BROWN RUDNICK BERLACK ISRAELS LLP

CLIENT ALERT

SEC ISSUES RULES IMPOSING REQUIREMENT for DISCLOSURE CONTROL REGIME

IN JUNE 2002, prior to the enactment of the Sarbanes-Oxley Act of 2002, the SEC published for comment proposed rules that would require public company CEOs and CFOs to certify the correctness of the company's financial statements. In July, Congress passed the Sarbanes-Oxley Act, Section 302 of which addressed many of the same issues as the SEC's proposed rule. Section 302 mandated that the Securities and Exchange Commission ("SEC") adopt final rules to implement its provisions by August 29, 2002. On August 27, the SEC did in fact issue final rules implementing Section 302. It did so by generally working from its own June proposed rule and conforming that rule to the requirements of the Sarbanes-Oxley Act. Those rules are in effect **now** and will apply to any Form 10-K or Form 10-Q filed in the future.

SUMMARY

The new Section 302 certification rules apply to annual and quarterly reports filed after August 29, 2002 by issuers filing reports under the Securities Exchange Act of 1934 (the "Exchange Act"), including foreign private issuers, investments companies and issuers of asset-backed securities, although special exceptions were created for the last two categories. The SEC action added new essentially parallel sets of rules under the Exchange Act: Rules 13a-14 and 13a-15 and Rules 15d-14 and 15d-15.

Rules 13a-14 and 15d-14 require the company's principal executive officer and principal financial officer (or persons performing similar functions) to certify that:

- he or she has reviewed the report;
- based on his or her knowledge, the report contains **no material misstatements or omissions;**
- 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 operation and cash flows of the company as of and for the period presented in the report;
- he or she and the other certifying officers:
- are responsible for establishing and maintaining "disclosure controls and procedures" for the company;
- have properly designed disclosure controls and procedures to ensure that all material information is made known to them;
- have evaluated the effectiveness of the disclosure controls and procedures within 90 days prior to the date of the report; and
- have presented in the report their conclusions about the effectiveness of the procedures;
- he or she and the other certifying officers have disclosed to the company's auditors and audit committee all significant deficiencies in the design or operation of internal controls, and any fraud (regardless of whether or not material) involving persons having a significant role in the internal controls of the issuer; and
- he or she and the other certifying officers have indicated in the report whether there were any significant changes in internal controls, including any corrective actions, subsequent to the date of their evaluation.

These rules generally track the language of Section 302(a) of the Sarbanes-Oxley Act, with one important exception. Section 302 of the Sarbanes-Oxley Act refers to "internal controls and procedures." This rubric was added to the securities laws in 1975 in response to the foreign bribery scandals in the early 1970s. It focuses on an issuer's financial reporting and control of its assets, so as to detect bribery, among other things. In the SEC's view, the legislative history of Section 302 supports a broader purpose here—while Subsections 302(a)(5) and (6) of the Sarbanes-Oxley Act do relate to the traditional internal controls and procedures framework, Subsection 302(a)(4) is intended to address controls and procedures related to the quality and timeliness of disclosure more generally. Accordingly, the new SEC rules create a new concept of "disclosure controls and procedures," to which this memorandum is devoted.

New Rules 13a-15 and 15d-15 require all companies subject to the certification requirements of Rules 13a-14 and 15d-14 to maintain and periodically update their disclosure controls and procedures to which the certifications relate.

Maintenance of Disclosure Controls and Procedures

New Rule 13a-15 defines "disclosure controls and procedures" to mean the controls and other procedures of an issuer that are designed to ensure that any 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 period specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a public company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its CEO and CFO, appropriate to allow timely decisions regarding disclosure.

As previously noted, the new rules expressly require the CEO and CFO to conduct an evaluation of the effectiveness of the design and operation of the disclosure controls and procedures within 90 days prior to the filing date of any quarterly or annual report filed or submitted under the Exchange Act. That evaluation must, at a minimum, address the matters specified by the rules. The SEC assumes that the evaluation will be carried out in a manner that would form the basis for the CEO and CFO certifications required by Section 302 of the Sarbanes-Oxley Act.

