

Client Alert

A report
for clients
and friends
of the firm September 2002

SEC Adopts New CEO/CFO Certification and Internal Procedures Requirements

On August 28, 2002 the Securities Exchange Commission, in Release 34-46427, adopted rules, which require the principal executive officers (CEOs) and principal financial officers (CFOs) of all companies, including foreign private issuers and U.S. small business issuers¹ filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 to provide a certification in their companies' annual and quarterly reports filed under those sections as to the disclosure in those reports. The SEC also adopted requirements for internal procedures relating to the preparation of these reports and for disclosure of information about these procedures.

The certification rules were required by Sec. 302 of the Sarbanes-Oxley Act of 2002.² The rules relating to internal procedures were the subject of earlier SEC proposals.³ The certification rules, except for the provisions relating to internal disclosure procedures, became effective as to reports filed on or after August 29, 2002. The provisions relating to internal procedures apply to reports for periods ending on or after that date.

Foreign Private Issuers

The certification requirements and the internal procedures requirements apply to foreign companies filing annual reports on Forms 20-F or 40-F (for certain Canadian companies). The rules are not applicable to reports on Form 6-K submitted to the SEC. In addition, Sec. 302 expressly provides that a U.S. company cannot avoid the provisions of the section by reorganizing in a foreign jurisdiction.

Reports Subject to the new Requirements

Certification:

- Annual reports on Form 10-K and 10-KSB (U.S. companies)
- Annual reports on Form 20-F (foreign private issues)
- Annual reports on Form 40-F (certain Canadian companies)
- Quarterly reports on Form 10-Q and 10-QSB
- All amendments to these reports

Unlike the one-time certifications required by the SEC's June 27, 2002 order to 947 large companies, the new rules are ongoing requirements and apply to all annual and quarterly reports filed under section 13(a) of 15(d) of the Exchange Act.

1 Certain U.S. registered investment companies and issuers of asset-backed securities are subject to somewhat different certification requirements. The Commission also has requested comments on a proposal to require CEOs and CFOs to certify to the disclosure in their companies' proxy and information statements. Part III of Forms 10-K and 10-KSB incorporates information about officers and directors from proxy statements. This information already is covered by the required certifications.

2 Sec. 906 of the Sarbanes-Oxley Act requires a different additional certification. The SEC did not address the certification requirements under Sec. 906, which remain in effect. The Sec. 906 certifications were the subject of an earlier Client Alert. Section 406 of the Sarbanes-Oxley Act also requires the SEC to adopt final rules within 180 days of July 30, 2002 to require disclosure of whether issuers have adopted codes of ethics for their senior financial officers and comptrollers or principal accounting officers and, if not, why not. Changes or waivers of these codes of ethics would be required to be disclosed in current reports on Form 8-K, presumably filed within two business days of the change or waiver. (Foreign private issuers are not required to file Form 8-K. It is not clear whether this provision will apply to them.) In addition, CEOs and CFOs of companies filing reports after August 14, 2002 which are subject to the SEC's June 27, 2002 order, will have a third form of certification which they are required to make. Finally, under corporate governance standards proposed by the New York Stock Exchange (NYSE), still subject to SEC approval, the CEOs of companies with securities listed on the NYSE will be required to certify, in the company's annual report to shareholders required by SEC and NYSE rules, that the company is in compliance with the NYSE's corporate governance listing standards

3 See Release No. 34-46079.

Internal Procedures Requirements⁴

Neither Sarbanes-Oxley or the SEC's rules provide requirements or guidelines for internal controls. Moreover, there are no established "one size fits all" guidelines.⁵ Each company and each CEO and CFO should assure themselves, in view of the company's circumstances, governance structure, personnel, culture, industry and other factors that the company has appropriate personnel, internal controls over financial reporting⁶ and procedures sufficient to provide reasonable assurance that they are able to collect, process and disclose, within the periods specified by SEC rules and forms⁷, the information required to be disclosed in annual, quarterly and current reports and proxy and information statements filed⁸ by them under the Exchange Act.

We discuss below, under **Suggested Internal Procedures**, certain procedures that a company should consider.

Form Of Certification

Each CEO and CFO must certify separately, in the exact form required by the signature instructions to the form to be certified, that:

- (1) the signing officer has reviewed the report
- (2) based on the officer's knowledge, the 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;
- (3) based on such officer's 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 registrant as of, and for, the periods presented in the report;
- (4) the signing officers are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act rules 13a-14(c) and 15d-14(c))⁹ for the registrant and they:

- (a) designed such disclosure controls to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to such officers by others within those entities, particularly during the period in which the periodic report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls as of a date within 90 days prior to filing date of the report (the "Evaluation Date"); and
 - (c) presented in the report their conclusions about the effectiveness of the disclosure controls based on their evaluation as of Evaluation date;
- (5) the signing officers have disclosed to the registrant's auditors and the audit committee of the board of directors (or persons fulfilling 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 signing 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.

