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SEC Proposed Rule 13b2-2:
Improper Influence on Conduct of Audits

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AMERICAN BAR ASSOCIATION – SECTION OF BUSINESS LAW
REGULATION OF FUTURES AND DERIVATIVES INSTRUMENTS
COMMITTEE MEETING

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SEC PROPOSED RULE 13b2-2:
IMPROPER INFLUENCE ON CONDUCT OF AUDITS

I. Introduction

By the time the program for which this paper is presented occurs, the Securities and Exchange Commission ("SEC") will most likely have a final rule 13b2-2. As of the date of this outline, it is expected that the rule as adopted will be approximately the same as the one in the proposing release ("Release"),[2] attached hereto.

Most importantly for this program is the impact of the rule on attorneys representing issuers, private or public, including broker-dealers and investment advisers, filing with the SEC financial statements audited or reviewed by independent public accountants. Audit letter responses, opinions and oral conversations by an attorney with an independent public account are within the scope of the rule. Attorneys will need to pay careful attention in responding to any auditor inquiries, oral or written, because any response to an independent public accountant regarding an issuer, publicly or privately, will necessarily be within the scope of the rule if the issuer's financial statements are filed with the SEC. Importantly, the omission of material information is actionable. Further, the rule may be violated even though there is no scienter. The rule also has as an underlying assumption as discussed below that all attorneys responding to an auditor's request understand generally accepted accounting principles and generally accepted

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auditing standards. Further, hindsight judgment may subject attorneys to significant regulatory liability under the rule, particularly in the absence of a scienter requirement. The only good news is that the rule does not create a private right of action.[3] These and other issues are discussed below.

II. Rule 13b2-2 As Proposed

Rule 13b2-2, as proposed, is relatively short. Set forth below is the proposed rule with certain key phrases and words underlined for emphasis. The rule as proposed reads as follows:

> Issuer's representations and conduct in connection with the preparation of required reports and documents.
>
> (a) No director or officer of an issuer shall, directly or indirectly:
>
> (1) Make or cause to be made a materially false or misleading statement; or
>
> (2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:
>
> (i) Any audit or examination of the financial statements of the issuer required to be made pursuant to this subpart; or
>
> (ii) The preparation or filing of any document or report required to be filed with the Commission to this subpart or otherwise.
>
> (b)(1) No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission if that person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading.

[2] Release No. 34-46685 October 18, 2002 (herein called the "Release").
[3] Release, FN 38.

(2) For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that "could, if successful, result in rendering such financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to fraudulently influence, coerce, manipulate, or mislead an auditor:

(i) To issue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other standards);

(ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(iii) Not to withdraw an issued report; or

(iv) Not to communicate matters to an issuer's audit committee.

(c) In addition, in the case of an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(48)), no officer or director of the company's investment adviser, sponsor, depositor, trustee, or administrator (or, in the case of paragraph (c)(2) of this section, any other person acting under the direction thereof) shall, directly or indirectly:

(1)(i) Make or cause to be made a materially false or misleading statement; or

(ii) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:

(A) Any audit or examination of the financial statements of the investment company required to be made pursuant to this subpart; or

(B) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise; or

(2) Take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that investment company that are required to be filed with the Commission if that person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading.

III. Analysis

A. The Term "ISSUER" is Broadly Defined to Include Any Issuer, Private or Public

The proposing Release in footnote 4 makes it clear that the SEC is applying the term "issuer" in Rule 13b2-2 as the term "issuer" is defined in Section 3(a)(8) of the Securities Exchange Act ("34 Act"),[4] which reads as follows:

> The term "issuer" means any person who issues or proposes to issue any security; except that 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 with respect to equipment-trust certificates or like securities or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

This means that the rule applies to any issuer, public or private. It would not apply to a sole proprietor and probably would not apply to a partnership, but any other type of entity that has an interest that is a security would qualify. This means that it will apply to privately held futures commission merchants ("FCM") that are broker-dealers and publicly held FCMs, commodity pools, CTAs and CPOs because all such entities file financial statements with the SEC.

[4] 15 U.S.C. 78c(a)(8).

The broad scope of the term "issuer" in Section 3(a)(8) goes well beyond the definition of issuer as defined in the Sarbanes-Oxley Act in Section 2(a)(7),[5] which section generally limits an issuer to one that has publicly held securities or is in the process of registering securities for distribution under the Securities Act of 1933.[6]

B. Subparagraph (a) of Rule 13b2-2.

Subparagraph (a) provides that no officer or director of an issuer shall "directly or indirectly" make any materially false or misleading statements or omit to state or cause another person to omit to state any material fact necessary in order to make statements made, in light of the circumstances in which such statements were made, not misleading "to an accountant in connection" with:

1. an audit or examination of financial statements of the issuer required to be made pursuant to this subpart; or

2. the preparation of any document or report required to be filed with the Commission pursuant to this subpart or otherwise (emphasis added).

