

# Corporate and Securities Law Developments **NEWSLETTER**

SEPTEMBER 12, 2002

## CERTIFICATION OF DISCLOSURE IN QUARTERLY AND ANNUAL REPORTS

On August 27, 2002, the Securities and Exchange Commission (the “SEC” or the “Commission”) adopted rules, as directed by Section 302(a) of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), that require an issuer’s principal executive and financial officers each to certify the financial and other information contained in the issuer’s quarterly and annual reports filed under the Securities and Exchange Act of 1934 (the “Exchange Act”). In addition, the new rules require issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Exchange Act is recorded, processed, summarized and reported on a timely basis.<sup>1</sup>

Certifications are required for any quarterly or annual reports filed on or after August 29, 2002, although certifications as to the maintenance and

evaluation of disclosure controls and procedures are only required in such reports for periods ending on or after August 29, 2002.

### **I. Certification of Quarterly and Annual Reports**

#### **A. Issuers Subject to Certification Requirement**

The certification requirement applies to any issuer that files quarterly and annual reports with the Commission under either Section 13(a) or 15(d) of the Exchange Act, including foreign private issuers, banks and savings associations, issuers of asset-backed securities,<sup>2</sup> small business issuers and registered investment companies.<sup>3</sup> Foreign private issuers that furnish materials to the Commission pursuant to Rule 12g3-2(b) of the Exchange Act are not subject to the certification requirement.

<sup>1</sup> These new rules are published in an SEC release dated August 29, 2002 (Release No. 33-8124)(the “Certification Release”). The full text of the Certification Release is available online at <http://www.sec.gov/rules/final/33-8124.htm>.

<sup>2</sup> Because the information reported by asset-backed issuers differs significantly from that reported by other issuers, the certification requirements for asset-backed issuers have been tailored specifically by the SEC. See “Statement by the Staff of the Division of Corporation Finance of the Securities and Exchange Commission Regarding Compliance by Asset-Backed Issuers with Exchange Act Rules 13a-14 and 15d-14,” which is available online at <http://www.sec.gov/divisions/corpfin/8124cert.htm>.

<sup>3</sup> For more information regarding the application of the new rules to registered investment companies, see our newsletter dated September 9, 2002, “New Rules for Registered Investment Companies Under the Sarbanes-Oxley Act of 2002.”

## B. Reports Subject to Certification Requirement

The new rules provide that certifications must be included in all annual reports on Forms 10-K, 10-KSB, 20-F and 40-F, and quarterly reports on Forms 10-Q and 10-QSB. The certification requirement also applies to amendments to, and transition reports on, any of the foregoing reports.

The Certification Release states that current reports, such as reports on Forms 6-K and 8-K, are not covered by the certification requirement. Although there is no specific certification requirement relating to current reports, disclosure controls and procedures are required to be maintained and evaluated to ensure accurate and timely disclosure in such reports, as well as in definitive proxy materials and information statements.

The SEC continues to consider whether it should extend a certification requirement to other documents filed under the Exchange Act, such as registration statements on Forms 10 and 10-SB and definitive proxy and information statements. The SEC is currently soliciting comments on whether these documents, or any other documents, should be certified by an issuer's senior officers.

## C. Required Certification

Newly adopted Exchange Act Rules 13a-14 and 15d-14 require an issuer's principal executive officer and the principal financial officer (or persons performing similar functions), each to certify with respect to each quarterly and annual report, including amendments to such reports or transition reports, filed or submitted by the issuer that:

### General Review

- he or she has reviewed the report;

### Material Facts

- 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 made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

### Fair Presentation of Financial Information

- based on his or her knowledge, the financial statements, and the 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;

### Disclosure Controls and Procedures

- he or she and the other certifying officers:
  - are responsible for establishing and maintaining "disclosure controls and procedures" for the issuer;
  - have designed such disclosure controls and procedures to ensure that material information is known to them, particularly during the period in which the periodic report is being prepared;
  - 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
  - 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;

Internal Controls – Disclosure to Auditors and Audit Committee

- he or she and the other certifying officers have disclosed to the issuer’s auditors and to the audit committee:
  - 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
  - any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls; and

Internal Controls – Significant Changes

- he or she and the other certifying officers have indicated in the report whether or not there were any 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.

