization neither assigns nor delegates supervisory responsibilities to such persons. Further, in addition to the documents already required to be submitted under the Interpretation in requesting approval of independent contractor status (e.g., Employment Agreement, Consent to Jurisdiction Form, written assurances that the member or member organization will supervise and control all activities of the independent contractor the same as it regulates the activities of all other registered representatives), the member or member organization will be required to submit a written statement confirming that it has not assigned or delegated any supervisory responsibilities to such person.

Branch Office Registration Fees

On 11/14/03, the SEC approved a NYSE rule change and amendment to reduce initial and annual branch office registration fees charged to member organizations with more than one thousand branch offices. The NYSE stated
it increased its registration and maintenance fees applicable to member organization branch offices, effective 1/1/03. The NYSE charges an initial fee upon the opening of a new branch office and an annual maintenance fee for each active branch office. A three-tiered fee structure is used for assessment of such fees in which a stepped-down rate is charged based on the applicable tier level. The structure provided an incremental reduction in fees for those branch offices that exceed the level of each breakpoint. The NYSE reductions of initial and annual branch office fees, which became retroactive to 1/1/03, are as follows:

- $350 for each of the first 1,000 branch offices (unchanged);
- $150 for each of the next 2,000 branch offices (reduced from $250); and
- $125 for each branch office over 3,000 (reduced from $225).

NYSE Governance and Management Architecture

On 11/13/03, the SEC announced that the NYSE proposed to amend and restate its Constitution to significantly change its governance structure. The NYSE stated that the objectives of the new governance architecture are to:

- Place responsibility for governance, compensation and internal controls, as well as for supervision of regulation, in the hands of a Board of Directors that is independent both from NYSE management and from the members, member organizations and listed companies; and
- Separately preserve the existing engagement of the broker-dealer community and listed company community with the NYSE by creating a Board of Executives that will also include the executives of major public and private “buy-side” entities as well as lessor members of the NYSE.

The proposed rule change calls for a Board of Directors that is completely independent except for the CEO. Requiring independence from owner-constituents goes beyond what the NYSE expects of public companies, and it aligns the NYSE’s Board with the interests of investors. It is the additional Board of Executives that is intended to ensure ongoing engagement with all of the NYSE’s constituents. Moreover, the Regulatory unit reports directly - and not through the CEO - to its independent Board of Directors, yet retains sufficient proximity to the marketplace to assure the market sensitivity that the NYSE noted is fundamental to effective regulation of the capital markets. The NYSE noted that under the amended and restated Constitution the new Board will have authority concurrent with its member owners to change specific provisions pertaining to its governance architecture, which means that further changes can be effected in those provisions without another membership vote.

A complete explanation of the purposes and details of the new architecture, and the reasons why the NYSE is desirous of making the changes, was contained in the proxy statement and related materials which have been furnished to the NYSE’s membership in connection with the upcoming membership vote on the proposal. Also contained in the proxy statement are the names of the eight persons whom the members are being asked to vote to elect as the new Board of Directors of the NYSE.

Board Approval of Voluntary Delisting

On 11/5/03, the SEC approved a rule change to delete NYSE Rule 500 in its entirety and to amend §806 of the NYSE Manual regarding the application by an issuer to delist its securities from the NYSE. Amended §806 would require a company to furnish the NYSE with a certified board resolution evidencing board approval of the voluntary delisting.

NYSE Rule 500 described the procedures a listed company must follow to voluntarily delist its securities from the NYSE. The NYSE will require only that a company voluntarily delisting its securities from the NYSE obtain the approval of its board and furnish the NYSE with a copy of the board resolution. The company would still be required under SEC rules to file an application with the SEC to withdraw the security from listing on the NYSE. The NYSE also noted that companies are obligated to publicly disclose material events, and it expects that a company that has made a final determination to
voluntarily delist its securities from the NYSE would promptly disclose that determination to the public. In making the rule change, the NYSE will delete Rule 500 in its entirety. The remaining requirement of board approval and notice to the NYSE will be codified in §806 of the NYSE Manual.

The NYSE noted that the rule change removes previous requirements that an issuer seeking to voluntarily delist a security from the NYSE obtain approval of its audit committee; notify 35 of its largest shareholders of the proposed delisting; and publish a press release announcing the proposed delisting. Under the rule change, the issuer is required only to furnish the NYSE with a certified board resolution evidencing board approval of the delisting.