The "or otherwise" appears to apply to any document or report involving an accountant. However, this broad provision of subparagraph (a) applying subparagraph (a) to any report or document "or otherwise" is not found in subparagraph (b) involving attorneys, but is found in subparagraph (c) involving attorneys acting at the direction of an investment company, its officers or directors.

C. Subparagraph (b) of Rule 13b2-2

Subparagraph (b) broadens the applicability of the rule to include attorneys by prohibiting an officer or director of an issuer or "any person acting under direction thereof" to

[5] Sarbanes-Oxley Act of 2002 (hereinafter defined as the "Act"); Pub. L. 107-204, 116 Stat. 745 (2002).
[6] 15 U.S.C. 77a, *et seq.*

> "directly or indirectly take <u>any</u> action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified public 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 Commission… (emphasis added)."

There is a further qualification that if the person "knew or <u>was unreasonable in not knowing</u> that such action could, if successful, result in rendering such financial statements materially misleading (emphasis added)."

Importantly, the language "for any other person acting under the direction" thereof seems to sweep in any attorney responding to an audit letter request, any attorney issuing an opinion at the request of a client, any attorney that discusses any matter with an accountant while employed, engaged or acting for an issuer. The SEC's proposing Release confirm the rule's broad scope.[7] Equally troublesome is the SEC's definition of "direction" in footnote 13 where the Release states:

> "<u>See, e.g.</u>, Webster's Dictionary (9th edition), which defines 'direction' to include not only guidance or supervision of action or conduct but also explicit instruction."

The SEC's Release indicates that within the words "fraudulently influence, coerce, manipulate, or mislead", only the word "influence" is limited by the word "fraudulently." Footnote 16 of the Release states that:

> "We view 'fraudulently' as modifying only 'influence.'"[8]

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[7] Release, p. 3.
[8] Release, FN 16.

Importantly, this would appear to mean that scienter may not be required for coercion or misleading. Manipulate has been held by the Supreme Court to require scienter and this would probably require scienter.[9]

The provisions of subparagraph (b)(2) are equally troubling. Subparagraph (b)(2) provides that "actions that 'could, if successful, result in rendering such financial statements materially misleading' include, but are not limited to, actions taken at any time with respect to the professional engagement period to fraudulently influence, coerce, manipulate, or mislead an auditor"[10] followed by a listing of specific conduct. The listed specific conduct includes:

> (i) To issue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other standards);
>
> (ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
>
> (iii) Not to withdraw an issued report; or
>
> (iv) Not to communicate matters to an issuer's audit committee (emphasis added).[11]

Underlying both (i) and (ii) above, is the assumption that an attorney responding to an auditor's request is completely familiar with generally accepted accounting principles, generally accepted auditing standards or "other standards". This assumption is compounded by the wording in (b)(1) that provides liability "if that person…was unreasonable in not knowing that such actions could if successful result in rendering such financial statements materially misleading." This seems to clearly impose an obligation to understand generally accepted accounting principles, generally

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[9] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
[10] Release, p. 10.

accepted auditing standards and "other standards". As discussed below, it is highly unlikely that most attorneys will understand generally accepted accounting principles, particularly Regulation S-X. It is less likely that most attorneys will understand generally accepted auditing standards. The other phrase, "other standards" is undefined. It seems difficult for an attorney to know what undefined "other standards" might be without knowing the minds of the staff of the SEC not to mention its five Commissioners. Furthermore, since the proposed rule applies to privately held issuers, many of whom will not have an audit committee, the failure to communicate with the issuer's audit committee is also troublesome.

D. Subparagraph (c) of Rule 13b2-2.

Subparagraphs (c)(1) and (c)(2) largely track the substance of subparagraphs (b)(1) and (b)(2) but with some important differences in that subparagraph (c) is an amalgamation of subparagraphs (a) and (b) with respect to investment companies and business development companies. Where subparagraph (b) is limited to financial statements, subparagraph (c) applies to any document or report filed with the SEC as does subparagraph (a). Importantly from the perspective of an attorney, subparagraph (c)(1), which includes activities of an attorney acting under the direction of an officer, director or the investment company, would include not only financial statements, but also "any document or report" filed with the SEC.

