

DETERMINED TO BE AN
ADMINISTRATIVE MARKING
E.O. 12065, Section 6-102
By *Jmi* NARS, Date *5/2/2012*

Circ. 6/3 for 6/12

Recommendation
Approved by
Commission
~~With Revisions~~

Melissa Kimps
Program Information Specialist

June 3, 2002

ACTION MEMORANDUM

TO: JUN 12 2002

The Commission

FROM: *P, H, G*

Division of Corporation Finance *mpd*

SUBJECT:

Certification of Disclosure in Companies' Quarterly and Annual Reports

*34-46079
6/14/02*

RECOMMENDATION:

That the Commission issue a release, substantially in the form of Attachment A, proposing new rules that would require registrants' principal executive officers and principal financial officers to certify the contents of Form 10-Q and 10-K reports

ACTION REQUESTED
BY:

June 12, 2002

SUNSHINE ACT
STATUS:

Open Meeting

REGULATORY
FLEXIBILITY ACT
STATUS:

The Draft Proposing Release includes an Initial Regulatory Flexibility Analysis.

COST-BENEFIT
ANALYSIS:

The Draft Proposing Release includes a consideration of the proposal's costs and benefits.

PAPERWORK
REDUCTION ACT
STATUS:

Paperwork Reduction Act filings will be submitted to the Office of Management and Budget in connection with these proposals.

MAJOR RULE
ANALYSIS:

We will consult with the Office of Economic Analysis as to whether the proposed rules constitute a major rule under the Small Business Regulatory Enforcement Fairness Act.

NOVEL, IMPORTANT
OR COMPLEX ISSUES: None

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**OTHER OFFICES OR
DIVISIONS**

CONSULTED:

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I. Introduction

The Division of Corporation Finance has prepared a draft release proposing new Exchange Act rules that would:

- Require a registrant's principal executive officer and principal financial officer to certify that the registrant's quarterly reports on Form 10-Q and annual report on Form 10-K contain all of the financial and other information about the registrant known to them that a reasonable investor would consider important in making a decision to purchase or sell the registrant's securities.
- Require a registrant to establish and maintain a system of internal procedures and controls sufficient to provide reasonable assurance that the company is able to process and disclose the financial and other information required in its quarterly and annual reports filed with the Commission.

The proposed rules are intended to encourage senior corporate executives to more actively participate in the preparation of their companies' Form 10-Q and Form 10-K reports. They also are expected to enhance security holders' awareness that these executives are accountable to security holders for the content of these disclosure documents.

II. Background

As part of his ten-point plan to improve corporate responsibility, President Bush has proposed that corporate executives personally vouch for the veracity, timeliness and fairness of their companies' public disclosures, including their financial statements.¹ In

¹ See Remarks of President George W. Bush at the Malcolm Baldrige National Quality Award Ceremony, March 7, 2002, available at <http://www.whitehouse.gov/news/releases/2002/03/20020307-3.html>.

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order to implement this proposal, the draft release proposes the adoption of new Exchange Act Rules 13b1-1 and 13b2-2.

Proposed Rule 13b1-1 would require a registrant's principal executive officer and principal financial officer, in connection with the filing of a registrant's quarterly report on Form 10-Q and annual report on Form 10-K,² to certify that:

- they have reviewed the report;
- the report contains true statements of all of the information about the registrant known to them that a reasonable investor would consider important in making a decision to purchase or sell a security of the company; and
- based on their knowledge,
 - the financial statements included in the report have been prepared in accordance with generally accepted accounting principles; and
 - considered together with all of the other financial information included in the report, represent a true and, in all important respects for a reasonable investor, complete presentation of the financial condition and results of the registrant, as of and for the periods presented in the report.

Proposed Rule 13b2-3 would require a registrant to:

- establish and maintain a system of internal procedures and controls sufficient to provide reasonable assurances that the registrant is able to record, process and disclose, within the time periods specified in the Commission's rules and forms, the financial and other information required to be disclosed in the registrant's quarterly and annual reports that it files pursuant to the Exchange Act;
- prior to the filing of its annual report on Form 10-K, conduct an evaluation to be carried out, under the supervision of the registrant's principal executive officer and principal financial officer, of the effectiveness of the design and operation of this system of internal procedures and controls; and
- prior to the filing of its annual report on Form 10-K, communicate the results of the evaluation to the registrant's principal executive officer and principal financial officer.

² The proposed rules also would apply to quarterly reports on Form 10-QSB [17 CFR 249.308b] and annual reports on Form 10-KSB [17 CFR 249.310b].

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Further, under Proposed Rule 13b1-1 the certification in an annual report on Form 10-K would be required to include a statement confirming that the principal executive officer and principal financial officer had reviewed the results of the evaluation of this system of internal procedures and controls.

III. Discussion

The proposed rules respond to President Bush's concern that the investing public believes that their interests are not being well-served by corporate executives. Declaring that the people who run public companies owe a special obligation to their investors, the President seeks to restore investor confidence in the accountability of senior management by requiring these individuals to expressly attest to the responsibilities of their positions. The proposed rules achieve this objective by requiring certification of a registrant's quarterly and annual reports and by ensuring that registrants develop and maintain adequate internal systems for capturing and reporting the relevant information that they must include in those reports.

