

October 22, 2002

SEC Proposes Rule Regarding Improper Influence on the Conduct of Audits

The SEC has proposed new Rule 13b2-2(b) regarding improper influence on the conduct of audits. The rule implements Section 303(a) of the Sarbanes-Oxley Act of 2002 (the "Act"). The requirements of the new rule will apply to all reporting companies, both U.S. and non-U.S.

The proposed rule would enhance existing rules and seek to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. The proposed rule prohibits 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.

I. Overview of the Rule

Section 303(a) of the Act requires 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 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 will be 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.

Proposed Rule 13b2-2(b), which substantially mirrors the language in section 303(a) of the Act, would further specifically prohibit:

- officers and directors, and persons acting under their direction,
- from fraudulently influencing, coercing, manipulating or misleading
- the auditor of the issuer's financial statements

- for the purpose of rendering the issuer's financial statements misleading.

Section 303(b) of the Act provides that the SEC shall have exclusive authority to enforce Section 303 and any rule or regulation issued thereunder. As a result, no private right of action would be created by the proposed rule.

II. Elements of the Rule

The following describe each of the four elements of proposed Rule 13b2-2(b).

A. Scope of Persons Covered

Proposed Rule 13b2-2(b) would 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 company'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. 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.

As proposed, Rule 13b2-2(b) also covers the activities of any other person acting under the *direction* of an officer or director of the issuer. In proposing the rule, the SEC indicated that it interpreted 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 they are not under the supervision or control of that officer or director. According to the SEC, such persons 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."

Persons acting under the direction of officers and directors 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 opinion on the issuer's financial statements.

The SEC has requested comment on whether the "under the direction" concept should be replaced with a statement that no person acting "at the behest of" or "on behalf of" an officer or director shall improperly influence the auditors. In the SEC's view, such language would make it clear that no specific direction by an officer or director is required to violate the proposed rules.

B. Conduct Covered

Proposed Rule 13b2-2(b)(1) addresses any action to fraudulently influence, coerce, manipulate, or mislead an auditor for the purpose of rendering the financial statements materially

misleading. Much of the conduct addressed by the proposed rule, 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. Interestingly, the SEC noted that they view the word “fraudulently” as only modifying “influence.” The SEC has also requested comment as to whether “fraudulently” should be replaced with “improperly,” to make clear the SEC’s view that a violation of the rule does not require *scienter*.

Types of conduct that the SEC believes might constitute improper influence 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.

The facts and circumstances of each case, including the purpose of the conduct (as discussed below), would be relevant to determining whether the conduct would violate the proposed rule. The SEC noted that the conduct may be actionable whether or not the purpose is achieved.

C. Conduct Directed at Auditors

Proposed Rule 13b2-2(b)(1) tracks the language in section 303(a) of the Act regarding the improper influence of an accountant “engaged in the performance of an audit” of the issuer’s financial statements. In proposing the new rule, 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, including during a review of interim statements 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. The proposed rule, therefore, would apply throughout the professional engagement 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.

According to the SEC, the proposed rule may even apply before the professional engagement period begins. For example, the proposed rule 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. "Purpose" Requirement

Under the proposed rule, a covered person would be acting "for the purpose of" rendering the issuer's financial statements materially misleading and therefore culpable if he or she knew, or was unreasonable in not knowing, that the improper influence could, if successful, result in rendering financial statements materially misleading. As proposed, *scienter* is not required. The SEC is seeking comment as to whether the rule should apply to conduct "having the effect of" as well as "for the purpose of" rendering the issuer's financial statements misleading.

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 fraudulently influenced, coerced, manipulated or misled not to perform audit or review procedures that, if performed, might divulge material misstatements in the financial statements.

According to the SEC, other examples of activities that would fall within the proposed rule would be for an officer, director, or person acting under an officer or director's direction, to improperly influence an auditor either not to withdraw a previously issued audit report when required by generally accepted auditing standards, or not to communicate appropriate matters to the audit committee.

III. Request for Comment on the Proposal and Alternatives

In the proposing release, the SEC made several requests for comments on the language that should be included in each of the four elements described above. As noted, the SEC also indicated that it is considering alternatives to the language that would have the effect of broadening the scope and coverage of the rule. The comment period is 30 days. The SEC is required to issue final rules implementing Section 303 of the Act by April 2003.

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Although on its face, the proposed rule 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), it does nonetheless increase the risk that in hindsight actions of management and other advisors relative to the audit process could be viewed as falling within its 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.

The recommendations set forth herein are intended to be general in nature. 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

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addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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