**Representation of NASD in the Unlisted Trading Privilege Plan**

On 11/17/03, the SEC announced that the NASD proposed to amend the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries (“Delegation Plan”) to remove the Nasdaq Stock Market, Inc.’s (“Nasdaq”) representation of the NASD in the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis (“UTP Plan”).

The SEC, as a condition to the approval of the Nasdaq’s SuperMontage rule filing, required the NASD to operate the Alternative Display Facility (“ADF”) to ensure the existence of an alternative venue for NASD members to quote and trade report in Nasdaq securities. While the ADF operates as a separate NASD facility for Nasdaq securities, the NASD delegated its participation rights, including the right to vote in the UTP Plan, to the Nasdaq. Accordingly, the ADF is not separately represented in the UTP Plan and has no voting authority.

The proposed rule change would amend the Delegation Plan to retract the delegation of its UTP participation rights to the Nasdaq. In addition, the proposed rule change replaces several references to “the Association” and “the NASD” in the text of the proposed rule change with “NASD.” The NASD no longer refers to itself using its full corporate name, “the Association” or “the NASD;” instead, it uses “NASD” unless otherwise appropriate for corporate or regulatory reasons.

**Affirmative Determination Requirements for Short Sale Orders**

On 11/24/03, the SEC approved a NASD rule change to require that before accepting a short sale order from a broker-dealer that is not an NASD member (“non-member broker-dealer”) a member must make an affirmative determination that the member will receive delivery of the security from the non-member broker-dealer or that the member can borrow the security on behalf of the non-member broker-dealer for delivery by settlement date. The rule change amends NASD Rule 3370(b)(2)(A) to require that no member or person associated with a member will accept a short sale order for any customer, or any non-member broker-dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-member broker-dealer, or that the member can borrow the security on behalf of the customer or non-member broker-dealer for delivery by settlement date. In such instances, members also would be required to comply with the corresponding recordkeeping requirements under NASD Rule 3370(b)(4)(B).

While NASD members generally are required to make affirmative determinations for both customer and proprietary orders, there are limited exceptions for proprietary orders that are *bona fide* market making, *bona fide* fully hedged or *bona fide* fully arbitraged transactions. Under the rule change, if a member can establish and document that a proprietary order it has received from a non-member broker-dealer meets one of the exceptions, it would be in compliance with the amendments to the affirmative determination requirements of NASD Rule 3370(b)(4)(B).

**Official Opening Price**

On 11/26/03, the SEC announced that the Nasdaq filed a proposed rule change to establish a Nasdaq official
opening price that would be made available for wholly voluntary use by NASD members and the public. The Nasdaq stated that it would calculate and disseminate the Nasdaq Official Opening Price using its proprietary systems, and that the Nasdaq Official Opening Price would not affect the dissemination of last sale information pursuant to the national market system plan governing trading of Nasdaq securities - the Nasdaq UTP Plan.

The Nasdaq proposed to calculate and disseminate a Nasdaq Official Opening Price for Nasdaq-listed securities. The Nasdaq would disseminate the Nasdaq Official Opening Price over the Nasdaq Index Dissemination Service data feed (“NIDS”), a proprietary data feed of the Nasdaq. Because the Nasdaq Official Opening Price would be neither a quotation nor a last sale report, it would not be disseminated over either the UTP Quote data feed or the UTP Trade data feed. The Nasdaq Official Opening Price message would contain the prevailing inside quote and the Nasdaq Official Opening Price value. The Nasdaq stated that the fees for the NIDS feed have previously been filed with the SEC, and that it is not proposing to change those fees.

The Nasdaq Official Opening Price would be equal to the reported price of the first trade executed in the Nasdaq National Market Execution System (“SuperMontage”), which would be based upon orders that are in queue when SuperMontage begins trading at 9:30 a.m. ET (“SuperMontage Opening Match”). The Nasdaq Official Opening Price value would be disseminated as soon as it is calculated, and changes to the underlying trade report would not affect the Nasdaq Official Opening Price.

**Automated Confirmation Transaction Service**

On 11/28/03, the SEC granted immediate effectiveness to a rule change to amend NASD Rule 6130 to clarify the reporting requirements applicable to transactions conducted through electronic communications networks (“ECNs”) and reported to the Automated Confirmation Transaction Service (“ACT”). The Nasdaq noted it recently amended various NASD rules governing trade reporting to define with greater clarity the reporting obligations applicable to transactions executed through ECNs that are reported to ACT. In general, the rule changes were not intended to require ECNs to modify their current trade reporting practices, but were intended to codify the practices in the form of clear, enforceable rules to provide greater guidance to market participants. Since that approval, however, several ECNs have informed the Nasdaq that one aspect of the rule change would result in an alternation of current practices (and associated programming costs), and the Nasdaq concluded that this alternation would not result in any offsetting benefit. The benefit the Nasdaq sought to gain was to enhance predictability and enforceability by codifying existing practices. In keeping with its goals, the Nasdaq stated that it is acceptable for executing ECNs to treat routing ECNs as order entry firms. Thus, the Nasdaq amended its Rule 6130(c)(6) accordingly.

