

## SEC ISSUES FINAL RULES FOR NEW CEO/CFO CERTIFICATION UNDER SECTION 302 OF THE SARBANES-OXLEY ACT

As noted in our previous client memoranda, the Sarbanes-Oxley Act of 2002 (the “Act”) calls for two new CEO/CFO certifications to be included in a company’s periodic reports filed with the Securities and Exchange Commission (“SEC”) under the Securities Exchange Act of 1934 (the “Exchange Act”). The first certification requirement under Section 906 of the Act took effect on July 30, 2002. At the end of last week, the SEC issued final rules<sup>1</sup> implementing Section 302 of the Act, which provides for the second CEO/CFO certification, effective as of **August 29, 2002**.<sup>2</sup> These rules as adopted differ significantly from the certification proposed by the SEC in June.<sup>3</sup> The new rules do not contain any provisions for integrating the overlapping certifications of Sections 302 and 906; in the absence of further SEC clarification, these two certifications should continue to be treated as separate certifications that must both be included in periodic reports filed with the SEC.

Among their most notable features, the new rules require companies to establish, maintain and periodically evaluate disclosure controls and procedures that are designed to ensure the full and timely collection and reporting of information required in Exchange Act reports. These rules extend the existing requirements that companies maintain systems of internal controls with respect to their financial reporting obligations to the reporting of material non-financial information.

### Section 302 Certification

New Rules 13a-14 and 15d-14 under the Exchange Act require each of an issuer’s principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, to certify, in each periodic report that:

1. he or she has reviewed the report;
2. based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements

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<sup>1</sup> SEC Release No. 33-8124 (August 28, 2002).

<sup>2</sup> The Section 302 certification is required for all periodic reports filed after this date. Certain provisions of the certification, however, are only applicable with respect to fiscal quarters that end after August 29, 2002. This may present an issue for companies that have a fiscal quarter which ended July 31, 2002.

<sup>3</sup> See our client memorandum, dated June 14, 2002, for a summary of the SEC proposals.

made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;<sup>4</sup>

3. based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;
4. he or she and the other certifying officers:
  - o are responsible for establishing and maintaining “disclosure controls and procedures” (a newly-defined term reflecting the concept of controls and procedures related to disclosure embodied in Section 302(a)(4) of the Act) for the issuer;
  - o have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
  - o have evaluated the effectiveness of the issuer’s disclosure controls and procedures as of a date within 90 days prior to the filing date of the report; and
  - o have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date;
5. he or she and the other certifying officers have disclosed to the issuer’s auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
  - o all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls; and
  - o any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls; and

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<sup>4</sup> For purposes of this provision, the certification in an annual report on Form 10-K would be considered to cover “Part III” information regarding directors and officers that may be incorporated by reference to a later filed proxy or information statement.

6. he or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

### **Areas of Special Concern**

- The SEC has explicitly noted that the statements in the certification regarding the material accuracy of the report and the fair presentation of financial information are to be made in the context of the particular report being certified. According to the SEC, the statements are not intended to expand the scope of disclosure in a particular report; rather the completeness of disclosure should be determined based on the standards derived from the existing rules, forms and interpretations applicable to that particular report.
  - The SEC has suggested that a quarterly report, for example, need not repeat items previously disclosed on a Form 8-K, except to the extent required in the rules relating to the quarterly report. Unfortunately, the certification is, by its terms, not expressly limited to the context of the report to which it relates. This may give pause to prospective certifiers.
  - The SEC has also indicated that the “knowledge” standard employed in the certification is not meant to change the current obligations of corporate officers in connection with the discharge of their duties. This would appear to suggest that the certification requirement does not impose a “due inquiry” standard on executives beyond the areas customarily understood to fall within the scope of their responsibilities.
- The certification of the fair presentation of financial information must provide “assurances that the financial information disclosed in a report, viewed in its entirety, meets a **standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.**”
  - The SEC has previously noted, in the context of Enron and other reporting failures, that it is possible for financial statements to comply with GAAP yet fail to “fairly present” the financial condition of the company.
  - In the release, the SEC stated that a “fair presentation” of an issuer’s financial condition, results of operations and cash flows “encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer’s financial condition, results of operations and cash flows.” A “fair presentation” is therefore one designed to enable

investors and others to assess the overall financial condition and results of operations of the company.

