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# Advisory

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## SECURITIES LAW

### Improper Influence of Audits and Retention of Auditor Records

In response to the mandates of Sections 303(a) and 802 of the Sarbanes-Oxley Act of 2002 (the "Act"), the Securities and Exchange Commission (SEC) recently issued final rules regarding:

- the improper influence by officers, directors and persons acting under their direction on the conduct of an audit of an issuer's financial statements, and
- the retention by auditors of records relating to audits and reviews of financial statements.

Both of these sets of rules are aimed at ensuring the integrity and reliability of issuers' financial reporting processes and their relationships with their auditors, in light of the accounting and financial reporting irregularities that led to the passage of the Act.

The rules relating to improper influence on the conduct of an audit will take effect on **June 27, 2003**, and compliance with the rules relating to retention of audit records will be required for all audits and reviews that are completed after **October 31, 2003**.

### Improper Influence on Conduct of Audits

Under the requirements of Section 303(a) of the Act, the SEC issued final rules to prohibit officers and directors of an issuer, and persons acting under their direction, from taking any action to *coerce, manipulate, mislead, or fraudulently influence* the auditor of the issuer's financial statements, if those persons knew or should have known that their actions, if successful, could result in rendering the issuer's financial statements materially misleading.<sup>1</sup>

<sup>1</sup> Final Rule, "Improper Influence on Conduct of Audits," Release Nos. 34-47890; IC-26050; FR-71; File No. S7-39-02, dated May 20, 2003. A full copy of the Release is available from the SEC's website at <http://www.sec.gov/rules/final/34-47890.htm>.

The new rules also provide that officers and directors of an issuer may not, directly or indirectly, make a materially false or misleading statement (or omit to state a material fact necessary to make such statements not misleading) to an accountant in connection with any audit, review or examination of the issuer's financial statements, or the preparation or filing of any document or report that is required to be filed with the SEC.<sup>2</sup>

The SEC notes that these rules are designed to ensure that management of an issuer makes open and full disclosure to, and has honest discussions with, the issuer's independent public accountants, and that the officers or directors of an issuer, or persons acting under their direction, do not thwart the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings.

***Who may be "under the direction" of officers and directors of an issuer for purposes of these rules?***

The SEC notes that the category of persons who may be under the "direction" of an issuer for purposes of these rules is meant to be even broader than the category of persons who may be under the "supervision" or "control" of an issuer. Such persons may include:

- employees of the issuer;
- customers, vendors, or creditors of an issuer, if they provide false or misleading confirmations or other false

or misleading information to the issuer's auditors, or enter into "side agreements" that enable the issuer to mislead the auditor; and

- partners or employees of the auditor itself, such as consultants or forensic accounting specialists retained by counsel for the issuer, or attorneys, securities professionals or other advisers to the issuer, if they 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, not to object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer's financial statements,

in each case if such persons were acting under the direction of the issuer's officers or directors, and if they *knew* or *should have known* that the effect of their conduct would be to render the issuer's financial statements materially misleading. The SEC notes that these rules are not intended to hold any party accountable under these rules for making "honest and reasonable mistakes or to sanction those who actively debate accounting or auditing rules." However, the SEC makes clear that the "should have known" element of the rules will be applied to capture conduct that is merely negligent, as opposed to active and intentional, if the effect of such conduct would be materially misleading financial statements.

***What types of conduct may be seen as violating these rules?***

Rule 13b2-2 under the Exchange Act, as amended by this rule release, states that

an officer, director or persons acting under their direction will violate the rule, and could render the issuer's financial statements materially misleading, if they coerce, manipulate, mislead or fraudulently influence an auditor, among other things:

- to issue or reissue a report on an issuer's financial statements that is not warranted under the circumstances, due to material violations of generally accepted accounting principles, generally accepted auditing standards, 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 necessary matters to an issuer's audit committee.