**Query Function During Trade Comparison Process**

On 11/25/03, the SEC granted immediate effectiveness to a Nasdaq rule change to raise ACT fees for users of the query function during the trade comparison process. ACT is an automated trade reporting and reconciliation service that speeds the post-execution steps of price and volume reporting, comparison, and clearing of trades completed in the Nasdaq, the OTC Bulletin Board, and other over-the-counter markets. ACT handles transactions executed through the Nasdaq’s automated trading systems, as well as transactions negotiated over the telephone and internalized transactions. It also manages post-execution procedures for transactions in exchange-listed securities that are traded in the Nasdaq InterMarket.

The ACT billing process generally has three steps. First, ACT assesses a fee to the contra party that performed the “browse/query” action. Second, ACT assesses a fee to both the reporting and contra party for locking-in the transaction via the “accept/decline” function. Third, ACT reverses the fee for the contra party’s accept/decline action.

The Nasdaq noted it is in the process of migrating many of its services, including ACT, onto a new, more efficient internal billing platform. The billing process for each ACT service would transfer seamlessly onto this new platform.
except for the fee reversal described as step three of the process. In light of the sharply reduced usage of this functionality, it would be impractical and expensive to duplicate the third step in the new billing system. Doing so would raise the overall costs of the system, which would then have to be passed on to other users. Therefore, the Nasdaq has determined that it is more equitable for the small number of users who continue to use this functionality to pay the actual costs associated with each step of the process.

California Arbitrator Disclosure Standards

On 11/4/03, the SEC granted immediate effectiveness to a NASD rule change to amend the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure that requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards to include claims by members against other members or associated person that relate exclusively to promissory notes.

In July 2002, the California Judicial Commission adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”), governing ethical standards for arbitrators. The rules were designed to address conflicts of interest in private arbitration forums that are not part of a Federal regulatory system overseen on a uniform, national basis by the SEC. The California Standards imposed disclosure requirements on arbitrators that conflict with the disclosure rules of NASD and the NYSE.

In November 2002, NASD and NYSE filed a lawsuit in Federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations (“SROs”). That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, several of which are also still pending. To allow arbitrations to proceed in California while the litigation is pending, the NASD implemented a pilot rule to require all industry parties (member firms and associated persons) to waive application of the California Standards to the case, if all the parties in the case who are customers, or associated persons with claims against industry parties, have done so. In such cases, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.

Specifically, the rule change would amend IM-10100(f) to provide that if a member bringing a claim against another member, or a claim against an associated person that relates exclusively to promissory notes, waives application of the California Standards to the dispute, then the industry respondents will also be deemed to have waived the application of the Standards. The rule change will allow to proceed the majority of the remaining intra-industry cases that are currently stalled due to the confusion surrounding the California Standards. It will also prevent delay in such cases that are filed in the future, and will facilitate the administration of cases against such parties in California while the rule is in effect.

Pegged Orders

On 11/25/03, the SEC granted immediate effectiveness to a NASD rule change to establish a new voluntary order type, known as pegged orders, for use within the Nasdaq SuperMontage. A pegged order is a limit order, the price of which is automatically adjusted to follow the price movements of the Nasdaq inside market. A “regular” pegged order would peg to the same side of the market it is entered on. Thus, the price of a regular pegged buy order would always equal the best inside bid in the Nasdaq, and the price of a regular pegged sell order would always equal the best inside offer in the Nasdaq. By entering a regular pegged order, a market participant indicates its willingness to provide liquidity at the best inside price set by other market participants.

A “reverse” pegged order would peg to the opposite side of the market. Specifically, it would peg at a price that deviates from the opposite side of the market by $0.01. Thus, a reverse pegged buy order would be priced at $0.01 less than the inside offer, and a reverse pegged sell order would be priced at $0.01 more than the inside bid. By entering a reverse pegged order, a market participant indicates its willingness to provide liquidity at a price as close as possible to the opposite side of the
market. As a result, in circumstances where the bid/ask spread is greater than $0.01, the entry of a reverse pegged order would establish a new inside price. A pegged order may not be pegged to prices away from the inside market. Like any other order whose price is changed, a pegged order would be given a new time-priority stamp whenever a change to the inside bid/offer results in an adjustment of the price of a pegged order.