Since the CEO and CFO must conduct such an evaluation before the time of filing of the next Form 10-K / 10-Q, it is important that procedures be established as soon as possible so that the CEO and CFO can review and assess them.

While the SEC did not prescribe any particular disclosure controls and procedures, and indicated that each company should develop a process consistent with its own business, it did make several recommendations.

The SEC recommended that companies create a formal committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. This committee (which would not be a committee of the Board of Directors, but rather a committee of employees and, where appropriate, professional advisors) would report to senior management, including the principal executive and financial officers, who under the Sarbanes-Oxley Act have express responsibility for designing, establishing, maintaining, reviewing and evaluating the company's disclosure controls and procedures.

The SEC release suggests that the members of this Disclosure Committee could include the following:

- the principal accounting officer or controller;
- the general counsel or another senior legal officer with responsibility for disclosure matters who reports to the general counsel;
- the principal risk management officer;
- the chief investor relations officer; and
- such other officers or employees as the company deems appropriate, such as the heads of major business units.

Recommendations with Respect to Disclosure Controls and Procedures—A Baker's Dozen

1. CEO/CFO Involvement. The CEO and CFO must be actively involved. Under the certification requirements of Section 302, they ultimately must personally certify that they have not only read the report, but that they have evaluated the quality of the disclosure control process and addressed any weaknesses that they have uncovered. In order to do that, they must be involved in the process. We strongly advise that they meet at least once each quarter with the Disclosure Committee described below to discuss the draft report and the disclosure control process.
2. Establish a Disclosure Committee. While the SEC only recommended, and did not mandate, the establishment of a Disclosure Committee, we would strongly recommend that you do so. This committee should be chaired by a relatively senior member of management, for example, the CFO or general counsel. It is probably better to keep this group relatively small for easier manageability. Each

committee member should be familiar with the SEC's disclosure rules and regulations and should read each periodic report (or at least those portions related to his or her area of expertise) and the Disclosure Committee should report directly to the CEO and CFO. (For many companies, the formation of a Disclosure Committee will, to a substantial degree, serve to formalize procedures already being followed in practice.) The Disclosure Committee should be continually updated and educated as to changes in both the SEC disclosure requirements and the environment in which the company operates, including its own business competitors. Companies should monitor SEC filings of key competitors, customers and suppliers as to possible relevant disclosures.

3. Establish a Disclosure Preparation Timetable. You should consider establishing a detailed annual timetable for your principal SEC filings, including annual report, quarterly reports, proxy statement, annual report to shareholders, annual meeting, release of quarterly earnings and board and committee meetings. This timetable should include deadlines for preparation of first drafts of documents, the receipt of comments, and the allowance of sufficient time for review of draft filings. Perhaps the most important aspect of such a timetable, particularly for smaller companies, is the preparation of draft reports, providing sufficient time in advance to allow for proper review by outside auditors and legal counsel, the audit committee and board of directors and, last but not least, the CEO and CFO who must personally certify to the correctness of the report.

4. Designate a Disclosure Control Official. You should consider designating one individual within the company with responsibility for supervising the operational aspects of disclosure procedures. This person would be responsible for ensuring that the procedures are properly documented, communicated, implemented and enforced, and would periodically report status back to the Disclosure Committee.

5. Establish Clear Individual Responsibility for Specific Aspect of Filings. Different employees or advisors should be delegated specific responsibility for portions of filings within their areas of expertise, such as the responsibility of heads of business units for the review of the description of their specific business units. The disclosure control officer should ensure that responsibility for each section of each periodic report is assigned to a specific person and responsibilities are documented and circulated.

6. Don't Forget to Update Risk Factors. As a subset of the assignment of personal responsibility for portions of the filing, a senior official of the company who is closest to the true risks of the business should be assigned personal responsibility for reviewing and updating, where appropriate, the risk factors contained in the SEC filings. This is an area where a study of competitors' SEC filings can often be helpful.

