

# Recommendations on Providing Relief to Internal Control Reporting

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In April 2006, the Advisory Committee on Smaller Public Companies released its final report to the Securities and Exchange Commission. The SEC established the Advisory Committee to assess the current regulatory system for smaller companies under the securities laws of the United States. There are several recommendations of the Advisory Committee that may affect investment managers that are sponsors of hedge funds, or commodity pools that are subject to the financial reporting requirements of the Securities Exchange Act of 1934 (i.e. funds or pools that file Forms 10-K and 10-Q with the SEC). In April 2006, Managed Funds Association submitted comments in response to the Advisory Committee's draft report. MFA's comment letter is available to view on [www.mfainfo.org](http://www.mfainfo.org). The Advisory Committee recommendation of most significance from an accounting perspective relates to potential relief from the internal control compliance requirements imposed by Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404).

## Background on Section 404 Internal Control Compliance

Public hedge funds or commodity pools that are subject to the Securities Exchange Act of 1934 are also subject to SOX 404 which requires management to document and assess the adequacy of internal controls over financial reporting. SOX 404 further requires an independent audit of management's report on its internal controls. The SEC has deferred the effective date for certain registrants and in general, public funds or commodity pools are required to report on internal controls in their 2007 Form 10-K.

## Advisory Committee Recommendations

The Advisory Committee recommends certain exemptive relief for small companies unless and until a framework for assessing internal control over financial reporting is developed for small companies. Microcap companies with less than \$125 million in annual revenue and smallcap companies with less than \$10 million in annual revenue would be exempt from the management reporting and independent audit of internal controls. Microcap companies with between \$125 million and \$250 million in annual revenue and smallcap companies with less than \$250 million but greater than \$10 million in annual revenue would be subject to management reporting of internal controls, but would be exempt from the independent audit of controls. Microcap is defined by the Advisory Committee as the lowest 1% of total U.S. equity market capitalization (companies under \$128 million capitalization). Smallcap is defined as the lowest 5% of total U.S. equity market capitalization (less than \$787 million capitalization).

Exempted companies would still provide quarterly certification exhibits on internal controls in Forms 10-Q and 10-K, as currently are required. Exempted companies would also be required to comply with other corporate governance provisions of SOX and SEC rules, such as maintaining a system of internal controls, disclosing any known weaknesses in internal controls, adopting a code of ethics, establishing an audit committee or a similar functioning group, etc.

## Questions for Public Funds or Commodity Pools to Consider

Because the provisions of SOX 404 and the Advisory Committee recommendations are primarily aimed at traditional public operating companies, and not investment funds, there are a number of questions that arise as to how the Advisory Committee recommendations would apply to public funds or commodity pools.

- How do public hedge funds and commodity pools fit within the definitions of market capitalization and revenues?
- How is market capitalization defined for a fund or pool? Is it net asset value?

- How is revenue defined for funds or pools (the Advisory Committee report uses the term product revenue)? Is revenue considered net trading gains? Is revenue considered trading gains plus interest income? What if there are net trading losses?
- How should a fund's gain/loss volatility be considered in revenue definitions of smallcap and microcap? There could be significant gains one year and losses the next – could compliance requirements change from year to year depending on trading gains or losses?
- Given that public funds and commodity pools have no public float, is it possible they could be granted some relief regardless of net asset value?

### *Next Steps*

The Advisory Committee submitted its recommendations to the SEC Commissioners on April 23, 2006. It is likely that the SEC Commissioners will take several months to consider the recommendations. It is difficult to predict whether the SEC Commissioners will accept the recommendations exempting small companies from some or all of SOX 404 internal control reporting requirements. Many in the financial communi-

ty, including some SEC Commissioners, have commented that smaller, less-sophisticated companies are potentially more susceptible to control weaknesses, and therefore, such companies should not be exempt from SOX 404. Others have commented that the costs of SOX 404 compliance far outweigh the benefits for smaller companies, and therefore, such companies should be exempt.

If you are a sponsor of a public hedge fund or commodity pool, it may not be advisable to wait and hope for exemptive relief. At a minimum you should consider documenting and evaluating the scope and adequacy of the fund's internal controls during 2006. If any weaknesses are identified, they should be corrected so the fund or pool is in compliance during 2007 in the event the SEC does not grant any relief and internal control reporting is required for the 2007 Form 10-K.

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