- o “Financial information” includes financial statements (including footnote disclosure), selected financial data, management’s discussion and analysis of financial condition and results of operations (“MD&A”) and other financial information in a report. Thus, although Section 302 of the Act does not contain an explicit reference to cash flows, the SEC added this language in the belief that it was consistent with Congressional intent regarding the scope of a “fair presentation” of a company’s results of operations.
  - o Given the SEC’s particular focus on MD&A recently,<sup>5</sup> issuers should pay particular attention to the trend and other forward-looking statements required in their MD&A disclosure, ensuring that such disclosure addresses known trends and uncertainties so that readers can assess the quality of the company’s earnings and the likelihood that its past performance will or will not be indicative of future performance.
  - o Issuers should also be mindful of a situation where the GAAP presentation of a financial transaction may not fully reflect the business realities of a transaction in a way generally understandable to shareholders. In such a case, a fuller description of the transaction should be included in the issuer’s MD&A discussion.
- Unlike the certification required under Section 906 of the Act, the Section 302 certification does not contain any new criminal liability provisions or penalties. Note, however, that principal executive and financial officers of an issuer are already responsible as signatories for the issuer’s disclosures under Exchange Act liability provisions and can be liable for material misstatements or omissions under general anti-fraud standards. False certifications could also potentially subject such officers to SEC action. Failure to include a certification would render the issuer’s SEC filing defective under the Exchange Act.

### **Applicability of Section 302 and Filing Requirements**

- Issuers filing periodic reports under Section 13(a) or 15(d) of the Exchange Act are subject to the Section 302 certification requirement, including foreign private issuers, banks and savings associations, issuers of asset-backed securities and small business issuers.

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<sup>5</sup> See, for example, SEC Release No. 33-8098 (May 10, 2002).

- Section 302 certifications must be included in the following periodic reports filed after August 29, 2002: annual reports on Forms 10-K, 10-KSB, 20-F and 40-F and quarterly reports on Forms 10-Q and 10-QSB. If any amendments to, or transition reports on, the foregoing reports are filed with the SEC, a new certification must be included. The SEC has explicitly stated that reports on Form 8-K and reports of foreign private issuers on Form 6-K are **not** subject to the Section 302 certification requirement.
- **The certification must follow the exact form set forth on Exhibit A without any changes (even if the change would appear to be inconsequential in nature).** The CEO and CFO must make separate certifications, to be inserted immediately following the signature section of the periodic report. The executive must personally sign the report and may not have the certification signed on his or her behalf pursuant to a power of attorney. In all other respects, including the use of typed, facsimile or electronic signatures, the customary procedures for signing SEC reports may be followed.
- The SEC release does not address the separate but similar CEO/CFO certification under Section 906 of the Act. Although we had received initial indications that the SEC might integrate these two certifications, members of the SEC staff have recently stated that Section 906 is a criminal provision to be administered principally by the Department of Justice. Accordingly, unless we receive further clarification, issuers should continue to include the Section 906 certification in their periodic reports, either as an exhibit or following the Section 302 certification.
- The SEC is continuing to consider expanding this certification requirement to encompass Form 10 registration statements and definitive proxy and information statements.

### **Disclosure Controls and Procedures**

New Rules 13a-15 and 15d-15 under the Exchange Act require each issuer filing reports under Section 13(a) or Section 15(d) of the Exchange Act to maintain “disclosure controls and procedures.”<sup>6</sup> Although the Act itself did not mandate the establishment of such controls and procedures, the SEC has stated that this new requirement is intended to complement existing requirements for internal controls with respect to financial information by covering a broader range of material, non-financial information.

- “Disclosure controls and procedures” are “controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it” under the Exchange Act (including 10-Qs, 10-Ks, 20-Fs, 40-Fs, 8-Ks and proxy statements) “is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms.” Such controls and procedures “include, without limitation, controls and procedures designed to ensure that

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<sup>6</sup> Asset-Backed Issuers (defined below) are exempt from this requirement.

information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.”

