

## SEC PROPOSES RULES ON IMPROPER INFLUENCE ON CONDUCT OF AUDITORS

On October 18, 2002, the Securities and Exchange Commission (the “SEC”) proposed rules implementing Section 303(a) of the Sarbanes-Oxley Act of 2002 (the “Act”).<sup>1</sup> Section 303(a) of the Act prohibits officers and directors of public companies, or persons acting under their direction, from taking any action to improperly influence or mislead the company’s auditors. This memorandum provides a brief overview of the proposed rules. The SEC has requested that comments on the proposed rules be received on or before November 25, 2002. The Act requires the SEC to issue final rules by April 26, 2003.

### *THE PROPOSED RULES*

The SEC has proposed to amend Regulation 13B-2 under the Securities Exchange Act of 1934 (the “Exchange Act”) by adding a new Rule 13b2-2(b) that would make it unlawful for any public company’s officers or directors, or any person acting under their direction, to take any action, directly or indirectly, to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit or review of financial statements required to be filed with the SEC if that person knew, or was unreasonable in not knowing, that such action could, if successful, result in rendering such financial statements materially misleading.

The proposed rules would supplement the rules currently in Regulation 13B-2. The current rules address the falsification of books, records and accounts, and false or misleading statements, or omissions to make certain statements, to auditors.<sup>2</sup>

Foreign companies would generally be subject to the proposed rules.

### *PERSONS COVERED*

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

- The term “officer” includes a company’s executive officers, such as its chief executive officer, as well as its president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any other

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<sup>1</sup> SEC Release No. 34-46685.

<sup>2</sup> The SEC notes that much of the conduct addressed by the proposed rules generally would be subject to the other provisions of the securities laws and regulations, including the existing rules in Regulation 13B-2. The proposed rules, however, would provide an additional means to address such conduct. For example, as noted below, the proposed rules, unlike the current rules, would prohibit coercive or misleading acts directed at the auditors that did not ultimately result in the financial statements being materially misleading.

person who routinely performs a corresponding function.<sup>3</sup> An officer who performs a policy-making function for the company would similarly be covered.<sup>4</sup> The SEC notes that a person may be deemed an “officer” regardless of the person’s formal title or role with a company; thus, executive officers of subsidiaries who perform policy-making functions for the parent company and “promoters” of a public company could be deemed “officers” of the company.

- The proposed rules also cover any person acting *under the direction* of an officer or director. This term is interpreted by the SEC to encompass a broader category of persons than those *under the supervision* or *under the control* of an officer or director. Examples provided by the SEC include customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmation or other false or misleading information to auditors, or enter into “side agreements.” Other groups of non-employees to whom the prohibition might apply under certain circumstances would be partners or employees of the company’s accounting firm, attorneys, securities professionals or other advisers who engage in conduct prohibited under the proposed rules (see below).
- With respect to registered investment companies, the proposed rules would cover not only officers and directors of the investment company itself, but also officers and directors of the investment company’s investment adviser, sponsor, depositor, trustee and administrator, or any person acting under their direction. Persons acting under the direction of officers and directors of the investment company may include, among others, employees of the investment company’s investment adviser, sponsor, depositor, trustee and administrator, as well as the officers, directors and employees of the principal underwriter, custodian, transfer agent or other service providers.

### ***PROHIBITED CONDUCT***

The proposed rules prohibit any action to fraudulently influence, coerce, manipulate, or mislead the auditor of the company’s financial statements in a manner that could reasonably be expected to result in such financial statements becoming materially misleading. The SEC notes that such actions would include conduct that did not succeed in affecting the audit or review; the *act* of wrongfully influencing or misleading is itself unlawful, there is no requirement that the purpose be achieved.

Actions that could reasonably be expected to result in materially misleading financial statements include, but are not limited to, those that would influence an auditor:

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<sup>3</sup> Rule 3b-2 under the Exchange Act. See also Exchange Act Section 3(a)(7).

<sup>4</sup> Rule 3b-7 under the Exchange Act.

- to issue a report on a company's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles "GAAP"), generally accepted auditing standards ("GAAS") or other standards);
- not to perform audit, review or other procedures required by GAAS or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to the audit committee.