D. Breadth of Certification

An important component of the new certification requirement is the statement regarding the fair presentation of financial information which is intended to 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 (“GAAP”). According to the Certification Release, this statement

is not limited to a representation that the financial statements and other financial information have been presented in accordance with GAAP and is not otherwise limited by reference to GAAP. In the SEC’s view, a “fair presentation” of an issuer’s financial condition, results of operations and cash flows<sup>4</sup> would include the selection of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and any additional disclosure necessary to provide investors with a materially accurate and complete picture of the issuer’s financial condition, results of operations and cash flows. It should be noted that this statement covers the entire presentation of an issuer’s financial disclosure, including the financial statements (including footnote disclosure), selected financial data, management’s discussion and analysis of financial condition and results of operations and other financial information.

E. Form and Location of Certification

In order to comply with the new rules, the required certification must be in the exact form set forth in the amendments. The SEC has expressly stated that 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 required certification is to follow immediately after the signature sections of the covered reports. The required certification is in addition to, and, therefore, does not alter, the current signature requirements for quarterly and annual reports filed under the Exchange Act.

The SEC has made it clear that the required certifications are in addition to, and do not replace, the certifications required by Section 906 of Sarbanes-Oxley. The SEC has indicated that it is discussing certain matters relating to Sarbanes-Oxley with the Department of Justice and the possibility of combining these certifications is among the topics being discussed.

<sup>4</sup> The SEC added a specific reference to cash flows even though Sarbanes-Oxley does not include such a reference because the SEC believes that the reference is consistent with Congressional intent to include both income or loss and cash flows within the concept of “fair presentation” of an issuer’s results of operations.

## F. Liability for False Certification

An officer who provides a false certification could be subject to action by the SEC for violating Section 13(a) or 15(d) of the Exchange Act and in addition be subject to SEC and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. The Certification Release also provides that a false certification may have liability consequences under Sections 11 and 12(a)(2) of the Securities Act of 1933 (“Securities Act”) where a quarterly or annual report is incorporated by reference into a registration statement on Form S-3 or F-3 or into a prospectus filed pursuant to Securities Act Rule 424(b).

## II. Disclosure Controls and Procedures

### A. Requirements

New Exchange Act Rules 13a-15 and 15d-15 require all issuers that file reports under Section 13(a) or Section 15(d) of the Exchange Act to establish and maintain “disclosure controls and procedures.” The SEC created this new term to differentiate the concept of disclosure controls and procedures from the pre-existing concept of “internal controls” that pertains to an issuer’s financial reporting and control of its assets. Accordingly, the SEC has defined disclosure controls and procedures as:

controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange Act] is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms.

Disclosure controls and procedures include controls and procedures designed to ensure the accumulation and communication of such information to

management, including an issuer’s principal executive and financial officers, to allow for decisions regarding required disclosure.

New Exchange Act Rules 13a-15 and 15d-15 also require that an issuer, under the supervision of its principal executive and financial officers, conduct an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures within 90 days of the filing day of any quarterly or annual report. The evaluation must, at a minimum, address the matters specified by the new rules.

Forms 10-K, 10-KSB, 10-Q, 10-QSB, 20-F and 40-F have been revised to require the disclosure of information related to both an issuer’s disclosure controls and procedures and its internal controls. The new requirement provides that an issuer disclose in the applicable quarterly and annual report:

- the conclusions of the issuer’s principal executive officer and principal financial officer about the effectiveness of the issuer’s disclosure controls and procedures based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of the applicable quarterly or annual report; and
- 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.