- According to the SEC, this definition is intended to address the quality and timeliness of disclosure and also to expand on the required “internal controls,” a pre-existing term that “pertains to an issuer’s financial reporting and control of its assets.”<sup>7</sup> Through this distinction, the SEC has further sought to effectuate Congress’ intent to have senior officers certify that the required material non-financial information, as well as financial information, is included in a company’s periodic reports.
- The procedures should ensure timely collection and evaluation of information disclosed in Exchange Act reports, including disclosure about the issuer’s business, property and management. They should also capture information relevant to an assessment of the need to disclose developments and risks that pertain to the issuer’s businesses.
  - Note that there is no prescribed list of areas that should be covered by an issuer’s disclosure controls and procedures, but rather these controls should be developed, as explained by the SEC, to “ensure that an issuer’s systems grow and evolve with its business and are capable of producing Exchange Act reports that are timely, accurate and reliable.”
  - Disclosure controls and procedures must enable the company to promptly identify events that must be reported on Form 8-K or 6-K. These controls and procedures will become increasingly important as the SEC adopts rules to implement Section 409 of the Act, which requires issuers to disclose material information on a “rapid and current basis.”
  - As proposed in a prior release, but not formally adopted as part of the final rule, the SEC recommends creation of a disclosure committee to consider, on an ongoing basis, the materiality of information and the issuer’s disclosure obligations on a timely basis. The committee could include the issuer’s principal accounting officer, general counsel, principal risk management officer and the chief investor relations officer and should report to senior management including the CEO and CFO.

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<sup>7</sup> The definition of “internal controls” cited by the SEC is provided in AICPA Professional Standards AU Section 319.06: “Internal controls is a process - effected by an entity’s board of directors, management and other personnel - designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations and (c) compliance with applicable laws and regulations.”

- o The SEC has stated that failure to maintain and review adequate procedures could subject an issuer to SEC enforcement action even when the failure did not lead to flawed disclosure.

### **Evaluation of Disclosure Controls and Procedures**

- Within the 90-day period prior to the filing date of any report that includes a Section 302 certification, an evaluation must be carried out, under the supervision and with the participation of the issuer's management, including the issuer's principal executive officer and principal financial officer, regarding the effectiveness of the design and operation of the issuer's disclosure controls and procedures.
  - o While no particular procedures for review and evaluation of the disclosure controls and procedures are prescribed, issuers are expected to develop a process consistent with their business, internal management and supervisory processes and conduct the evaluation to address the adequacy of their controls with respect to both the financial and non-financial information required to be disclosed in Exchange Act reports.

### **Disclosure Requirement**

- In each periodic report,<sup>8</sup> the issuer must disclose (1) the conclusions of the principal executive officer or officers and principal financial officer or officers about the effectiveness of the disclosure controls and procedures based on the above evaluation and (2) whether or not there were significant changes in the issuer's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.<sup>9</sup>

### **Asset-Backed Issuers**

Asset-Backed Issuers<sup>10</sup> filing annual reports have modified certification obligations. Either the trustee of the trust (if the trustee signs the annual report) or the senior officer in charge of

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<sup>8</sup> This disclosure should be inserted as indicated in the revised instructions to the applicable form provided by the SEC.

<sup>9</sup> Section 404 of the Act requires the SEC to prescribe rules requiring each annual report to include a report on internal controls and procedures for financial reporting, which is to include an assessment of the effectiveness of the issuer's internal control structures and procedures. This assessment is to be reported on by the issuer's registered public accounting firm. No time frame is specified in the Act for adopting such rules, and the SEC has stated that these rules will be the subject of a separate rulemaking project.

<sup>10</sup> An "Asset-Backed Issuer" is defined as "any issuer whose reporting obligation results from the registration of securities it issued that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period

securitization of the depositor (if the depositor signs the annual report) or, alternatively, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent functions) must include a certification addressing the following items:

- Review by the certifying officer of the annual report and other reports containing distribution information for the period covered by the annual report;
- The absence in these reports, to the best of the certifying officer's knowledge, of any untrue statement of material fact or omission of a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- The inclusion in these reports, to the best of the certifying officer's knowledge, of the financial information required to be provided to the trustee under the governing documents of the issuer; and
- Compliance by the servicer with its servicing obligations and minimum servicing standards.

