Final Rule Prohibiting Improper Influence on Conduct of Audits

The SEC recently adopted a final rule that prohibits officers and directors of an issuer, and others acting under their direction, from improperly influencing an independent public accountant engaged in an audit or review of financial statements required to be filed with the SEC if the person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading. This rule implements Section 303 of the Sarbanes-Oxley Act. The rule takes effect on or about June 19, 2003.

Prohibited Actions

Prohibited actions include, but are not limited to, any actions taken directly or indirectly to coerce, manipulate, mislead or fraudulently influence an auditor:

- to issue or reissue a report on an issuer's financial statements that is not warranted due to material violations of GAAP or other professional or regulatory standards;
- not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to an issuer's audit committee.

Persons Subject to the Rule

The new rule applies to "issuers" as defined in Section 3 of the Exchange Act. That definition generally covers a person who issues or proposes to issue securities, rather than the slightly narrower Sarbanes-Oxley definition of "issuer" that covers only companies required to file reports with the SEC and companies in registration. However, although the definition technically picks up private issuers, this should not have a practical impact because the new rule only covers auditors preparing financial statements *required to be filed with the SEC.*

In addition to officers and directors, the rule covers persons acting "under the direction" of an officer or director even though they may not be under the control or supervision of an officer or director. This group may include employees, customers, vendors and creditors of the issuer who, under the direction of an officer or director, provide false or misleading confirmations to the auditors or who enter into side agreements that enable the issuer to mislead the auditors. The rule also covers persons in the audit firm other than the auditors (such as consultants or forensic accountants) and attorneys and other advisers to the issuer who pressure the auditors to limit the scope of their audit, to issue an unwarranted report or to fail to object to an inappropriate treatment, withdraw a misleading report or communicate appropriate matters to the audit committee. The actions of these individuals are covered when they knew or should have known that the effect of their actions could be to render the issuer's financial statements materially misleading.

Examples of Prohibited Conduct

The adopting release offers the following "helpful" examples of conduct that could run afoul of the rule:

- 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.

Other activities, such as suggesting an inappropriate vendor response to an accountant's inquiry or opportunistically changing the scope of an audit engagement, would also be prohibited.

Negligence Standard

Officers and directors (or persons acting under their direction) need not have fraudulent or bad intent to violate the rule. The rule uses a negligence standard, so that a person who knew or should have known that his or her acts could result in materially misleading financial statements will be in violation of the rule. The SEC determined that a negligence standard was more appropriate than a fraud standard in view of the fact that the rule does not provide for private rights of action.

Investment Companies

The coverage of the rule is broader with respect to registered investment companies. The new rule adds a separate section to Rule 13b2-2 which provides that both the current prohibition on misleading statements or omissions to accountants and the new prohibition on improper influence on audits apply not only to the officers and directors of the investment company, but also to the officers and directors of its investment advisor, sponsor, depositor, trustee and administrator, as well as persons operating under the direction of any of the foregoing.

Contact Information

If you have any questions or would like to learn more about the new regulations, please contact the lawyer who normally represents you.