Users may voluntarily select a price execution cap beyond which a pegged order would not be executed. Once a price cap is reached, the pegged/reverse pegged order would be permanently converted to an unpegged limit order at the cap price and would be retained by the system for display and potential execution solely at that price or better; the price of a pegged order that is converted into an unpegged limit order would not thereafter be adjusted, even if the inside bid/offer is later in the range where pegging had previously been occurring. If no execution cap price amount is selected, SuperMontage would continue to adjust the price of the pegged order to follow the inside bid or offer to which it is pegged.

Pegged orders may only be entered as DAY orders. Pegged orders may be entered (but not displayed or executed) prior to market open. Because a pegged order reflects a NNMS participant’s willingness to provide liquidity, pegged orders entered before market open would be added to the book and become available for interaction with other orders at 9:30 a.m. The price of pegged orders would be established at 9:30 a.m., based on the inside market at the open. Pegged orders may not be preferred or directed to another market participant.

A regular pegged order may not itself establish the inside bid or offer. Therefore, if all non-pegged displayable interest at the inside is exhausted, the new inside would be established at the next best price level where displayable non-pegged quotes/orders exist, and the price of pegged orders would be adjusted accordingly. If there are no other market participants on the same side of the market, a regular pegged order would be cancelled and sent back to the entering party. Because the price of a reverse pegged order is based on changes on the opposite side of the market (e.g., a reverse pegged buy order’s price is adjusted based on changes in the offer), the order may remain alone at the inside. If there are no participants on the contra-side of the market, however, a reverse pegged order would be cancelled and sent back to the entering party.

Because pegged orders would not allow a market participant to maintain a price that is away from the inside market, they are consistent with the Nasdaq’s “Autoquote Policy” reflected in NASD IM-4613. Pegged orders would allow all market participants to adjust the prices of orders in a manner similar to the practice of computer generated quoting described in NASD IM-4613(c), which is currently permitted on a case-by-case basis. Because of the potential negative impact that the automatic adjustment of quotes/orders can have on system capacity and performance, however, the Nasdaq specifically retained the right to restrict or prohibit the entry of any type of pegged order entirely, or in a particular issue(s), at any time when SuperMontage is operational or available for the entry of such orders. Pegged or reverse pegged orders that are in the system at the time the Nasdaq determines not to accept further such orders would continue to be normally adjusted and executed.

**Trade Reporting and Compliance Engine**

On 11/4/03, the SEC announced that the NASD filed a proposed rule change and amendment to amend NASD Rule 7010(k) relating to fees for the Trade Reporting and Compliance Engine (“TRACE”) prior to the expiration of the pilot program for fees on 1/31/04 and requested permanent approval of the fee structure. The proposed rule change would establish a permanent fee structure for the TRACE system that would ensure recovery of developmental costs of the TRACE system, fund ongoing operational costs, and fund the regulatory activities necessary for surveillance of the market. The NASD stated that the proposed rule change would equitably distribute the costs to participants of the TRACE system.

The NASD noted that the revenues are derived from a combination of System Fees to access TRACE, Transaction Reporting Fees for trade reporting, and Market Data Fees for access and display of aggregated TRACE data. The proposed fees are also divided into the same three general categories: (a) system fees paid by
member firms based on the technology method chosen by the member to report corporate bond transactions; (b) transaction reporting fees paid by members to file trade reports and cancel or correct trade reports; and (c) market data fees paid by members and non-members that use or distribute the data collected through the TRACE system and disseminated by NASD. The NASD requested permanent approval of the fees relating to the TRACE system. However, the NASD remains committed to reviewing and reassessing TRACE fees over time.

The NASD noted that a member may report TRACE transaction data to NASD by one of three approved methods: (a) web browser access; (b) direct computer-to-computer interface (“CTCI”); or (c) indirectly through third-parties, such as vendors, service bureaus, clearing firms, or the National Securities Clearing Corporation. The member determines the reporting method they would like to use based on such factors as volume, size, and cost. The NASD stated it will review and reassess the appropriateness of TRACE fees over time to ensure that the fees are reasonable and equitable for participants in the TRACE system. The NASD noted that the rule change provides for the equitable allocation of reasonable dues, fees, and other charges among members and other persons using any facility or system, which the association operates or controls.