In addition, the adopting release includes the following non-exclusive list of the types of conduct that the SEC would view as constituting improper influence in violation of these rules:

- offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- providing an auditor with an 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;

<sup>2</sup> The SEC notes in the release that the definition of "issuer" for purposes of these rules is different from the definition of that term as used in other sections of the Act. Under these rules, the applicable definition is the same as that set forth in Section 3 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which generally provides that an issuer is "any person who issues or proposes to issue any security." Under the Act, the term issuer is generally defined to mean entities (i) whose securities are registered with the SEC under Section 12 of the Exchange Act, (ii) that are required to file reports with the SEC under Section 15(d) of the Exchange Act, or (iii) that have filed registration statements with the SEC that have not yet become effective and have not been withdrawn. The SEC notes that it does not believe that the use of the definition from Section 3 of the Exchange Act will extend the application of these rules to cover private issuers of securities, because the rule by its terms applies to improperly influencing auditors of financial statements "that are required to be filed with the Commission." However, it does appear that this formulation of the definition could require compliance by officers, directors and those under their direction at private companies, if the audited financial statements of those companies are required to be included in a document filed with the SEC (such as a proxy statement or registration statement filed in connection with a merger of a private company with a public company).

- seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- blackmailing;
- making physical threats;
- knowingly providing to the auditor inadequate or misleading information that is key to the audit; and
- when predicated by an intent to defraud, verbal abuse, creating undue time pressure on the auditors, not providing information to auditors on a timely basis, and not being available to discuss matters with auditors on a timely basis,

in each case if the person engaging in this conduct knows or should know that the conduct, if successful, could result in making the issuer's financial statements materially misleading.

The SEC notes that the individual facts and circumstances of each case will be examined in determining whether a particular course of conduct has violated the rule. Further, it is not necessary that the prohibited conduct actually succeed in causing the financial statements to become materially misleading in order to constitute a violation of these rules.

***When will these types of actions be prohibited?***

The final rules provide that officers, directors and persons acting under their direction may not engage in conduct that violates these rules during any period from the time the accountant is selected to perform audit or review services for an

issuer, and continuing until there is a formal or informal public notification that the professional relationship has ended. This period does not just include activities taking place during the annual audit of the issuer's financial statements, but also includes negotiations with respect to the hiring of an auditor, the review by an auditor of quarterly financial statements, and activities associated with the issuance of a consent to the use of an auditors' report [for example, for purposes of including such a report in a registration statement to be filed under the Securities Act of 1933, as amended (the "Securities Act")].

***Do these rules include a private right of action for violations?***

These rules expressly provide that a private right of action is *not* available to enforce these requirements. Accordingly, only the SEC may bring an action to enforce these rules. The SEC notes that most of the actions described in the rules are already prohibited under the SEC's existing anti-fraud and other rules designed to impose standards of candor and honesty on issuers. These new rules will simply give the SEC another tool to use in enforcement actions, if necessary. The SEC has indicated to us informally that it is likely to continue its past practice of bringing enforcement actions directly against individual officers, directors and persons under their direction, including customers and lower-level employees, if those persons are found to have violated these rules.<sup>3</sup> The remedies sought by the SEC in these enforcement actions appear to have been limited to the issuance of

cease-and-desist orders, requiring the individuals involved to refrain from any conduct in violation of these rules.

***Do these rules also apply to small business issuers and foreign private issuers?***

Yes; the SEC made no exception to these rules for foreign private issuers or small business issuers.

## **Retention of Records Relevant to Audits and Reviews**

In order to address the destruction or fabrication of evidence relating to financial and audit records, and to provide concrete standards for the preservation of those records, Section 802 of the Act directed the SEC to promulgate rules for the retention of records related to the audits and reviews of financial statements that are filed by issuers with the SEC. The final rules adopted by the SEC under Section 802 require accountants who audit or review an issuer's financial statements to retain certain records relevant to that audit or review for a period of seven years after the completion of the audit or review.<sup>4</sup>

***When does the record retention requirement apply?***

The record retention requirement applies when there has been an audit or review by an accountant of an issuer or any registered investment company. The retention requirements also apply equally to small business issuers and to domestic and foreign accounting firms auditing the financial statements of foreign issuers.

