

Client Alert

A report
for clients
and friends
of the firm May 2003

SEC Adopts Rules Prohibiting Improper Influence by Corporate Executives and Third Parties on Conducts of Audits

On May 20, 2003, the Securities and Exchange Commission issued a release, Re. 34-47890 (the "Adopting Release"), announcing its adoption of rules required by Sec. 303 of the Sarbanes-Oxley Act of 2002 ("SOX"). These rules, which will become effective on June 27, 2003, prohibit officers and directors of a domestic or foreign company acting under their "direction" from taking actions to coerce, manipulate, mislead or fraudulently influence any auditor of the issuer's financial statements if the officer or director or other person knew or "should have known" that their action, if successful, could result in rendering the issuer's financial statements materially misleading.

Background

Sec. 303 of SOX provides that it is unlawful for any officer or director of an "issuer"¹ or any person acting under their direction to take any action to "fraudulently"² influence, coerce, manipulate or mislead any "independent public or certified accountant"³

engaged in performing an audit of that issuer's financial statements for "the purpose of" rendering that issuer's financial statements materially misleading. Sec. 303(c) provides that Sec. 303 does not preempt any other law or any rule or regulation under any other law.

Sec. 303 and the SEC's rules thereunder and the SEC's existing rules under section 13(b) of the Exchange Act are designed to protect and enhance the independent audit function by ensuring that management makes open and full disclosure to, and has honest discussions with, the issuer's auditors.

The SEC's existing rules under section 13(b)(2)-2 of the Exchange Act (enacted as part of the Foreign Corrupt Practices Act in the mid-1970s), Rules 13b2-1 and 13b2-2, prohibit "any person" falsifying or causing falsification of any book, record or account subject to section 13(b)(2)(A) of that Act and prohibit officers and directors 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 to make or cause to be made materially false or misleading statements or materially misleading omissions to an accountant.

The SEC's Rules- Rule 13b2-2⁴

Rule 13b2-2(a) provides that no "officer"⁵ or "director"⁶ of an issuer shall, directly or indirectly, make or cause to be made a materially false or misleading statement or omit to state or cause another person to omit to state any material fact necessary in order to

1 In Rule 13b2-2, the SEC uses the term "issuer" as defined in section 3 of the Securities Exchange Act of 1934 (the "Exchange Act") (essentially, any person who issues a security). This is a broader definition than the term "issuer" as defined in Sec. 2(a)(7) of SOX (essentially, most companies subject to reporting to the SEC under the Exchange Act.)

2 The term "fraudulently" in Sec. 303 could be read to modify "influence, coerce, manipulate or mislead" and, thus, require proof of intentional conduct to support a violation. The SEC, however, as discussed below, has interpreted the term "fraudulently" in Sec. 303, to modify only "influence" and, thus, intends to apply a negligence standard to acts that "coerce, manipulate or mislead".

3 This prohibition is not limited to improperly influencing an auditing firm registered in accordance with Title I of SOX (a "registered public accounting firm"). The prohibition also applies, for example, to improperly influencing an internal auditor.

4 The application of these rules to investment companies registered under the Investment Company Act of 1940 and to "business development companies", as defined under that Act, is not addressed in this client alert.

5 As defined in Rule 3b-2 under the Exchange Act. The term "officer" includes persons performing equivalent functions under local law and corporate governance practices for foreign private issuers.

6 As defined under section 3(a)(7) of the Exchange Act.

make the statements made, in light of the circumstances in which they were made, not misleading to an “accountant” (including an internal auditor), in connection with:

- Any audit, review or examination of the financial statements of the issuer required to be made under the SEC’s rules under section 13 of the Exchange Act; or
- The preparation or filing of any document or report required to be filed with SEC.

Rule 13b2-2(b)(1) provides that no officer or director of an issuer or any other person acting under their “direction” shall, directly or indirectly, take any action to coerce, manipulate, mislead or fraudulently influence (collectively, sometimes referred to as “improperly influence”) any independent public or certified accountant 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 the person knew or should have known the action, if successful, could result in rendering the financial statements materially misleading.

Note: Under the SEC’s Rule, a person’s intended purpose needed not be accomplished for there to be a violation of the Rule. Thus, the Rule covers the civil equivalent of an attempt under the criminal law.

Under Rule 13b2-2(b)(2), actions that could render a financial statement misleading include improperly influencing an accountant:

- To issue a report on 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 professional standards;
- Not to perform an audit in accordance with GAAS or other professional standards;
- Not to withdraw an issued report; or
- Not to communicate matters to the issuer’s audit committee.

Rule 13b2-2 covers the following types of conduct, among others:

- Offering or paying bribes or other financial incentives, including future employment or contracts for non-audit services;
- Providing an auditor with an inaccurate or misleading legal analysis;
- Threatening to cancel or canceling an existing no-audit engagement, if the auditor objects to the issuer’s accounting;

- Seeking to have an audit partner removed from the audit engagement because he or she objects to the issuer’s accounting; and
- Physical threats.