Tax Issues

Reporting Dividends Paid by Foreign Corporations

On 11/26/03, the Internal Revenue Service (“IRS”) issued Notice 2003-79 containing comprehensive guidance regarding provisions in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “JGTRRA”) applying reduced Federal income tax rates (i.e., 15% or 5%) to dividends received by individuals from qualified foreign corporations (“QFCs”). Notice 2003-79, which is effective for taxable years beginning on or after 1/1/03: (a) provides guidance for persons required to make returns (e.g., Form 1099-DIV) and provide statements under §6042 of the Internal Revenue Code (“IRC”) regarding distributions with respect to securities issued by a foreign corporation, and for individuals receiving the statements; (b) provides simplified procedures for persons required to make the returns and provide the statements for 2003; (c) describes when a security (or an American depositary receipt) issued by a foreign corporation that is other than ordinary or common stock (e.g., preferred stock) will satisfy the alternative QFC “readily tradable test”; (d) describes generally the certification process that the IRS intends to develop for future years (after 2003); and (e) contains a waiver of penalties provision.

Background. The determination whether a distribution with respect to a security issued by a foreign corporation is eligible for the reduced tax rates under the JGTRRA requires a series of five separate determinations, in general, as follows: (a) the security with respect to which the distribution is made must satisfy the equity test; (b) the distribution must satisfy the earning and profits (“E&P”) test; (c) the security must satisfy the readily tradable test, or the foreign corporation must satisfy either the possessions test or the treaty test; (d) the foreign corporation must satisfy the foreign investment company (“FIC”) exclusion test (which also excludes certain other disqualified entities); and (e) the recipient of the distribution must satisfy the holding period test.

Notice 2003-79. Notice 2003-79 (which should be referred to in its entirety) discusses the information reporting determinations concerning each of the above tests relevant to whether a distribution with respect to a security issued by a foreign corporation is a qualified dividend, summarized in general, as follows:

- **The Equity Test.** In order to be a qualified dividend, a distribution must be made with respect to equity rather than indebtedness, as determined under U.S. Federal income tax principles. The characterization of an instrument for U.S. Federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. See, e.g., IRS Notice 94-47.

For 2003 information reporting, a person required to make a return under §6042 for a distribution with respect to a security issued by a foreign corporation should treat the security as satisfying the equity test if the security is a common or an ordinary share. In addition, if the security is not a common or an
ordinary share, the person should treat the security as satisfying the equity test if the foreign corporation has filed a public statement with the SEC stating that the security will be, should be, or more likely than not will be properly classified as equity rather than as debt for U.S. Federal income tax purposes.

For 2004 and future information reporting, the IRS intends to issue regulations providing a certification procedure under which foreign corporations may certify that a security with respect to which a distribution is made meets the equity test.

- **The E&P Test.** In order to be a qualified dividend, a distribution must be a dividend. §316, IRC, generally provides that a dividend means any payment made by a corporation to its shareholders out of E&P. A person required to file an information return under §6042 may not know in a given circumstance whether a distribution by a corporation represents a distribution of E&P. If a person making a payment of or with respect to a distribution by a corporation is unable to determine the portion of the payment that is a dividend or is paid with respect to a dividend, then under §6042(b)(3) the person making the payment must treat the entire payment as a dividend or as an amount paid with respect to a dividend.

- **Alternative Tests: Readily Tradable Test, or Possessions Test, or Treaty Test.** These three alternative tests are as follows:

  - **Readily Tradable Test.** A foreign corporation is treated as a QFC with respect to any dividend paid by the corporation if the stock with respect to which that dividend is paid is readily tradable on an established securities market in the U.S. IRS Notice 2003-71 defines when ordinary or common stock is considered readily tradable on an established securities market in the U.S. In addition, for 2003, a security (or an American depositary receipt) issued by a foreign corporation that is other than ordinary or common stock (e.g., preferred stock) will satisfy the readily tradable test if it is listed on a national securities exchange that is registered under §6 of the Exchange Act or on the Nasdaq, as described in Notice 2003-71.

  - **Possessions Test.** The JGTRRA provides that, in order to satisfy the possessions test, a corporation must be incorporated in a possession of the U.S. For 2003 and future years, a person required to make a return under §6042 should treat a corporation incorporated in a possession of the U.S. as satisfying the possessions test.

  - **Treaty Test.** The JGTRRA provides that, in order to satisfy the treaty test, a corporation must be eligible for benefits of a comprehensive income tax treaty with the U.S. which the U.S. Treasury Department determines is satisfactory and which includes an exchange of information program. IRS Notice 2003-69 contains the current list of treaties that meet the treaty requirements of the JGTRRA.

