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SEC Adopts Rules Regarding Improper Influence on the Conduct of Audits

The SEC has adopted new Rules 13b2-2(b) and 13b2-2(c) under the Securities Exchange Act regarding improper influence on the conduct of audits. The rules implement Section 303(a) of the Sarbanes-Oxley Act of 2002 (the "Act").

The new rules, together with existing provisions, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of an issuer's financial statements. The new rules prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the issuer's financial statements and to provide a true report of the auditor's findings.

The new rules generally apply to all issuers of securities. As a practical matter, however, because the rules are triggered by undue influence in respect of financial statements that are required to be filed with the SEC, the new rules effectively apply to all U.S. and non-U.S. companies that have SEC reporting obligations.

The new rules become effective on June 27, 2003.

I. Overview of the Rules

Section 303(a) of the Act required the SEC to prescribe rules preventing any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

Existing Section 13(b)(2) of the Securities Exchange Act requires every reporting issuer to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Existing Rule 13b2-1 provides that no person shall, directly or indirectly, falsify or cause to be falsified, any such book, record or account.

Existing Rule 13b2-2 (which is redesignated as Rule 13b2-2(a)) provides that no director or officer of an issuer, in connection with an audit or examination of the issuer's financial statements or the preparation of any document or report to be filed with the SEC, directly or indirectly shall (a) make or cause to be made a materially false or misleading statement to an accountant or (b) omit to state to an accountant, or cause another person to omit to state to an accountant, any material fact necessary to make statements made, in light of the circumstances under which such statements were made, not misleading. In connection with the adoption of the new rules, the SEC clarified that Rule 13b2-2(a) would apply to false or misleading statements made to an accountant in connection with an audit review or the preparation of a document or report required to be filed with the SEC.

New Rule 13b2-2(b) would further specifically prohibit:

- officers and directors, and persons acting under their direction,
- from coercing, manipulating, misleading or fraudulently influencing
- independent public or certified public accountants engaged in the performance of an audit or review of the financial statements of the issuer that are required to be filed with the SEC
- if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

New Rule 13b2-2(c) applies similar provisions to audits of investment companies' financial statements.

Section 303(b) of the Act provides that the SEC has exclusive authority to enforce Section 303 and any rule or regulation issued thereunder. As a result, no private right of action has been created by the new rules.

II. Elements of the Rules

The following are the principal elements of the new rules.

A. Scope of Persons Covered

The new rules address activities by an officer or director of an issuer, or any other person acting under the direction of an officer or director.

Under existing rules, the term "officer" is defined to include the issuer's president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated. The term "officer" also includes an issuer's chief executive officer and other executive officers. The SEC also believes that the term "officer" also covers, among others, those who set corporate governance policies and legal policies of the issuer. A person may be an "officer" under the existing definition regardless of the person's title or the legal entity with which he or she is associated. For example, an officer of a wholly owned subsidiary of a public company may be an "officer" of the public company. The term "director" has a similar functional and flexible nature. In applying the new rules to foreign private issuers, the terms "officer" and "director" indicate those performing equivalent functions under the local laws and corporate governance practices of the place where the issuer is domiciled.

The new rules also cover the activities of any other person acting under the *direction* of an officer or director of the issuer. In adopting the new rules, the SEC indicated that it interprets the term "direction" in the Act to encompass a broader category of behavior than "supervision." In other words, someone may be "acting under the direction" of an officer or director even if such person is not under the supervision or control of that officer or director so long as such person participated in an effort to improperly influence the auditor when such person knew or should have known that the effect of its conduct would be to render an issuer's financial statements materially misleading.

According to the SEC, persons acting under the direction of an officer or director might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor. In the case of a registered investment company, persons acting under the direction of officers and directors of the investment company may include, among others, officers, directors and employees of the investment company's investment adviser, sponsor, depositor, administrator, principal underwriter, custodian, transfer agent or other service providers.

Persons acting under the direction of an officer or director also may include other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and attorneys, securities professionals or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment or not to withdraw an issued audit report on the issuer's financial statements.

In the adopting release, the SEC rejected the suggestion of certain commenters that a misleading legal analysis would violate the new rules only if accompanied by fraudulent or bad intent on the part of the attorney providing the analysis and that the new rules by covering negligent communication of misleading information would have a chilling effect on communications during the audit process. The SEC reiterated that for many years, it has initiated enforcement actions against those who by negligently providing misleading confirmations to auditors cause an issuer to violate the financial reporting or books and record provisions of the Securities Exchange Act. In the SEC's view, the new rules only add an additional tool to the SEC for dealing with such conduct. Third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications.

B. Conduct Covered

The new rules address any action to coerce, manipulate, mislead or fraudulently influence an auditor performing an audit or review of an issuer's financial statements if that person knew or should have known that such action would render the financial statements materially misleading.

Much of the conduct addressed by the new rules, particularly efforts to "manipulate or mislead" the auditor, generally would be subject to other provisions of the securities laws and rules, including existing Rules 13b2-1 and 13b2-2. In the SEC's view, the new rules provide an additional means to address conduct to coerce, manipulate, mislead or fraudulently influence an auditor during its examination or review of the issuer's financial statements, including conduct that did not succeed in affecting the audit or review.

