

August 13, 2002

## SARBANES-OXLEY ACT OF 2002

### Introduction

In response to recent corporate and accounting scandals, Congress adopted the Sarbanes-Oxley Act of 2002 (the "Act") on July 25, 2002, and President Bush signed the Act into law on July 30, 2002. The Act provides for widespread changes in the areas of corporate governance, accounting practices, and disclosure for public companies. The Act expressly excludes investment companies from many provisions. The application of other provisions to registered investment companies, including the certification requirements discussed below, is less clear and will not be known until the Securities and Exchange Commission (the "Commission") issues regulations later this month. Industry sources expect the Commission to apply the certification requirements to investment companies either by application of the Act or by separate rulemaking authority. *Accordingly, we recommend that registered investment companies and their investment advisers begin taking steps immediately to assess the potential impact of the Act on the fund complex and begin to prepare for compliance with the Act.*

### Summary

This memorandum provides an overview of various provisions of the Act with an emphasis on the potential effects these provisions may have on registered investment companies. Among other things, the Act:

- Obligates CEOs and CFOs (under two separate provisions discussed below), or their functional equivalents, to certify the company's financial statements and establishes both civil and criminal sanctions for false certifications.
- Directs the Commission to require exchanges to adopt listing standards which would govern the composition of audit committees and enhance the powers of such committees.
- Requires attorneys who represent public companies before the Commission to report evidence of securities law violations to a company's chief legal officer or CEO, and if those officers do not take appropriate action, to the company's audit committee, its independent directors or the board as a whole.
- Provides for accelerated disclosure of holdings in company securities by corporate directors, principal stockholders and officers who are subject to Section 16 reporting requirements.
- Creates a "Public Accounting Oversight Board" to regulate the accounting profession and places other substantive limits on the accounting profession, including limits on nonaudit services.
- Lengthens the statute of limitations for securities fraud suits.

### **CEO and CFO Certifications**

Section 302 of the Act directs the Commission to adopt rules no later than **August 29, 2002**, requiring CEOs and CFOs (or their functional equivalents) to certify in connection with the filing of periodic reports under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (“Exchange Act”) that:

- The officers have reviewed the report and, based on their knowledge, (i) the report does not contain any material misstatement or omission; and (ii) the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations for the relevant periods.
- The officers are responsible for establishing and maintaining the company’s internal controls and have designed internal controls necessary to ensure that material information relating to the company is made known to such officers by others within those entities, particularly during the period in which the report is being prepared.
- The officers have evaluated the effectiveness of the internal controls as of a date within 90 days prior to the report and have included in the report their conclusions about the effectiveness of such internal controls.
- The officers have disclosed to the company’s independent auditor and audit committee of the board of directors all significant control deficiencies and any fraud, whether or not material, that involves management or other employees who have a significant role in the company’s internal controls.
- The officers have indicated in the report whether or not there were any significant changes in internal controls or in other facts that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions taken with regard to significant deficiencies or material weaknesses in the internal controls.

Section 906 of the Act contains separate requirements concerning certifications accompanying periodic reports containing financial statements filed with the Commission pursuant to Section 13(a) or Section 15(d) of the Exchange Act. This section requires such reports to be accompanied by a statement from the CEO and CFO certifying that the report complies fully with the requirements of those provisions of the Exchange Act and the information in the periodic report “fairly presents, in all material respects, the financial conditions and results of operations of the issuer.” This provision became effective July 30<sup>th</sup>, and violation of this provision involves criminal penalties.

### **Recommendations**

The entire area of CEO/CFO certifications is evolving rapidly and presents unique issues for investment companies. The ramifications of the Act on registered investment companies are not likely to be known until the Commission issues regulations on or before the August 29<sup>th</sup> deadline. We strongly encourage mutual fund complexes to take the following steps immediately:

- Consult with counsel to determine whether the provisions of Section 906, which are now effective, apply to your fund. Because Form N-SAR does not contain financial statements, it is arguable that the Section 906 provisions do not apply to investment companies.<sup>1</sup>

- Review the list of persons with the title of CEO or CFO for each fund and determine whether such persons are best suited to make the required certifications. If not, determine whether board or other action is needed to designate the appropriate person(s).
- Develop a due diligence process for the completion of the required certifications and internal control reports.
- Accelerate the timeline for filing any Form N-SARs due in August and make all N-SAR filings on or before August 28, 2002.
- For closed-end funds, advise all persons subject to Section 16 reporting requirements of the new accelerated filing deadline and review any compliance processes designed to assist in such filings.
- Advise fund boards or audit committees, as appropriate, of steps management is taking to comply with the Act.

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<sup>1</sup> While Form N-SARs are filed pursuant to Rule 30b-1 of the Investment Company Act of 1940, such filing satisfies Exchange Act reporting obligations as well. On the other hand, annual and semi-annual reports of investment companies are filed pursuant to the 1940 Act.

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