For 2003 information reporting, a person required to make a return under §6042 should treat a foreign corporation as satisfying the treaty test provided that: (a) the foreign corporation is organized in a country whose income tax treaty with the U.S. is listed in Notice 2003-69; and (b) if the relevant treaty contains a limitation on benefits provision, the corporation’s common or ordinary stock is listed on an exchange covered by the public trading test in that limitation on benefits provision. However, a person required to make the return may not treat a foreign corporation as satisfying the treaty test if the person knows or has reason to know that the corporation is not eligible for benefits under the relevant treaty. For this purpose, a person will be considered to have reason to know the corporation is not eligible for treaty benefits if the person knows or has reason to know that the corporation is not eligible for treaty benefits if the corporation has so stated in its most recent SEC annual filing (if any) for the security (e.g., Form 20-F).

For 2004 and future information reporting, the IRS intends to develop a certification procedure under which a foreign corporation may certify that it meets the treaty test. For corporations that complete a Form W-8BEN for other purposes, it is expected that filing a copy of this form with the IRS could be used as a means of meeting the certification requirement with
respect to the treaty test, depending on the circumstances.

- **Foreign Investment Company Exclusion Test.**
  The JGTRRA provides that a QFC does not include any foreign corporation that is a FIC, a foreign personal holding company (“FPHC”), or a passive foreign investment company (“PFIC”) for the taxable year in which the dividend was paid or the preceding year. A person required to make a return under §6042 for 2003 should treat a foreign corporation as satisfying the FIC exclusion test unless the person knows or has reason to know that the corporation is or expects to be a FIC, FPHC, or PFIC. For this purpose, a person would have the requisite reason to know if a corporation has stated in its most recent annual public filing with the SEC that it is or expects to be a FIC, FPHC, or PFIC. The IRS intends to develop a certification procedure for 2004 and future information reporting under which a foreign corporation may certify that it satisfies the FIC exclusion test.

- **Holding Period Test.**
  The JGTRRA provides that a recipient of a dividend (i.e., the stockholder) must satisfy certain holding period requirements (triggered off the ex-dividend date) in order for the dividend to be considered a qualified dividend. The instructions to Form 1099-DIV direct a person required to file Form 1099-DIV to report in Box 1b as qualified dividends any dividends for which it is impractical to determine whether the recipient has met the holding period requirements for the stock with respect to which the dividend is paid. Accordingly, if a person required to make a return under §6042 has determined that a recipient has satisfied the relevant holding period requirements or if it is impractical for the person to determine whether a recipient has satisfied the holding period requirements, the person required to make the return should treat the recipient as satisfying the holding period test.

**Penalties.**
The IRS stated that it will exercise its authority under §6724(a), IRC, to waive penalties under §§6721 and 6722 with respect to reporting of calendar year 2003 payments if a person required to make a return under §6042 makes a good faith effort to report payments consistent with the simplified procedures contained in Notice 2003-79.

A person required to make a return under §6042 may believe a particular distribution should be reported in Box 1b of Form 1099-DIV as a qualified dividend even though the distribution does not satisfy the simplified information reporting procedures. In that case, the person required to make a return under §6042 may report the distribution in Box 1b as a qualified dividend, subject to the applicable penalty provisions. To illustrate this, Notice 2003-79 contains an example in which a foreign corporation distribution is reported as a qualified dividend in a situation where the alternative readily tradable, possessions, and simplified 2003 treaty tests are not satisfied but the person required to make a return nonetheless believes that the foreign corporation is eligible for income tax treaty benefits and thus satisfies the treaty test.

**Recipients.**
For taxable years beginning in 2003, a recipient of Form 1099-DIV may treat amounts reported in Box 1b as qualified dividends, unless and to the extent that the recipient knows or has reason to know that the amounts are not qualified dividends. As provided in §1.6664-4(b)(1), this reliance may constitute reasonable cause and good faith reliance for purposes of applicable penalties, depending on the facts and circumstances. In addition, a recipient of Form 1099-DIV may treat a dividend excluded from Box 1b as a qualified dividend if the person believes the dividend is a qualified dividend, subject to applicable penalties in the event the amount so reported is not in fact a qualified dividend.

**Foreign Tax Credits.**
Note that the reduced tax rates on dividends paid by QFCs result in a coordinated reduction in the recipient’s foreign tax credit limitation.