### **Foreign Companies**

The SEC has emphasized that foreign private issuers that file periodic reports under Section 13(a) or 15(d) of the Exchange Act must comply with the certification requirements of Section 302 of the Act and, notwithstanding their extra-territorial reach, the rules regarding disclosure controls and procedures described above. The principal executive and financial officers of a foreign private issuer must sign the certification even though they are not required to sign Form 20-F itself. The SEC has also confirmed our previous advice that reports on Forms 6-K (even those that include interim financial statements) are **not** subject to the Section 302 certification requirement.

### **Certification of Registered Investment Company Annual and Semi-Annual Reports**

Under new Investment Company Act Rule 30a-2, a registered investment company that files periodic reports under Section 13(a) or 15(d) of the Exchange Act (Form N-SAR) after August 29, 2002 must include the certification specified by Section 302 of the Act in those periodic reports.

- Unlike Forms 10-K and 10-Q, Form N-SAR does not require the filing of financial statements. However, Form N-SAR requires management investment companies to

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plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.”



provide certain financial information based on the financial statements as of the same date contained in the investment company's annual and semi-annual reports to shareholders.

- In the case of a unit investment trust, the certification should be signed by the personnel of the sponsor, trustee, depositor or custodian who perform functions similar to those of a principal executive and financial officer on behalf of the trust.
- Signing officers of a registered management investment company will now be required to certify under the new Investment Company Act Rule that the financial information included in the report and the financial statements on which the financial information is based fairly present, in all material respects, the financial condition, results of operations, changes in net assets and cash flows (if the financial statements are required to include a statement of cash flows) of the investment company. These officers will also be required to make the certifications described above regarding disclosure controls and procedures and internal controls.
- The certification required by new Investment Company Act Rule 30a-2 must be in the exact form set forth by the SEC in amendments to Form N-SAR. The wording of the required certification may not be changed in any respect (even if the change would appear to be inconsequential in nature). The certification should be filed as an exhibit to Form N-SAR.
- Investment companies filing reports on Form N-SAR under Sections 13(a) and 15(d) of the Exchange Act will also be required to maintain disclosure controls and procedures under new Exchange Act Rules 13a-15 and 15d-15 and conduct an evaluation of the effectiveness of the design and operation of the investment company's disclosure controls and procedures within 90 days of the filing date of each report requiring certification under new Investment Company Act Rule 30a-2. The evaluation should also be carried out in a manner that would form the basis for the certification statements required by Section 302 of the Act regarding disclosure controls and procedures.
- The SEC is also proposing rules that would require annual and semi-annual reports to shareholders of registered investment management companies to include the required certification by the principal executive officer and financial officer.<sup>11</sup>

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<sup>11</sup> SEC Release No. 34-46441 (August 30, 2002).

If you wish to obtain additional information regarding the foregoing, assistance in developing a detailed program to help ensure compliance with these new rules or copies of any of our previous client memoranda, in London please contact Gregory Astrachan (44-207-696-5442, [gastrachan@willkie.com](mailto:gastrachan@willkie.com)), and in New York please contact John S. D'Alimonte (212-728-8212, [jd'alimonte@willkie.com](mailto:jd'alimonte@willkie.com)), Yaacov M. Gross (212-728-8225, [ygross@willkie.com](mailto:ygross@willkie.com)), Jeffrey S. Hochman (212-728-8592, [jhochman@willkie.com](mailto:jhochman@willkie.com)), or the partner who regularly works with you.

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September 6, 2002

**EXHIBIT A**

**CERTIFICATIONS\***

I, [identify the certifying individual], certify that:

1. I have reviewed this [quarterly/annual] report on Form [identify applicable form] of [identify registrant];
2. Based on my knowledge, this [quarterly/annual] report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this [quarterly/annual] report;
3. Based on my knowledge, the financial statements, and other financial information included in this [quarterly/annual] report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this [quarterly/annual] report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this [quarterly/annual] report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this [quarterly/annual] report (the "Evaluation Date"); and
  - c. presented in this [quarterly/annual] report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

- b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this [quarterly/annual] report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: \_\_\_\_\_

\_\_\_\_\_  
[Signature]  
[Title]

\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.