Note that paragraph (4)(c)(6) requires that presentations by the CEO and CFO be included in the report that they are certifying as to their conclusions as to the effectiveness of the company's internal controls, based on their required evaluations, and as to changes in internal controls since their last evaluation.¹⁰

⁴ On the same day that it adopted the certification rules under Sec. 302 of the Sarbanes-Oxley Act, the SEC adopted accelerated reporting rules for certain companies filing annual reports on Form 10-K and quarterly reports on Form 10-Q. Accelerated filing of Forms 20-F is being considered by the SEC. In addition, the SEC has proposed to require that most annual reports on Form 8-K be filed within two business days of the event required to be reported and proposed that a number of new events be required to be reported. See Rel. 34-46084. These proposals were the subject of an earlier client alert.

⁵ Section 404 of Sarbanes-Oxley requires the SEC to adopt rules requiring managements of SEC reporting companies to assess and report on their companies' internal controls and for the company's "registered independent auditors" to attest to that assessment. There is no required outside date for this rulemaking and the registration requirements for independent auditors may not be effective before 450 days after the enactment of the Sarbanes-Oxley Act.

⁶ See Section 13(b) of Exchange Act

⁷ The SEC, in a statement about Management's Discussion and Analysis of Financial Condition and Results of operations, suggested that, in addition to disclosure about related party transactions, the MD&A should discuss internal transactions with "almost related parties", that is, parties with whom the registrant or its related parties have a relationship that enables the parties to negotiate terms of material transactions that may not be available from other more clearly independent parties on an arms' length basis fee.

⁸ The SEC has requested comment as to whether the certification requirements also should apply to proxy and information statements.

⁹ Controls and other procedures that are designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the required time periods. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding the required disclosure.

¹⁰ Items 307 of Regulation S-K, Item 15 of Form 20-F and General Instruction B(6) of Form 40-F contain the disclosure requirements for this information and the disclosure about significant changes in internal controls mentioned below.

Form of CEO/CFO Presentation on Internal Controls

Sec. 302 does not specify the form of this presentation, nor do the SEC's rules.

Suggested Internal Procedures

Where appropriate, these suggested procedures should be considered on divisional, segment product line or geographic bases.

Duty of Inquiry

The SEC stated in the release proposing its certification requirements that the certifying officers, "would not, as the result of the proposed certification requirement, have to separately inquire as to information not known to him or her by virtue of his or her certification" However, the SEC also stated "while these corporate officers would not have to undertake a separate inquiry as to information not known to them, their critical review of a report would necessarily include other inquiries where appropriate, including, without limitation, regarding disclosures they do not understand or the materiality of information known to them."

Other SEC Positions

The SEC has made it clear that they view internal disclosure controls to be considerably broader than the internal accounting controls that are required by section 13(b) of the Exchange Act. Accordingly, companies and their CEOs and CFOs cannot rely only on internal accounting controls in developing and maintaining internal procedures and controls to support the required certifications.

Having appropriate internal disclosure controls and procedures in place will become even more critical in 2003 when many companies will become subject to SEC rules requiring accelerated filing of Forms 10-K (within 75 days for 2003 and 60 days thereafter) and forms 10-Q (within 40 days for 2004 and 35 days thereafter).

SEC Suggestions

The SEC has not mandated any particular procedures. However, in issuing its original proposals and in Release 34-46427, it did recommend that companies create committees, reporting to the CEO and CFO, with the responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The SEC suggested that the committee could include:

- the principal accounting officer or the controller;
- the general counsel or other senior legal official with

responsibility for disclosure matters who reports to the general counsel;

- the principal risk management officer;
- the chief investor relations officer (or an officer with equivalent responsibilities); and
- other officers or employees, including individuals associated with the company's business units, as the company deems appropriate.

Additional Suggested Internal Procedures

In addition to the suggestions of the SEC discussed above, we suggest that companies and their CEOs and CFOs consider the following and, in any event, they should document the procedures that they follow:

- In addition to reviewing the report that they must certify, the CEO and CFO and other responsible executives should review that report in draft form a reasonable time in advance of filing to assure sufficient review time.
- In addition to reviewing the report, review:
 - (i) The immediately previous report and the report for the corresponding period in the previous year;
 - (ii) Any earnings releases or related announcements for the period covered by the report;
 - (iii) Audit committee, compensation committee and board minutes, since the beginning of the periods covered by the report;
 - (iv) Information concerning material litigation;
 - (v) Information about pending material transactions and material transactions completed during the period covered by the report;
 - (vi) Information about related party transactions;¹¹
 - (vii) Data about the industry or industries in which the company operates, including public information about competitors; and
 - (viii) Recent security analysts research reports.
- Discuss newly adopted critical accounting policies and estimates with appropriate company accounting and risk management personnel and the independent auditors and the audit committee;¹²
- Discuss the company's internal controls over financial reporting with appropriate company accounting and risk management personnel and the independent audi-