**Tax Shelter Transactions**
On 11/7/03, the IRS issued Notice 2003-76 updating the list of transactions that have been determined by the IRS to be “listed transactions” for purposes of the tax shelter regulations. The IRS stated that transactions that are the same as or substantially similar to transactions described in Notice 2003-76 have been determined by the IRS to be tax avoidance transactions and are listed transactions for purposes of §1.6011-4(b)(2) and §301.6111-2(b)(2).
As a result, the IRS stated that taxpayers may need to disclose their participation in these listed transactions as prescribed in §1.6011-4, and promoters (or other persons responsible for registering tax shelter transactions) may need to register the transactions under §301.6111-2. In addition, material advisors must maintain lists of investors and other information with respect to these listed transactions pursuant to §301.6112-1.

Background. On 10/16/02, as part of ongoing efforts to address abusive tax avoidance transactions, the IRS released amended tax shelter disclosure and list-maintenance regulations. The amended regulations expanded the rules for the disclosure by taxpayers of their participation in potentially abusive tax avoidance transactions and the maintenance of lists by promoters of taxpayers who have entered into the transactions. The amended regulations generally apply to transactions entered into on or after 1/1/03.

In general, under the amended regulations, disclosure is required by every taxpayer (corporations, individuals, trusts, partnerships, etc.) that has participated directly or indirectly in the tax shelter. The disclosure requirements apply to the following categories of tax shelters: (a) listed transactions specifically identified by the IRS; (b) confidential transactions; (c) transactions with contractual protection; (d) loss transactions exceeding specified amounts; (e) transactions with a significant book-tax difference exceeding specified amounts; and (f) transactions involving a brief asset holding period.

On 2/7/03, the IRS issued final regulations finalizing the rules for disclosure of reportable transactions, registration of confidential corporate tax shelters, and list maintenance of potentially abusive tax shelters under §§6011, 6111, and 6112. The IRS also issued Revenue Procedures (“Rev. Proc.”) 2003-25 and 2003-24 on certain book-tax differences and certain losses not considered when determining whether a transaction is a reportable tax shelter. Unless the taxpayer elects retroactive treatment to 1/1/03, as provided in §1.6011-4(h), the final regulations apply to transactions entered into on or after 3/4/03. With the same exception, Rev. Procs. 2003-25 and 2003-24 are effective for transactions entered into on or after 2/28/03.

Under the provisions of the final regulations (which should be referred to in their entirety), taxpayers are required to disclose reportable transactions on Form 8886, Reportable Transaction Disclosure Statement. Reportable transactions entered into on or after 1/1/03, and prior to 3/4/03, for which the taxpayer does not choose to apply the final regulations, may be disclosed on Form 8886 or as provided in §1.6011-4T(c) as published in the Federal Register on 6/18/02. Form 8886 allows taxpayers to aggregate substantially similar transactions on one form for disclosure purposes.

Notice 2003-76. Notice 2003-76 restates the inventory of listed transactions published in Notice 2001-51 and updates the list by adding transactions identified as listed transactions in notices and other guidance released subsequent to 8/2/01. It also identifies the underlying IRS pronouncements (which should be referred to in their entirety) and provides the date that the IRS identified the transaction as a listed transaction, as follows:

1. **Certain Qualified Plan Contributions.** Revenue Ruling (“Rev. Rul.”) 90-105 (transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year [2/28/00]). See also Rev. Ruls. 2002-46 and 2002-73.

2. **Certain Welfare Benefit Funds I.** Notice 95-34 (certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of §§419 and 419A, IRC, [2/28/00]).

3. **Insubstantial Foreign Economic Profit.** Part II of Notice 98-5 (transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits [2/28/00]).

Note. Also see IRS Notice 2003-81, dated 12/4/03, identifying as listed transactions certain transactions involving two pairs of offsetting options on foreign currencies that, collectively, are structured to have little real risk of economic gain or loss.
(4) **Certain Contingent Installment Sales.** ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (CA-D.C. 2000), and ACM Partnership v. Commissioner, 157 F.3d 231 (CA-3, 1998) (transactions involving contingent installment sales of securities by partnerships in order to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or foreign person, and to allocate later losses to another partner [2/28/00]).

(5) **Certain Charitable Remainder Trusts.** §1.643(a)-8 (transactions involving distributions described in §1.643(a)-8 from charitable remainder trusts [2/28/00]).

(6) **Certain Distributions of Encumbered Property.** Notice 99-59 (transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered [2/28/00]).