<sup>3</sup> See, e.g., *In the Matter of Ronald G. Davies*, Accounting and Auditing Enforcement Release (AAER) No. 1281 (June 29, 2000) (SEC enforcement action brought against an executive vice president of a customer of the issuer, for providing "a misleading audit response" to the issuer); *In the Matter of John K. Bradley*, AAER 1568 (June 5, 2002) (SEC enforcement action brought against the collections manager of an issuer, for providing incomplete year-end deferred revenue reports to the issuer's auditors, at the direction of the issuer's chief financial officer); and *In the Matter of Donald F. Marcus*, AAER 1712 (February 10, 2003) (SEC enforcement action brought against a sole proprietor and distributor of the products of an issuer, who participated in a scheme to mislead the issuer's auditors through the use of falsified purchase orders and a "script of misrepresentations" used in connection with an audit committee investigation).

<sup>4</sup> Final Rule, "Retention of Records Relevant to Audits and Reviews," Release Nos. 33-8180; 34-47241; IC-25911; FR-66; File No. S7-46-02, dated January 24, 2003. A full copy of the Release is available from the SEC's website at <http://www.sec.gov/rules/final/33-8180.htm>.

Although the application of the rule is restricted to the audits and reviews of the financial statements of issuers and registered investment companies, the SEC notes in the release that it does not condone more liberal document destruction policies for audit records relating to other entities. For example, the SEC notes that it would expect the auditors of financial statements of investment advisers, broker-dealers, and entities subject to the Municipal Securities Rulemaking Board to retain relevant audit and review records consistent with applicable laws, regulations and professional standards.

***What documents must be retained?***

The final rule requires that the auditor retain records relevant to the audit or review of an issuer’s financial statements, including workpapers and other documents that form the basis of the audit or review, memoranda, correspondence, communications, and other documents and records, including electronic records, provided that such documents meet two criteria:

- the materials are created, sent or received in connection with the audit or review, and
- the materials contain conclusions, opinions, analyses, or financial data related to the audit or review.

Section 802 of the Act requires the retention of more documents than have traditionally been considered to be auditors’ workpapers and therefore subject to retention under existing rules. Accordingly, to clarify the distinction between workpapers and other documents to be retained, the SEC has defined the term “workpapers” in the final rule. Documents to be considered workpapers include the following:

- documentation of auditing or review procedures applied;
- evidence obtained; and

- conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the SEC or by the Public Company Accounting Oversight Board.

As noted below under “*What documents do not fall within the scope of the rule?*”, documents that are created by audit clients and reviewed or examined as part of the audit process will not be required to be retained by auditors unless they become part of the auditors’ workpapers or are otherwise retained by the auditor as part of the audit.

In addition, the SEC believes that records containing significant information that is *inconsistent* with the auditors’ final conclusions would be relevant to an investigation of possible violations of the securities laws, SEC rules, or criminal laws. Accordingly, auditors must retain not just records that support their final conclusions with respect to the audit or review, but also records that potentially contradict their final conclusions.

***What documents do not fall within the scope of the rule?***

Non-substantive materials, such as administrative records, that are not part of the auditors’ workpapers, and other documents that do not contain relevant financial data or the auditors’ conclusions, opinions or analyses relating to the audit or review generally do not fall within the scope of the rule.

In addition, the following documents generally do *not* fall within the scope of the rule:

- superseded drafts of memoranda, financial statements or regulatory filings;
- notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking;

- previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees;
- duplicates of documents; *or*
- voice-mail messages.

However, as noted above, all materials, including those in the list above, containing information or data related to a significant matter that proves to be inconsistent with the auditor’s final conclusions, opinions or analyses on that matter, or that are inconsistent with the audit or review in general, are considered relevant and must be retained.

The SEC also noted that it would not require retention under this rule of all of the issuer’s financial information, records, databases, and reports that the auditor examines on the issuer’s premises, but that are not made part of the auditor’s workpapers or otherwise retained by the auditor. Accordingly, unless documents that are provided by a company for review as part of the audit process are made part of the workpapers or are kept by the auditor, auditors will not be required to retain such documents.

***What steps must a company take now in response to these rules?***

Issuers themselves are not required to take any specific actions in light of these rules. However, issuers should be aware that their auditors are subject to these new rules, and will accordingly be keeping records relating to their audits and reviews pursuant to these new guidelines, and are likely to implement new record retention policies and procedures reflecting these rules.

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*Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions or concerns regarding this information.*