### B. Discussion of Disclosure Controls and Procedures

New Rules 13a-15 and 15d-15 were adopted in order to complement existing requirements for issuers to establish and maintain systems of internal controls relating to their financial information and

assets.<sup>5</sup> The SEC intends for these new rules to ensure that an issuer will develop and maintain procedures for gathering, analyzing and disclosing all information, including non-financial information, that is required to be set forth in its Exchange Act reports. It should be noted that the new certification requirement makes reference to certain disclosures regarding both disclosure controls and procedures and internal controls that must be made in quarterly and annual reports.

Under the new rules, the SEC does not require an issuer to implement any particular procedures for conducting the required review and evaluation of its disclosure controls and procedures but rather expects each issuer to develop a process that is consistent with its business and internal management and supervisory practices. The SEC recommends, however, that an issuer create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The committee would report to the issuer's senior management, including the principal executive and financial officers, who bear the responsibility for establishing, maintaining and evaluating such issuer's disclosure controls and procedures. The Certification Release states that the officers and employees who have an interest in, and the expertise to serve on, such a committee could include the principal accounting officer (or controller), the general counsel or other senior legal official, the principal risk management officer, the chief investor relations officer and persons associated with the issuer's business units.

### **III. Preparing for the Certification Requirement**

Set forth below are some basic procedures for issuers to consider to help ensure that their principal executive officer and principal financial officer have sufficient information on which to make the requisite certifications in upcoming quarterly and annual reports. The appropriate procedures for any

particular issuer will depend on the nature of its business and organization and other facts and circumstances that are special to its business.

We recommend that issuers subject to the new rules begin with a careful review of their existing procedures for preparing SEC filings to determine if they are sufficient to support the statements contained in the certifications. Specifically, issuers should document and evaluate the internal procedures used to prepare their SEC filings in order to assure that they have a complete and accurate written record of their procedures and any issues that may surface as a result of the evaluation. In connection with such an evaluation, issuers should consider taking the following steps:

- form a disclosure committee, comprised of at least those members of senior management who currently prepare and review required disclosure, to consider materiality of information and determine disclosure obligations;
- consider adding additional individuals to the disclosure committee as suggested by the Certification Release, including those involved in preparing required disclosure and verifying and reviewing such disclosure;
- identify the key people who have information that may require disclosure and determine how to effectively gather information from these people including:
  - questionnaires;
  - interviews;
  - participation in preparation of draft disclosure;
  - review of draft disclosure; and/or
  - educational meetings or memoranda on disclosure requirements.

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<sup>5</sup> The SEC notes that it will also develop rules under Sarbanes-Oxley to provide for an internal control report to be contained in an issuer's annual report that assesses the effectiveness of the issuer's internal control structure and procedures for financial reporting.



- determine the appropriate level of diligence that should be undertaken to confirm accuracy of disclosure, including interviews and review of documentation by the disclosure committee or its members or advisors;
- establish a time frame that will ensure that all required disclosure is identified and prepared and that the principal executive and financial officers will have enough time to carefully review and analyze the disclosure and to follow-up on any issues raised by their review and analysis;
- consider how to document evaluations of disclosure controls and procedures in order to support the required certification and the required disclosure, including:
  - memoranda describing controls;
  - minutes of the disclosure committee; and
  - interview notes.
- determine whether financial and reporting systems are adequate to produce consistently accurate results and evaluate the procedures in place to ensure the accuracy of the financial information presented in reports; and

- examine what controls exist to reduce the risk of fraud in financial information and the adequacy of such controls.

An issuer's principal executive and financial officers will have to certify as to adequacy of these controls in the near future; by mid-November for issuers with a calendar year fiscal year. Accordingly, the review of existing procedures and establishment of new procedures should begin promptly.

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If you would like additional information on the new certification requirements or assistance in preparing disclosure controls, please contact the following, or any other Wilmer, Cutler & Pickering attorney:

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