IV. Issues Confronting Attorneys

A. General

As noted above, Rule 13b2-2 will apply to any issuer, public or private, that files any financial statements, audited or not, required pursuant to the 34 Act, the rules thereunder or

[11] Release, p. 11.

otherwise required to be filed with the SEC under any other rule or provision. With respect to investment companies, the rule will apply to any report or document filed with the SEC, not just financial statements. Contrary to the mandate of the Sarbanes-Oxley Act which was intended to apply to public issuers, the SEC's rule extends far beyond Sarbanes-Oxley scope and will apply to attorneys and others acting at the direction of an issuer, whether public or privately held. Specifically, it seems to apply to broker-dealers that are also FCMs. The proposed rule may not apply to FCMs that are notice registered broker-dealers because they are permitted to file Form 1-FR containing financial statements with the Commodity Futures Trading Commission ("CFTC") in lieu of a FOCUS Report filed with the SEC under SEC Rule 17a-5.[12] Thus, the scope will include many audit letters, opinions and activities of attorneys acting for privately held FCM broker-dealers as well as publicly held CFTC registrants.

B. Assumption that Attorneys Know GAAP and GAAS

As discussed above, underlying Rule 13b2-2 is the basic assumption that persons including attorneys acting at the direction of an issuer understand generally accepted accounting principles and generally accepted auditing standards. The SEC has a simplistic and incorrect view that most or all attorneys are cognizant of all generally accepted accounting principles and of all generally accepted auditing standards. For example, in responding to an annual audit letter request regarding litigation, most attorneys are going to be unfamiliar with the generally accepted accounting principles and the generally accepted auditing standards that may be applicable regarding whether a contingent liability that might result from an adverse decision should be accrued, partially accrued, not accrued or disclosed in the footnotes to financial statements. As demonstrated above, the wording in subparagraph (b)(1) imposes without scienter a requirement

[12] 17 C.F.R. 240.17a-5(l)(4).

that a person “not be unreasonable in not knowing” that the person’s actions could if successful result in rendering such financial statements materially misleading. These words could be interpreted by the SEC to mean that an attorney’s lack of knowledge of generally accepted accounting principles or generally accepted auditing standards would be a defense, particularly if the principles are highly esoteric or sophisticated concepts. Hopefully the SEC will so interpret this wording. However, an opposite interpretation holding that attorneys would be unreasonable in responding to an audit letter without knowledge of generally accepted accounting principles and generally accepted auditing standards is also a possible interpretation. While this latter interpretation is highly unrealistic, the vague wording of the proposed rule could lead to such an interpretation. Hopefully the SEC will not interpret the rule by taking such an extreme position. However, the rule should be clarified.

C. Familiarity With Disclosures of the Issuer

In most cases, litigation counsel responding to an auditor’s request has never seen and probably never will see the financial statements that are proposed to be filed with the SEC or the issuer’s disclosures to the SEC. Nevertheless, the proposed rule seems to impose an obligation on any attorney responding to an auditor’s request to be familiar with the issuer’s prior disclosures to the SEC and the issuer’s financial statements. In most cases, litigation counsel and many other counsel that provide services to an issuer on a regular basis never see an issuer’s financial statements and never review its disclosures nor are they engaged to do so. Nevertheless, subparagraph (b)(1) may require an issuer’s counsel responding to an auditor’s response be familiar with the financial statements and disclosures of the issuer. Hopefully the SEC will issue some interpretation in the adopting release or change the rule so that it is clear that attorneys that

would not normally review the issuer's financial statements or disclosures would not be required to do so in responding to audit letter requests, particularly when attorneys is handling a limited piece of litigation.

D. Hindsight Application

The single biggest problem in the proposed rule is that it would obviously be applied with hindsight. This is compounded, as noted above, because the rule assumes that attorneys are familiar with generally accepted accounting principles, generally accepted auditing standards and the issuer's disclosures. In most cases, any deficiency will be a material non-disclosure, not an affirmative misstatement. Many attorneys that will be issuing audit response letters will not be familiar with the financial statements of the issuer, will not be familiar with generally accepted accounting principles or generally accepted auditing standards or what must be disclosed under the 33 Act or the 34 Act and Regulation S-X with respect to financial statements. This puts attorneys in an impossible position and exposes attorneys to significant regulatory liability. This is compounded in connection with opinions given in connection with underwritings or other corporate finance transactions, including mergers and acquisitions. The opinion may be given in connection with a transaction with no contemplation whatsoever of the use of the opinion by an auditor in connection with financial statements at a later date. For example, two privately held companies may merger and six months later be acquired by a publicly held company. The financial statements of the privately held issuers and attorneys' audit responses or opinions given in connection with the prior merger would be subject to the rule because of the consents required.