A non-exclusive list of types of conduct that would potentially constitute "improper influence" includes:

- 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.

#### *MENTAL STATE*

Under the proposed rules, a person would only be culpable if he or she "knew, or was unreasonable in not knowing," that an action taken could result in rendering a financial statement materially misleading.

#### *Commentary:*

- Section 303(a) of the Act prohibited conduct undertaken *for the purpose* of rendering the company's financial statements materially misleading. In its proposed rules, the SEC has noted that a state of mind short of fraud would be sufficient to impose culpability under the proposed rules,<sup>5</sup> a much lower standard

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<sup>5</sup> While the proposed rules bar actions that "fraudulently influence, coerce, manipulate, or mislead," the SEC notes that the term "fraudulently" in the proposed rules only modifies the word "influence"; *any* act that pressures an auditor may be deemed an act of "coercion" covered by the proposed rule.

of culpability. Under the SEC's standard, a party not affirmatively seeking to produce materially misleading financial statements could nonetheless be liable for improperly influencing an auditor.<sup>6</sup> Moreover, as noted earlier, under the proposed rules culpability could arise even if the conduct did not actually result in the financial statements becoming materially misleading.

### *SCOPE OF AUDIT ACTIVITY*

The proposed rules prohibit the improper influence of an auditor "engaged in the performance of an audit or review" of the company's financial statements.

- The SEC notes that the phrase "engaged in the performance of an audit or review" would encompass the entire professional engagement period as well as any other time that the auditor is called upon to make decisions regarding the company's financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports.
- In limited circumstances, the proposed rules would even apply *before* the professional audit period begins if, for example, an officer offers to engage an accounting firm on the condition that the firm issue an unqualified audit report on financial statements that do not conform with GAAP or limit the scope or performance of audit or review procedures in violation of GAAP.
- The proposed rules would not be limited to the audit of annual financial statements, but would include, among other things, improperly influencing an auditor during a review of interim financial statements or in connection with the issuance of a consent to the use of the auditor's report or in issuing attestation reports required to be filed with the SEC.<sup>7</sup>

### *ENFORCEMENT*

Under Section 303(b) of the Act, civil enforcement for improperly influencing auditors rests exclusively with the SEC. Accordingly, violations would not result in a private right of action.<sup>8</sup> Willful violations could result in criminal penalties under the Exchange Act.<sup>9</sup>

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<sup>6</sup> Consistent with this approach, the SEC is seeking comment whether the prohibited conduct should be characterized as "improper" rather than "fraudulent," thereby conveying a mental state short of "scienter." The SEC is also seeking comment as to whether to further dilute the mental state requirement by replacing the requirement that the person "knew or was unreasonable in not knowing" (that the action could result in misleading financial statements) with "have the effect of rendering the financial statements materially misleading," thereby eliminating the need to prove *any* particular purpose or intent.

<sup>7</sup> These would include, for example, attestation reports under Section 404 of the Act. See our earlier memorandum to clients, "SEC Proposes Rules on Disclosure of Internal Controls, Codes of Ethics and Financial Experts on Audit Committees," dated November 8, 2002.

<sup>8</sup> Violations under current Regulation 13B similarly do not give rise to a private right of action.

If you wish to obtain additional information regarding these new proposals or other initiatives, assistance in developing a detailed program to help ensure compliance or copies of any of our previous client memoranda, in New York please contact John S. D'Alimonte (212-728-8212, [jd'alimonte@willkie.com](mailto:jd'alimonte@willkie.com)), Yaacov M. Gross (212-728-8225, [ygross@willkie.com](mailto:ygross@willkie.com)), Jeffrey S. Hochman (212-728-8592, [jhochman@willkie.com](mailto:jhochman@willkie.com)), and in London please contact Gregory Astrachan (44-207-696-5442, [gastrachan@willkie.com](mailto:gastrachan@willkie.com)), or the partner who regularly works with you.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at [www.willkie.com](http://www.willkie.com).

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<sup>9</sup> See Exchange Act Section 32(a).