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¹² The SEC has proposed rules to require disclosure in the MD&A about critical accounting and estimates and newly adopted accounting policies. See Release 33-8098. In addition, the SEC has cautioned companies that they should discuss critical accounting policies in the MD&A. See Release 33-8040.

tors and the audit committee;

- Discuss with the appropriate company management personnel the company's procedures for collecting, processing and disclosing in a timely manner information required by SEC and stock exchange or Nasdaq rules;
- Discuss with appropriate company accounting and risk management personnel and the independent auditors and the audit committee the company's financial position, liquidity and capital resources, including:
 - (i) Limitations on the availability of credit;
 - (ii) Compliance with loan covenants;
 - (iii) Security rating agency actions;¹³
 - (iv) Material contingent liabilities, including guarantees of the indebtedness of others and obligations under off balance arrangements;¹⁴
 - (v) Possible material write offs;¹⁵
 - (vi) Any significant tax issues;
 - (vii) New SEC or other accounting standard setters disclosure or accounting requirements; and
 - (viii) Termination of material business relationship agreements.¹⁶
- Meet with the independent auditors to discuss the following:
 - (i) Adjustments to the financial statements identified by the auditors and whether they were proposed by the auditors and made by management;¹⁷
 - (ii) Revenue recognition issues;
 - (iii) Accounting for expenses, including any issues as to capitalization of expenses;
 - (iv) Internal controls over financial reporting, including any identified material weaknesses and any uncorrected weakness not regarded by the auditors as material;
- (v) Critical accounting policies and estimates;¹⁸
- (vi) Alternative accounting policies discussed with management;
- (vii) Material written communications with management, including management letters;¹⁹
- (viii) Any off-balance sheet financing and whether it is properly or aggressively accounted for.
- (ix) Related party transactions;
- (x) Disagreements with management as to items reflected in the financial statements;
- (xi) Accounting positions taken by management that might be challenged by the SEC;
- (xii) Important accounting policies followed by the company that differ significantly from those employed by other companies in the industry;
- (xiii) Accounting for reserves;
- (xiv) Impacts of new or pending accounting rules of the SEC or other accounting standard setters;
- (xv) The auditors' judgments about the quality of the company's accounting principles as applied in its financial reporting;
- (xvi) Any disagreements with management and difficulties in performing the audit;
- (xvii) Consultation by management with other auditors on significant matters; and
- (xviii) If applicable, significant issues discussed by the auditors with management before the auditors were engaged.
- Meet with the audit committee²⁰ to discuss any memoranda prepared by the independent auditors for the audit committee and the procedures followed by the CEO and the CFO to enable them to provide the required certifications;
- Make sure that they understand the disclosure in the report and the answers they receive to questions about the report, the company's internal control procedures

13 The SEC has proposed requirements to disclose adverse security rating agency actions on Form 8-K within two days of the company being advised of the action. See Release 34-46084.

14 The SEC has suggested disclosure about off-balance sheet financing arrangements be discussed in the company's MD&A. See Release 33-8056. In addition, the SEC has proposed to require disclosure about creation and triggering of material contingent liabilities on Form 8-K within two business days of the event. See Release 34-46084. Also, Sec. 401(a) of the Sarbanes-Oxley Act requires the SEC, within 180 days of the enactment of that Act, to issue final rules requiring disclosure in annual and quarterly reports of all material off-balance sheet arrangements.

15 The SEC has proposed to require disclosure about material write offs on Form 8-K within two business days of the event. See Release 34-46084.

16 The SEC has proposed to require disclosure about termination of material business relationships or agreements on Form 8-K within two business days of the event. See Release 34-46084.

17 Sec. 401(a) of the Sarbanes-Oxley Act requires that a company's financial statements reflect all material correcting adjustments that have been identified by the company's registered public accounting firm. See section 13(i) of the Exchange Act. These requirements may not take effect until 450 days after the enactment of Sarbanes-Oxley.

18 Sec. 204 of the Sarbanes-Oxley Act requires a registered public accountant to discuss these matters with the audit committee. These provisions may not take effect until 450 days after the enactment of that Act.

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20 Sec. 301 of the Sarbanes-Oxley Act requires that the SEC adopt rules, within 270 days of the enactment of that Act, to require the national securities exchange and Nasdaq to require independent audit committees, with specified procedures. The NYSE and Nasdaq have proposed their own corporate governance listing standards relating to audit committees.

- Request company counsel to confirm that the report complies as to form with SEC rules and any applicable stock exchange or Nasdaq rules; and
- Obtain certifications, within the limits of their functions and expertise, from managers who directly report to the CEO and/or CFO.

Conclusion

The SEC is required to undertake considerable additional rule-making under the Sarbanes-Oxley Act and it has its own rule-making agenda. Accordingly, more guidance may be forthcoming on matters discussed in this client alert and experience may demonstrate different or additional procedures are necessary or appropriate to comply with the requirements of the Act and the SEC, stock exchange or Nasdaq accounting, disclosure and corporate governance rules.

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