E. Audit Letter Responses

In responding to an issuer's request for a response to its auditors, attorneys will certainly be within the scope as contemplated by 13b2-2(b) and (c). Consequently, a host of issues arise. Attorney audit letter responses must be carefully drafted in accordance with the Auditors Letter Handbook containing the accord between the American Bar Association and the American Institute of Certified Public Accountants ("AICPA"). Because of Rule 13b2-2, attorneys' audit letter responses should be even more critically examined by committees of issuing law firms. Although it is unclear whether an audit letter response is a waiver of attorney-client privilege, it is expected that this will become an even bigger issue and will probably be tested.

Attorneys that are handling litigation and other matters on a one time or even on a regular basis but are not involved with financial statements or disclosures of the issuer will need to necessarily qualify their audit responses that they do not have available and have not seen any financial statements of the issuer. These opinions will probably disclaim advice, opinion or statement with respect to the impact of their response on the financial statements or disclosures of an issuer's SEC filing. Whether these disclaimers would be effective or not remains to be seen. It is clearly unfair to apply Rule 13b2-2 to an attorney that is handling an isolated piece of litigation and who does not have regular access to the financial statements of the issuer or its disclosures. A law firm may have to consider whether it wants to respond at all to an audit letter, other than to say that it is not in a position to give any response and gives no opinions because the law firm does not have available and is not involved with the issuer's financial statements or its disclosures. Alternatively, it is conceivable that attorneys handling a single piece of litigation for an issuer could want to conduct a full due diligence review of the issuer's disclosures at the issuer's financial

statement if requested to respond to an auditor's request. This seems far fetched, and most issuers would obviously refuse to pay for it. The SEC should provide guidance in this area.

Often, attorneys are asked by independent public accountants orally for additional information regarding their audit letter or for clarification. Because of the regulatory penalties that might be applied to an attorney, attorneys should be very careful in responding orally outside of the written audit request response. In any case, any response should be in writing and reviewed by the law firm's opinion committee. Some law firms may elect to refuse to discuss their audit letter responses at all, although this could result in the law firm being exposed to a claim of misleading the accountants by not responding. Rule 13b2-2 clearly puts attorneys in a dilemma that exposes them, particularly by hindsight judgment, to significant regulatory liability.

F. Opinions

Opinions for an issuer provided to an issuer's underwriter in connection with corporate transactions may be shared with independent public accountants. Attorneys may wish to specifically provide in their opinions that they will not be shared with independent public accountants without the consent in writing of the law firm. This should be done to avoid issuers using stale opinions with public accountants and to prevent the attorney from being charged with "misleading" an auditor.

G. Client Review of Audit Letter Responses

Attorneys may be reluctant to submit their audit letter responses to their clients for review as is usually done before the attorney releases an audit letter response. If the client asks for a change, it makes a record that can be used in the future to argue that the change was to mislead

the accountant. Alternatively, if the attorney doesn't have the letters reviewed by the issuer and doesn't know of a material understated development, the letter itself may result in material omission because it was not submitted to review by the issuer and its inside counsel.

H. Discussions with Accountants Regarding Corporate Transactions

It is not infrequent that accountants will discuss with attorneys that have been involved in structuring or documenting a corporate transaction the relevant documents and what they may mean. It appears that such discussions at the direction of a client or without the direction of a client (if the transactions were done for an issuer) would fall within the scope of the rule. The proper response is probably to inform the independent public accountants that they should consult with their own attorneys regarding any conclusions to be drawn from the documents. However, this approach has the downside that the failure to disclose something that is material could be actionable in and of itself.

V. Conclusion

Rule 13b2-2 is a significant trap for both the wary and the unwary attorney. It appears that every attorney may be held to a standard of expert knowledge with respect to generally accepted accounting principles and generally accepted auditing standards and will require attorneys to be familiar with every issuer's financial statements and disclosures. Since this is an impossibility, even if an attorney has all of those qualifications and since the rule will operate by hindsight without a scienter standard, it exposes even the most sophisticated counsel to liability in dealing with an independent public accountant. For most attorneys who are not familiar with generally accepted accounting principles or generally accepted auditing standards, and have no knowledge regarding the company's public disclosures, audited financial statements, the lack of scienter and

hindsight application exposes them to an even greater extent. It raises the question whether attorneys, in order to protect themselves, will limit their audit letter responses and opinions to disclaim knowledge of generally accepted accounting principles or generally accepted auditing standards and the issuer's financial statements and disclaimer? Will such disclaimers be accepted by the SEC? In addition, should the American Bar Association significantly revise the Accord between the American Bar Association and the AICPA with respect to audit letter responses? It seems that the time has come to do so. It also appears that informal communication with independent public accountants will be limited, if not eliminated, as a result of the rule. One seriously wonders whether this rule is in the public interest and defeats the mandated goal of Congress in the Sarbanes-Oxley Act. Hopefully the final rule and adopting release will provide clarification.

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