INTRODUCTION

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the “Act”) was signed into law. The Act was primarily designed to address recent problems and scandals involving the governance and financial disclosure of major public companies such as Enron and Worldcom. However, on August 27, 2002, the Securities and Exchange Commission (the “SEC”) issued regulations that make it clear that at least part of the Act applies to registered investment companies. The SEC’s rules require that as part of investment companies’ annual and semi-annual reports on Form N-SAR, the principal executive and financial officers (“CEO” and “CFO”) of a company or persons holding equivalent positions (the “certifying officers”) make six specified certifications. Under additional proposed rules, certifications would also be required for an investment company’s semi-annual and annual shareholder reports and all other disclosure documents filed under the Securities Act of 1933, the Securities Exchange Act of 1934 (the “1934 Act”) and the Investment Company Act of 1940.

COMPLIANCE DATES

Adopted Rules. There are two relevant compliance dates for the certifications. Those relating to the review of the Form N-SAR and the accuracy of the fund’s financial statements are required in all N-SARs filed after August 29, 2002 or amendments to N-SARs filed after this date. The remaining certifications, which relate to disclosure controls and procedures and to internal controls, apply to all N-SARs filed for periods ending after August 29, 2002. In addition to the certification requirements, there are new disclosure, evaluation and procedural requirements that must be complied with in connection with all N-SARs filed for periods ending after August 29, 2002.

Proposed Rules. The SEC has set October 16, 2002 as the date by which public comments on the proposed rules must be received. If adopted, these additional rules would become effective 30 days after notice is published in the Federal Register.
REQUIRED CERTIFICATIONS

Under the SEC’s adopted rules, any registered investment company that is subject to periodic reporting requirements (almost all investment companies) must include the following certifications signed by the certifying officers in their Form N-SARs:

- They have reviewed the report on Form N-SAR;

- Based on their knowledge, the report does not contain any untrue statement of material fact, or omit to state a material fact that is necessary to make the statements not misleading, in light of the circumstances under which they were made, with respect to the period covered by the report;

- Based on their knowledge, the financial information contained in the report (as well as the underlying financial statements on which the report is based) fairly presents all material aspects of the investment company’s financial condition, results of operations, changes in net assets, and cash flows for the period covered by the report;

- They are responsible for maintaining and establishing disclosure controls and procedures (this certification is discussed more extensively below) for the company;

- They have disclosed to the fund’s auditors and the audit committee of the fund’s board of directors any significant deficiencies in the design or implementation of internal controls and have identified to the auditors any material weaknesses in such internal controls as well as any fraud, whether material or not, that involves management or other employees who have a significant role in the internal controls; and

- Whether there were any significant changes in internal controls (or in other factors that could affect internal controls).

These certifications may pose significant practical issues for many investment companies, as well as for their investment advisers.

DESIGNATION OF CERTIFYING OFFICERS

One immediate problem will be determining who should be designated as the CEO and CFO for purposes of the certifications. This may involve rearranging fund management, changing titles, and/or appointing new positions within the investment company. Because of the unique structure of investment companies, a person may hold a title in a fund or fund
complex suggesting that he or she is either a CEO or CFO, but that person may not be
involved enough in the financial operations of the fund, or oversight of the Form N-SAR
preparation process, to make the required certification. One common example of this is that
many mutual funds appoint a portfolio manager to the principal executive officer position.
However, the portfolio manager may not participate in the N-SAR process. Similarly, some
funds’ directors hold positions equivalent to CEO or CFO. However, board members are
not typically involved in oversight of the N-SAR or a fund’s financial statements. These
funds may therefore need to appoint other persons in management to be certifying officers
who actually oversee the N-SAR and the financial statements.

**DISCLOSURE CONTROLS AND PROCEDURES**

One of the required certifications involves an investment company’s disclosure controls and
procedures. The SEC has stated that the term “disclosure controls and procedures” means
those controls and procedures that are designed to ensure that both financial and non-finan-
cial information disclosed on the N-SAR is recorded, processed, summarized and reported
in a timely manner and is accumulated and communicated to the certifying officers in a
manner that allows for timely decisions regarding the disclosure. The provision requiring
that disclosure controls and procedures be in place was effective as of August 29, 2002.
Consequently, most investment companies and their advisers are moving promptly to
respond to the requirement. The SEC recommends that funds create a “disclosure commit-
tee” for considering the materiality of information and determining disclosure obligations on
a timely basis. Management will need to determine the composition of such a committee,
which may vary depending on how the fund is structured. Management may also want to
consider appointing a person to serve as the disclosure controls coordinator to report to the
certifying officers and/or to the disclosure committee. Funds will also probably want to
draft written disclosure policies and an N-SAR preparation timetable and distribution list, so
that disclosure procedures are clear, deadlines are adhered to and the lines of communica-
tion are open. Management should also focus on clarifying the roles of fund counsel, the
independent auditors and other service providers in the process.

In addition, the Act requires that the certifying officers conduct an evaluation of a fund’s
disclosure controls and procedures within 90 days prior to the filing of each N-SAR. Their
conclusions about the effectiveness of their fund’s disclosure controls and procedures must
then be included in the N-SAR. Importantly, a fund is subject to SEC enforcement action
for inadequate controls and procedures, even if this failure does not result in flawed disclo-
sure.
INTERNAL CONTROLS

According to the SEC, “internal controls” are the fund’s controls and procedures for financial reporting purposes. The certifications regarding internal controls will probably require fund management to enhance communication with the auditors and the audit committee. It also seems implied that each member of the audit committee be knowledgeable about the fund’s internal controls so that they are in a position to assess these communications.

In addition, all N-SARs filed after August 29, 2002 (and any amendments thereto) must disclose whether or not there were any significant changes in the fund’s internal controls (or other factors) that could significantly affect the controls.

INSURANCE AND INDEMNIFICATION

Managers should also review director and officer (“D&O”) insurance coverage with fund counsel to determine whether an action against a certifying officer for false certification would be covered by the fund’s existing policy and the adviser’s policy, if the certifying officer is an employee of the adviser. The terms of D&O policies vary. Some policies may have restrictive provisions that could exclude coverage for the risk to certifying officers of personal liability in connection with their certifications. Additionally, management should be aware that the Act may indirectly cause increased insurance premiums in light of some officers’ increased exposure to personal liability. Finally, advisers will want to clarify with counsel the extent of indemnification of officers and directors in their funds’ bylaws and charters as well as their own company’s bylaws and charters if a certifying officer is an adviser employee.

PROPOSED REGULATIONS

Under the SEC’s proposed rules, the officer certification will be extended to all investment company annual and semi-annual shareholder reports. The proposed rules will require that these reports and certifications be filed on a new Form N-CSR. These certifications will be in addition to the N-SAR certifications and will extend to any information contained in the reports, including the management’s discussion of fund performance. In addition, funds will be required to maintain disclosure controls and procedures covering all disclosure documents, including registration statements. Finally, it appears likely that the proposed regulations will cause Section 906 of the Act to become applicable to investment companies. Section 906 requires the certifying officers to separately certify that the report containing the financial statements complies with applicable rules and that the financial statements fairly represent, in all material respects, the Fund’s financial condition and results of operations. There are criminal penalties associated with filing an inaccurate certificate under Section 906.
CONCLUSION

The SEC’s final and proposed rules will require funds and their managers to act promptly to take a hard look at their disclosure and internal controls and procedures to assess whether any modifications are necessary. Further, to the extent necessary, managers should clarify the roles of all fund personnel in the public reporting process and document in writing the fund’s disclosure and internal controls.

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