A. Scope of Certification Requirement

Proposed Rule 13b1-1 provides express assurances to investors that a registrant's two most senior officers, its principal executive officer and its principal financial officer, are satisfied that the financial and other information in the registrant's Exchange Act periodic reports is true and complete.

In the case of an annual report on Form 10-K, the proposed rule does not expand the number of required signatories to the report.³ The proposed rule does, however, change the existing signature requirements for quarterly reports on Form 10-Q. The Commission's current rules do not expressly require that a registrant's principal executive officer sign the quarterly report on Form 10-Q.⁴ The proposed rule imposes this requirement, thereby ensuring that both a registrant's principal executive officer and principal financial officer sign the quarterly report.

The proposed certifications are to be made in a "Plain English" format that should be easily understood by investors. To alleviate concerns that the proposed use of a "Plain English" format would expand or otherwise change the current standard for the disclosure of "material" information, proposed Rule 13b1-1(e) makes clear that the Commission is

³ Currently, both the principal executive officer and the principal financial officer, among others, are required to sign a registrant's annual report on Form 10-K. See General Instruction D(2)(a) to Form 10-K.

⁴ Currently, a quarterly report on Form 10-Q must be signed on a registrant's behalf by a duly authorized officer of the registrant and by the principal financial officer or the chief accounting officer of the registrant. As a practical matter, therefore, the principal financial officer may be the sole signatory to the report. See General Instruction G to Form 10-Q.

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not altering the standard as set forth by the Supreme Court in Basic v. Levinson.⁵ We believe that, under current law, the disclosure requirements for quarterly and annual reports, coupled with the general disclosure obligation of Exchange Act Rule 12b-20,⁶ embody the same disclosure standard that is reflected in the proposed certifications. Consequently, the proposed rule should not change the existing liability standard for the individuals that would have to provide the certifications.

The proposed certification of a registrant's financial information has two distinct purposes. First, it simply attests to the officers' belief that the registrant's financial statements conform to generally accepted accounting principles. Secondly, the officers must affirm that the overall financial disclosure presents a complete and accurate picture of the registrant's financial condition in all important respects. This second component is intended to be broader than the first, consistent with current law.⁷ Again, proposed Rule 13b1-1(e) makes clear that the financial certification carries the same meaning as the current liability standard.

B. Scope of Internal System of Procedures and Controls

Proposed Rule 13b2-3 requires that a registrant establish (if it has not already done so) and maintain an overall system of internal procedures and controls that is adequate to meet its Exchange Act reporting obligations. This system necessarily encompasses the system of internal procedures and controls for financial reporting purposes required by Section 13(b)(2)(B)⁸ and Regulation 13B-2.⁹

The proposed rule is intended to complement, rather than overlap, the current responsibilities of a registrant's audit committee with respect to the registrant's financial reporting.¹⁰ In other words, a registrant must maintain an internal system of procedures and controls to ensure that the registrant collects and reports both financial and non-financial information in a timely and complete manner. From a registrant's perspective, the potentially new aspect of this requirement is the need for a system of procedures and controls to capture and report non-financial information. We believe that most registrants have such systems in place. Consequently, the proposed rule should not result in a significant new burden for registrants.

⁵ 485 U.S. 224 (1988).

⁶ 17 CFR 240.12b-20.

⁷ See, for example, United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

⁸ 15 U.S.C. §78m(b)(2)(B).

⁹ 17 CFR 240.13b2-1 et seq.

¹⁰ See Item 306 of Regulation S-K [17 CFR 229.306].

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The proposed requirement that registrants annually evaluate their systems of internal procedures and controls would be new. We are not aware of the extent to which registrants already perform similar evaluations. In addition, proposed Rule 13b1-1 would require the principal executive officer and principal financial officer to certify that this evaluation had been conducted.

C. Foreign Registrants

We are not proposing to apply the proposed rules to foreign private issuers at this time. In the case of domestic registrants, the proposed rules, for the most part, do not expand existing signature requirements and, thus, should not be viewed as a significant development. This is not true for foreign private issuers. In many instances, the senior executives of foreign private issuers do not sign their companies reports on Form 20-F. Consequently, the inclusion of foreign private issuers in this rulemaking would be viewed as a significant substantive development internationally. We have included questions about foreign registrants in the draft release, however, so that we can revisit this issue if we think it is appropriate to do so in the future.

V. **Conclusion**

At a minimum, the proposed rules should increase senior executive awareness of the importance of their companies' public reports. We believe that the proposed requirements will lead to greater involvement on the part of executives in the preparation of these reports and in the overall corporate reporting process. This should help restore investor confidence in the quality of the disclosure contained in quarterly and annual reports. For these reasons, the Division of Corporation Finance recommends that the Commission authorize the issuance of the attached release.

Attachment

Attachment A -- Draft Proposing Release