

rendering the financial statements materially misleading.

Many commenters indicated that the examples in paragraph (b)(2) were appropriate and should be retained.<sup>86</sup> Some commenters suggested that the list of examples be expanded to include improperly influencing the auditor to permit the inconsistent use of generally accepted accounting principles ("GAAP") or the use of "non-preferable" GAAP in the issuer's financial statements.<sup>87</sup> Others suggested including improperly influencing an auditor in connection with the auditor's report on an issuer's assertions about its internal controls.<sup>88</sup> Another commenter suggested that the examples be replaced with a statement that actions that could result in "rendering the financial statements materially misleading" include improperly influencing an auditor during the performance of any procedures by the auditor.<sup>89</sup> We believe that the list of examples in paragraph (b)(2) is sufficiently broad to include the majority of instances, including under appropriate circumstances those addressed by commenters, where improperly influencing an auditor could result in the issuer publishing misleading financial statements. As noted above, the list of examples is not all-inclusive. Other actions, in appropriate circumstances, could result in rendering the issuer's financial statements materially misleading.

"Knew or should have known."

Section 303(a) states that conduct by an officer, director, or person acting under the direction of the officer or director designed to improperly influence an issuer's auditor is actionable if undertaken "for the purpose of rendering [the issuer's] financial statements materially misleading." We proposed, however, the rule state that an officer, director, or person acting under the direction of the officer, who engaged in conduct to improperly influence an auditor would be culpable if he or she "knew or was unreasonable in not knowing" that the improper influence, if successful, could result in

rendering financial statements materially misleading. In the proposing release we noted that we would consider changing this wording to another phrase to convey that proving a particular purpose or intent is not required. We are adopting in the final rule the phrase "knew or should have known," which historically has indicated the existence of a negligence standard.<sup>90</sup> As noted elsewhere in this release, this standard is consistent with the Commission's enforcement actions in this area.<sup>91</sup>

Several commenters suggested that the rule should contain the statutory language, which they believe requires a fraudulent intent, instead of the proposed language, which they believe reflected a negligence standard.<sup>92</sup> Other commenters, however, indicated that the proposed language should be adopted<sup>93</sup> or that, at a minimum, a reasonableness standard is appropriate when evaluating the actions of officers and directors.<sup>94</sup>

We believe that the adopted language, particularly in the absence of any private right of action under the rule,<sup>95</sup>

<sup>90</sup> See, e.g., section 21C(a) of the Exchange Act, 15 U.S.C. 78u-3, which authorizes the Commission to order a person to cease and desist from committing or causing violations, or future violations, of the federal securities laws due to actions that the person "knew or should have known" would contribute to the violation, and *KPMG LLP v. Securities and Exchange Commission*, 289 F. 3d 109, 126 (D.C. Cir. 2002), which states, "We affirm the Commission's determination that negligence is an appropriate basis for violations underlying a Section 21C cease-and-desist order. \* \* \*

<sup>91</sup> See, e.g., *In the Matter of Donald F. Marcus and In the Matter of Harry P. Adler*, AAE 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAE 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAE 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAE 720 (September 26, 1995).

<sup>92</sup> See, e.g., letters from Wells Fargo dated November 22, 2002, Dorsey and Whitney LLP dated November 25, 2002, Sullivan & Cromwell dated November 25, 2002, The Business Roundtable dated November 29, 2002, America's Community Bankers dated November 25, 2002, Steven Hazen dated November 25, 2002, New York State Bar Association dated November 25, 2002, KPMG LLP dated November 25, 2002, and Plains All American Pipeline LP dated November 25, 2002.

<sup>93</sup> See, e.g., letters from the American Institute of Certified Public Accountants dated November 25, 2002 and the National Association of State Boards of Accountancy dated November 25, 2002.

<sup>94</sup> See, e.g., letter from Ernst & Young LLP dated November 25, 2002.

<sup>95</sup> We believe that the mental state requirements of the rules generally should be construed consistently with the existing rules in Regulation 13B-2. Because there is no private right of action, among other reasons, the Commission believes that a lesser standard of liability is appropriate. See Release No. 34-15570 (February 15, 1979); 44 FR 10970. See also, Report of the Committee on Banking, Housing, and Urban Affairs, To Accompany S. 2673, "Public Company Accounting Reform and Investor Protection Act of 2002," 107th

best achieves the purpose of restoring investor confidence in the audit process.<sup>96</sup> For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("GAAS") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule. Excusing this conduct from the scope of the rule would be inconsistent with the restoration of investor confidence in financial statements and in the integrity of the audit process.

*Response to Other Significant Comments.* In the proposing release, we asked if we should replace the statement in paragraphs (b)(1) and (c) of the rule that no person acting "under the direction" of an officer or director shall improperly influence the auditors of the issuer's financial statements, with a statement that no person acting "at the behest of" or "on behalf of" an officer or director shall improperly influence the auditors. Although some commenters supported use of the phrase "on behalf of,"<sup>97</sup> in general commenters opposed changing this aspect of the proposed rule.<sup>98</sup> We agree that there may be circumstances where a person acting on behalf of an officer or director would be considered to be acting under the direction of that officer or director as contemplated by the rule. We believe, however, that the rule, as proposed and adopted, is sufficiently clear. Replacing

Cong., 2d Sess., (S.R. 107-205), at 26 (Comm. Print, July 3, 2002), which cites as a reason for enacting section 303 the testimony of witnesses who were concerned with addressing fraud and other "misconduct in the audit process."

<sup>96</sup> See *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAE 720 (September 26, 1995), which states, in part, "The Commission will not tolerate conduct by third party vendors \* \* \*, which poses a very real threat to the integrity of the disclosure process."

<sup>97</sup> See, e.g., letters from Transparency International—USA dated November 8, 2002, National Association of State Boards of Accountancy dated November 25, 2002, and Independent Community Bankers of America dated November 25, 2002.

<sup>98</sup> See, e.g., letters from the American Bar Association dated December 13, 2002, The Business Roundtable dated November 29, 2002, the New York State Bar Association dated November 25, 2002, BDO Seidman LLP dated November 25, 2002, Ernst & Young LLP dated November 25, 2002, and the National Association of Real Estate Investment Trusts dated November 25, 2002.

<sup>86</sup> See, e.g., letters from National Association of State Boards of Accountancy dated November 25, 2002, Independent Community Bankers of America dated November 25, 2002, Plains All American Pipeline LP dated November 25, 2002, Ernst & Young LLP dated November 25, 2002, and PwC dated November 25, 2002. One commenter, however, suggested that the list of examples be removed. Letter from Intel Corporation dated November 25, 2002.

<sup>87</sup> Letter from Robert Waxman dated November 25, 2002.

<sup>88</sup> Letter from Transparency International—USA dated November 8, 2002.

<sup>89</sup> Letter from Deloitte & Touche dated November 27, 2002.