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Update

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SEC ADOPTS RULES TO PROHIBIT IMPROPER INFLUENCE ON CONDUCT OF AUDITS

On May 20, 2003, the Securities and Exchange Commission (the "SEC") adopted rules to prohibit actions deemed to constitute improper influence on the conduct of audits, as directed by Section 303(a) of the Sarbanes-Oxley Act of 2002 (the "Act"). See [Rel. No. 34-47890](#). The new rules supplement rules currently included in Regulation 13B-2 of the Securities Exchange Act of 1934 (the "Exchange Act"), which address the falsification of books, records and accounts and false or misleading statements, or omissions to make certain statements, to accountants.

Summary of New Exchange Act Rule 13b2-2

The new rules, which are enumerated at Rules 13b2-2(b) and (c), prohibit officers and directors of an issuer, and persons acting under their direction, from taking any action to coerce, manipulate, mislead or fraudulently influence (collectively referred to herein as "improperly influencing") the independent public or certified public accountant engaged to perform an audit or to review the financial statements of the issuer that are required to be filed with the SEC, when the officer, director or other person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading. In addition, current Exchange Act Rule 13b2-2 has been redesignated as Rule 13b2-2(a).

Application

New Rule 13b2-2(b) applies to any officer or director of the issuer, or any other person acting under the direction of an officer or director. The SEC has defined the term "issuer" to include any person who issues or proposes to issue any security with limited exceptions.¹ The new rules apply to foreign private issuers as well as domestic issuers.

New Rules 13b2-2(b) and (c) address the improper influence of any "independent public or certified public accountant." The term "independent public or certified public accountant" includes all accountants engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the SEC. "Independent public or certified public accountant" also includes accountants in foreign countries engaged 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.

New Rules 13b2-2(b) and (c) apply throughout the period of the independent or certified public accountant's professional engagement and after the engagement has ended when the accountant is considering whether to consent to the use, reissue or withdrawal of prior audit reports. In some circumstances, new Rules 13b2-2(b) and (c) may apply before the engagement begins.

Effectiveness

New Rule 13b2-2 becomes effective on June 27, 2003.

Persons Affected

New Rule 13b2-2(b) applies to any officer or director of the issuer, or any other person acting under the direction of an officer or director. The SEC has defined the term "officer" 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.² A person may be viewed as an "officer" regardless of the person's title or the legal entity with which he or she is associated. For example, officers of wholly owned subsidiaries of public companies and promoters may be "officers" of public companies.

The definition of "director" has a similar functional and flexible nature. The term "director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

In applying new Rule 13b2-2(b) to foreign private issuers, the terms "officer" and "director" would include those persons performing equivalent functions under the local laws and corporate governance practices where the issuer is domiciled.

In addition, new Rules 13b2-2(b) and (c) cover the activities of not only officers and directors, but also any other person acting under the direction of an officer or director. The adopting release interprets the use of the term "direction" in the Act to encompass a broader category of behavior than "supervision." Persons under "direction" may include not only the issuer's employees but also 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. Under certain circumstances, 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.

In the case of a registered investment company, the prohibitions extend to officers and directors of the investment company's investment adviser, sponsor, depositor, administrator or persons acting under their direction.

Prohibited Conduct—Coerce, Manipulate, Mislead or Fraudulently Influence

The adopting release provides that in the context of new Rules 13b2-2(b) and (c), the words "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. Because "fraudulently" modifies only the word "influence," an officer or director, or any person under the direction of such officer or director, can seek to influence, but not "fraudulently

influence,” the issuer’s independent auditors. New Rules 13b2-2(b) and (c) provide that improper influence does not depend on whether the influence is successful in affecting the audit or review.

New Rules 13b2-2(b) and (c) can be violated by conduct rising merely to the level of negligence (*e.g.*, providing negligently inaccurate or misleading legal analysis) because it uses the phrase “knew or should have known.” Although the adopting release states that the SEC does not intend to hold any third party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues, the SEC does believe that those third parties who, under the direction of an issuer’s officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to SEC sanctions.

The facts and circumstances of each case will be relevant to determining whether the conduct would violate the new rules. The adopting release provides the following nonexhaustive list of the types of conduct that might violate the rule:

- Offering or paying bribes or other financial incentives, including 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.

Rendering Financial Statements Misleading

To be actionable, one of the criteria is that the improper influence, if successful, could result in rendering the issuer’s financial statements materially misleading. New Rule 13b2-2(b)(2) provides a nonexhaustive list of examples of such actions an auditor might be improperly influenced to take that could render the issuer’s financial statements materially misleading:

- Issuing a report on the issuer’s financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards (“GAAS”), or other professional or regulatory standards);
- Not performing audit, review or other procedures required by GAAS or other professional standards;
- Not withdrawing an issued report; or
- Not communicating appropriate matters to an issuer’s audit committee.

No Private Right of Action

Section 303(b) of the Act provides the SEC with exclusive authority to enforce Section 303 of the Act and any rules or regulations issued under that section. Accordingly, there is no private right of action under new Rules 13b2-2(b) and (c).

Recommendations

It is evident from the language of the adopting release that the SEC intends to apply the prohibition of new Rule 13b2-2(b) as broadly as possible. An issuer may want to consider adopting the following measures to avoid problems under new Rule 13b2-2(b).

- **Identify the Persons Subject to the Prohibition.** The list of officers should include all of the persons described in Exchange Act Rule 3b-2 (and by reference from the adopting release, those “executive officers” included in Rule 3b-7). Additionally, the list should include persons who may interact with the auditors and are potentially viewed as being under the direction of the identified officers and directors.
- **Educate Persons Subject to the Prohibition.** The issuer should inform and train all of the officers identified as being subject to the prohibition as to the wide-ranging nature of the prohibition and their obligation to abide by it.
- **Adopt Internal Policy to Prohibit Conduct Covered by New Rules 13b2-2(b) and (c).** The issuer should consider adopting an internal policy to prohibit any conduct that could be potentially viewed as being prohibited by new Rules 13b2-2(b) and (c).
- **Establish Mechanism to Monitor Compliance.** The audit committee should consider establishing mechanisms to monitor compliance with the prohibition. The mechanisms could include (i) periodic meetings with the persons identified as being subject to the prohibition (and/or their supervisors) and (ii) periodic meetings with the auditor to determine whether the auditor believes that there has been any activity that could be viewed as an effort to improperly influence the conduct of an audit.

¹ The term “issuer” means any person who issues or proposes to issue any security; except with respect to certificates of deposit for securities, voting trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term “issuer” means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term “issuer” means the person by whom the equipment or property is, or is to be, used.

² By reference from the text of the adopting release, new Rule 13b2-2(b) would also apply to any “executive officer,” *i.e.*, the issuer’s president, any vice president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy-making functions for the issuer.