(7) **Certain Fast-Pay Arrangements.** §1.7701(l)-3 (transactions involving fast-pay arrangements [2/28/00]).

(8) **Certain Offsetting Debt Instruments.** Rev. Rul. 2000-12 (certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions [2/28/00]).

(9) **Artificially Inflated Partnership Basis.** Notice 2000-44 (transactions generating losses resulting from artificially inflating the basis of partnership interests [8/1/00]).

(10) **Certain Subsidiary Stock Transactions.** Notice 2000-60 (transactions involving the purchase of a parent corporation’s stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent’s employees, and the eventual liquidation or sale of the subsidiary [11/16/00]).

(11) **Guamanian Trusts.** Notice 2000-61 (transactions purporting to apply §935 to Guamanian trusts [11/21/00]).

(12) **Certain Intermediary Corporate Asset Sales.** Notice 2001-16 (transactions involving the use of an intermediary to sell the assets of a corporation [1/18/01]).

(13) **Certain High Basis Asset Transactions.** Notice 2001-17 (transactions involving a loss on the sale of stock acquired in a purported §351 transfer of a high basis asset to a corporation and the corporation’s assumption of a liability that the transferor has not yet taken into account for Federal income tax purposes [1/18/01]).

(14) **Certain Stock Redemptions.** Notice 2001-45 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer [7/26/01]).

(15) **Certain Loan Assumption Agreements.** Notice 2002-21 (transactions involving the use of a loan assumption agreement to inflate basis in assets acquired from another party to claim losses [3/18/02]).

**Note.** Also see IRS Notice 2003-77, dated 11/19/03 as revised 12/1/03, in which the IRS identifies as listed transactions five transactions that use liability trusts improperly to attempt to accelerate deductions for contested liabilities under §461(f), IRC. Among other matters, Notice 2003-77 focuses on transactions where a taxpayer transfers it own stock or debt, or stock or debt of a related party, to the contested liability trust, and where the taxpayer limits the trustee’s power over trust assets.

(16) **Certain Offsetting Notional Principal Contracts.** Notice 2002-35 (transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future [5/6/02]).
(17) **Certain Straddle Transactions.** Notice 2002-50 (transactions involving the use of a straddle, a tiered partnership structure, a transitory partner, and the absence of a §754 election to claim a permanent non-economic loss [6/25/02]); Notice 2002-65 (transactions involving the use of a straddle, an S corporation or a partnership, and one or more transitory shareholders or partners to claim a loss while deferring an offsetting gain); and Notice 2003-54 (transactions involving the use of economically offsetting positions, one or more tax indifferent parties, and the common trust fund accounting rules of §584 to allow a taxpayer to claim a noneconomic loss).

(18) **LILO Transactions.** Rev. Rul. 2002-69 (transactions in which a taxpayer purports to lease property and then purports to immediately sublease it back to the lessor (i.e., lease-in/lease-out or “LILO” transactions) [2/28/00]).

*Note.* Also see IRS Coordinated Issue Paper, dated 10/17/03, on losses claimed and income to be reported from LILO transactions.

(19) **Certain Reinsurance Transactions.** Notice 2002-70 (transactions involving reinsurance arrangements between a taxpayer and the taxpayer’s own reinsurance company that is subject to little or no Federal income tax [10/15/02]).

(20) **Certain ESOP Transactions.** Rev. Rul. 2003-6 (certain arrangements involving the transfer of ESOPs that hold stock in an S corporation for the purpose of claiming eligibility for the delayed effective date of §409(p) [12/17/02]).

(21) **Certain Leasing Company Arrangements.** Notice 2003-22 (certain arrangements involving leasing companies that have been used to avoid or evade Federal income and employment taxes [4/4/03]).

(22) **Certain Welfare Benefit Funds II.** Notice 2003-24 (certain arrangements that purportedly qualify as collectively-bargained welfare benefit funds excepted from the account limits of §§419 and 419A [4/11/03]).

(23) **Certain Compensatory Stock Option Transactions.** Notice 2003-47 (transactions involving compensatory stock options and related persons to avoid or evade Federal income and employment taxes [7/1/03]).

(24) **Lease Strips.** Notice 2003-55 (transactions in which one participant claims to realize rental or other income from property or service contracts and another participant claims the deductions related to that income [2/28/00]).

*Note.* Also see IRS Notice of Withdrawal of REG 209817-96, dated 11/7/03, in which the IRS withdraws proposed regulations relating to lease strips (obligation shifting transactions), initially issued on 12/27/96.

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