"Coerce" and "manipulate" imply compelling the auditor to act in a certain way through pressure, threats, trickery, intimidation or some other form of purposeful action. "Mislead" implies directly or indirectly making or causing to be made materially misleading statements to auditors. In the SEC's view, "causing misleading statements to be made to an auditor" already includes and will continue to include the entering by an officer or director into an arrangement with a third party to send a misleading confirmation or to provide other misleading information or data to the auditor.

Types of conduct that the SEC believes might constitute improper influence (if the person engaged in that conduct knows or should know that the conduct, if successful, could result in rendering the issuer's financial statements materially misleading) include, but are not limited to, directly or indirectly:

- offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- providing an auditor with inaccurate or misleading legal analysis,
- threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting,
- seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting,
- blackmailing, and
- making physical threats.

In the SEC's view, other conduct such as knowingly providing to the auditor inadequate or misleading information that is key to the audit, transferring managers or principals from the audit engagement and when predicated by an intent to defraud, verbal abuse, creating undue time pressure on the auditor, not providing information to the auditor on a timely basis and not being available to discuss matters with the auditor on a timely basis, each in the appropriate circumstances and upon satisfaction of the criteria in the new rules, could result in improper influence on the auditor.

The facts and circumstances of each case would be relevant to determining whether the conduct would violate the new rule.

C. Conduct Directed at Auditors Performing an Audit or Review

The new rules address the improper influence of an independent public or certified public accountant engaged in the performance of an audit or review of the issuer's financial statements that are required to be filed with the SEC.

The new rules cover accountants in foreign countries who engage in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the SEC, regardless of the title or designation used in those countries. The rules also cover all persons associated with public accounting firms registered with the Public Company Accounting Oversight Board.

The SEC clarified that providing misleading information to an *internal auditor*, while it would be relevant to the status of the issuer's internal accounting or disclosure controls, is not covered by the new rules. However, to the extent that the work of the internal auditor is used by the independent auditor in conducting an audit or review of the issuer's financial statements, misleading or inaccurate information provided to the internal auditor may be deemed to be provided to the independent auditor.

In proposing the new rules, the SEC indicated that to effectuate the intent of Congress, the phrase "engaged in the performance of an audit" should be given a broad reading. The SEC indicated its belief that Congress intended that the phrase encompass the professional engagement period and any other time the auditor is called upon to make decisions regarding the issuer's financial statements, and subsequent to the professional engagement period. The new rules, therefore, would apply throughout the professional engagement period, including during negotiations for the retention of the auditor or during a review of interim statements and after the professional engagement has ended when the auditor is considering whether to consent to the use of, to reissue or to withdraw prior audit reports. For the SEC, the professional engagement period would begin when the accountant either signs an initial engagement letter or other agreement to review or audit a client's financial statements or begins audit, review or attest procedures, whichever is earlier. The professional engagement period would end when the audit client or the accountant notifies the SEC that the client is no longer that accountant's audit client.

According to the SEC, the new rules may even apply before the professional engagement period begins. For example, the new rules would apply if an officer, director, or person acting under the direction of an officer or director, offers to engage an accounting firm on the condition that the firm either issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards.

D. Knowledge Requirement

Section 303(a) of the Act prohibits conduct designed to improperly influence an issuer's auditor if undertaken "for the purpose of" rendering the issuer's financial statements materially misleading. As adopted, however, the new rules prohibit conduct designed to improperly influence an issuer's auditor if its author "knew, or was unreasonable in not knowing," that the improper influence could, if successful, result in rendering the issuer's financial statements materially misleading.

The new rules therefore imply a negligence standard, and *scienter* is not required. The SEC adopted a lower standard from that set forth in Section 303(a) of the Act because it believes that in the absence of any private right of action, a lesser standard of liability is appropriate to best achieve the purpose of restoring investor confidence in the audit process. For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures mandated by generally accepted auditing standards because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the purpose of rendering the financial statements misleading. If that officer however knew or should have known that not performing these procedures could result in the auditor not detecting or seeking correction of material errors in the financial statements, then the SEC believes that the officer's conduct would be subject to the rules.

Because the financial statements are prepared by management and the auditor conducts an audit or review of those financial statements, the auditor would not directly "render [the] financial statements materially misleading." Rather, the auditor might be improperly influenced to, among other things, issue an unwarranted report on the financial statements, including suggesting or acquiescing in the use of inappropriate accounting treatments (e.g., allowing an issuer to improperly correct material misstatements over time or to not restate prior period financial statements) or not proposing adjustments required for the financial statements to conform with generally accepted accounting principles. An auditor also might be coerced, manipulated, misled or fraudulently influenced not to perform audit or review procedures required by generally accepted auditing standards that, if performed, might divulge material misstatements in the financial statements.

According to the SEC, other examples of activities that would fall within the new rules would be where an officer, director, or person acting under an officer or director's direction, improperly influences an auditor either not to withdraw a previously issued audit report or not to communicate appropriate matters to the audit committee.

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Although on their face, the new rules will have less of an impact on the dynamics of the relationship between management and the auditors in contrast to some of the other provisions of the Act (particularly those directed at the responsibility of the audit committee), they do nonetheless increase the risk that in hindsight actions of management and other advisors relative to the audit process could be viewed as falling within their proscriptions. In addition, the scope of coverage serves as a reminder that the SEC in enforcement contexts may well look beyond a registrant to customers, suppliers and advisors as possible additional targets of enforcement.

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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