7. Perform a Rules Check. One person, either one of the key internal company employees on the Disclosure Committee or legal counsel, should be responsible for performing an overall rules check of each filing against SEC requirements.

8. Document the Process. Keep records documenting the process that was undertaken, which persons reviewed which portions of which drafts and when. However, this documentation should focus on confirming the process and not on recording the substance of every change or comment. This may be important later in the event of an SEC inquiry or a stockholder lawsuit.

9. Specify the Role of the Outside Counsel. A public company's disclosure controls and procedures should clearly spell out the role of its outside legal counsel in the process. The nature of that role will depend on the division of responsibility between internal counsel, if any, and external counsel and the level of involvement the company wishes external counsel to have, but the procedures should be clearly spelled out and followed consistently.

10. Specify the Role of the Outside Auditor. The Disclosure Committee should coordinate closely with the Audit Committee concerning the level of review to be performed by the outside auditor beyond the traditional role of an independent auditor on the audited year-end financial statements. This should include the outside auditor's review of unaudited financial statements, the MD&A, including the description of critical accounting policies, and the description of new accounting standards and other specific portions of the filing, depending upon the type of filing and nature of the company's business.

11. Establish Procedures for Real Time Disclosure on Form 8-K. The SEC has separately made a proposal, that we expect to be adopted in some form in the relatively near future, that will dramatically increase the number of events that are required to be reported within two days after the event on a Form 8-K. Public companies should disseminate to all senior management a list of those developments that will be specifically required by the SEC proposal to be reported on Form 8-K, and should educate senior management about those topics and other developments which may require public disclosure. The new Form 8-K requirements will probably require that a larger number of managers be involved in the disclosure

process, particularly for larger organizations, because of the requirement for immediate disclosure of a significant number of events (for example, the termination of a material contract) which may not always be immediately known to the CEO or CFO.

12. Don't Rely on Checklists. While proper controls and procedures are important, it also is important that the members of the Disclosure Committee continue to think critically about what is and is not important to the company's business, so that SEC filings properly describe the company's business, in one of the SEC's favorite phases "through the eyes of management." The process should not become one of rote checking off of a punch list.

13. Evaluate the Controls. We suggest that the Disclosure Committee periodically evaluate proper disclosure controls by soliciting feedback from each person involved in the process, to ensure that each is being given adequate time, training and staffing assistance for the drafting and review of the filings. In addition, all parties should also be interviewed to discuss their conclusions and concerns about the process. The Disclosure Committee should also review the control procedures of peers to determine if changes to the controls need to be implemented.

• • •

For more information, please contact your Brown Rudnick attorney or one of the following attorneys:

IN BOSTON

David H. Murphree
617.856.8362
dmurphree@brbilaw.com

Philip J. Flink
617.856.8555
pflink@brbilaw.com

IN PROVIDENCE

Jayne Donegan
401.276.2612
jdonegan@brbilaw.com

IN HARTFORD

David E. Golden
860.509.6579
dgolden@brbilaw.com

IN NEW YORK

Steven F. Wasserman
212.209.4999
swasserman@brbilaw.com

Kenneth S. Goodwin
212.209.4862
kgoodwin@brbilaw.com

IN LONDON

Lawrence M. Levy
+44.20.7851.6000
llevy@brbilaw.com

IN DUBLIN

Mark A. Dorff
+44.20.7851.6000
mdorff@brbilaw.com

BR BI BROWN RUDNICK BERLACK ISRAELS LLP

www.brownrudnick.com

Boston
Dublin
Hartford
London
New York
Providence

Brown Rudnick Berlack Israels LLP is a full-service, international corporate law firm with offices in the United States and Europe. We have 200 attorneys who provide advice across five major areas off the law: Corporate, Banking & Finance, Real Estate, Litigation and Government Law & Strategies.