Standard of culpability. Notwithstanding the statutory language which appears to require that person act “fraudulently” with a “purpose” to render the issuer’s financial statements materially misleading, the SEC has imposed a negligence standard (“knew or should have known”) under Rule 13b2-2. The SEC believes that a negligence standard is appropriate in view of the legislative purpose of Sec. 303 and, particularly, in view of the absence of a private right of action under that Section and the SEC’s rules thereunder.

“Acting under the direction of”. The term “acting under the direction of [an officer or director of the issuer]” is not defined in Sec. 303 or rule 13b2-2. However, in the Adopting Release, the SEC has included an extensive discussion of what it means by the term. In the view of the SEC, the term encompasses a broader category of behavior than acting under “supervision” of an officer or director. It includes the issuer’s employees, customers, vendors or creditors who undertake, at the direction of an officer or director of the issuer, to provide false or misleading communications or confirmations to accountants or enter into side agreements that enable the issuer to mislead its accountants. The term also could include consultants or forensic accountants retained by counsel to the issuer, attorneys, market professionals or other advisers who pressure accountants to limit the scope of the audit, issue an unwarranted unqualified report or not object to inappropriate accounting treatment or not to withdraw an issued report.

Affects on third parties. Given the SEC’s broad interpretation of the term “acting under the direction of”, Rule 13b2-2 applies to persons who are not officers, directors or employees of an issuer; the issuer’s suppliers and customers, even though they may be private companies, but who provide confirmations to the issuer’s outside auditors, for example. While the SEC could and has, brought actions against persons submitting misleading confirmations, under aiding and abetting theories, aiding abetting requires proof of knowing conduct. Rule 13b2-2 only requires that the SEC prove that the defendant acted negligently. Thus, companies providing confirmations to auditors of issuers should consider internal procedures to provide reasonable assurance that their employees do not engage in acts that would violate Rule 13b2-2.

Since, among other things, the SEC in the Adopting Release, has stated that one type of conduct prohibited by Rule 13b2-2 is providing an auditor with an inaccurate or misleading legal analysis, the Rule could pose particular problems with respect attorneys responding to audit inquiry letters pursuant to the American Bar Association’s Statement of Policy

(December 1975), which has been accepted practice for almost 30 years. Under the statement policy, if an attorney, during the course of an engagement, concludes that there is an unasserted claim that would require disclosure in the issuer client's financial statements, the attorney must discuss the matter with the client. However, under the ABA Statement of Policy, the attorney can only address in the letter to the issuer's auditor those unasserted claims identified by the client in the inquiry letter. The client, which is in a better position than the attorney to judge materiality, may disagree with the attorney's assessment and not identify the unasserted claim in the inquiry letter.

Thus, the attorney may face the dilemma of choosing between violating an issuer client confidence or the attorney client privilege or risking a charge of negligently misleading the client's auditors. Such a result, seems inconsistent with the reporting "up the ladder" requirements of the SEC's attorney conduct rules under Sec. 307 of SOX. Under those rules, as currently in affect, the attorney's obligation is to report material violations of law or breaches of fiduciary duty to the issuer's chief legal officer and then, if the attorney does not receive a satisfactory response, to report up the ladder, eventually to the highest authority within the issuer, generally, the issuer's board of directors. Having done so, the attorney has satisfied his or her obligation under the SEC's rules. However, if the attorney is then required to report the suspected violation to a third party, the issuer's outside auditors, a purpose of the SEC's attorney conduct rules would appear to be frustrated.

Accordingly, law firms may have to reconsider their policies procedures and practices for responding to audit inquiry letters.

Enforcement

Under Sec. 303, the SEC has the exclusive authority to enforce Sec. 303 and its rules and regulations thereunder,⁷ although Sec. 303(c) also provides that Sec. 303(a) does not preempt any other provision of law. The SEC maintains, rightfully, that this provision was intended to preclude implied private rights of action under Sc. 303. However, it is a certainty that private plaintiffs will attempt to use Sec. 303 and the SEC's rules thereunder to their advantage.

Foreign Private Issuers

Rule 13b2-2 applies to the officers and directors of a "foreign private issuer" and those acting under their direction.

⁷ Presumably, the Department of Justice has the authority to bring criminal proceedings under Sec. 303 and Rule 13b2-2. Under sections 13(b)(4) and (5) of the Exchange Act a person may be prosecuted criminally for violating the accounting and internal controls provisions of section 13(b)(2) only if the person acted knowingly. However, Sec. 303 is not an amendment to section 13(b)(2); it is a stand alone provision, although violations of Sec. 303 and the rules thereunder are violations of the Exchange Act. See SOX Sec. 3(b).

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Small Business Issuers

Rule 13b2-2 applies to the officers and directors of a "small business issuer" and persons acting under their direction.

Conclusion

Rule 13b2-2, if administered prudently, could assist in restoring investor confidence in public companies and our financial markets. If administered with a heavy hand, given the SEC's imposition of a negligence standard under the Rule, the Rule could be a trap for the unwary and chill honest debate about accounting issues.

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