is certified that this proposed rule would not have significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (air).

The Proposed Amendment

In consideration of the foregoing, the Federal Aviation Administration proposes to amend 14 CFR Part 71 as follows:

PART 71—[AMENDED]

1. The authority citation for 14 CFR part 71 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40103, 40113, 40120; E.O. 10854; 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389.

§ 71.1 [Amended]

2. The incorporation by reference in 14 CFR 71.1 of Federal Aviation Administration Order 7400.9K, Airspace Designations and Reporting Points, dated August 30, 2002, and effective September 16, 2002, is proposed to be amended as follows:

Paragraph 6005 Class E airspace areas extending upward from 700 feet or more above the surface of the earth.

* * * * *

AEA PA E5 Philadelphia, PA [Revised]

Philadelphia International Airport
(Lat. 39°52′19″ N., long. 75°14′28″ W.)
Chester County G. O. Carlson Airport, PA
(Lat. 39°58′44″ N., long. 75°51′56″ W.)
New Castle County Airport, DE
(Lat. 39°40′43″ N., long. 75°36′24″ W.)
Summit Airpark, DE
(Lat. 39°31′13″ N., long. 75°43′14″ W.)
Millville Municipal Airport, NJ
(Lat. 39°22′05″ N., long. 75°04′25″ W.)

That airspace extending upward from 700 feet above the surface within a 31-mile radius of Philadelphia International Airport extending clockwise from a 225° bearing to a 307° bearing from the airport and within a 37-mile radius of Philadelphia International Airport extending from a 307° bearing to a 053° bearing from the airport and within a 33-mile radius of Philadelphia International Airport extending from a 053° bearing to a 173° bearing from the airport and within a 10-mile radius of Philadelphia International Airport extending from a 173° bearing from the airport and within a 7-mile radius of Chester County G. O. Carlson Airport and within a 6.7-mile radius of New Castle County Airport and within a 8-mile radius of Summit Airpark and within a 6.5-mile radius of Millville Municipal Airport, excluding the airspace that coincides with the Wrightstown, NJ; Pittstown, NJ; Princeton, NJ; Reading, PA; and Allentown, PA Class E airspace areas.

* * * * *

Issued in Jamaica, New York, on October 9, 2002.

John G. McCartney,

Acting Assistant Manager, Air Traffic Division, Eastern Region.

[FR Doc. 02–26583 Filed 10–23–02; 8:45 am]

BILLING CODE 4910–13–M

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release Nos. 34–46685; IC–25773; File No. S7–39–02]

RIN 3235–AI67

Improper Influence on Conduct of Audits

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: As directed by Section 303(a) of the Sarbanes-Oxley Act of 2002, we are proposing rules to prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading.

DATES: Comments should be received on or before November 25, 2002.

ADDRESSES: You should send three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. You also may submit your comments electronically to the following address: *rule-comments@sec.gov.* Please use only one method of delivery. All comment letters should refer to File No. S7–39–02; this file number should be included in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549–0102. We will post electronically-submitted comment letters on the Commission's Internet Web site (*http://www.sec.gov*). We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael J. Kigin, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, at (202) 942–4400, Office of the Chief Accountant, or Fiona A. Philip, Senior Counsel, or David M. Estabrook, Associate Chief Accountant, at (202) 942–4510, Division of Enforcement, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing to redesignate rule 13b2–2 of Regulation 13B–2[1] as rule 13b2–2(a) and to add new rule 13b2–2(b).

I. Executive Summary

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the ''Act'')[2] was enacted. Section 303(a) of the Act states:

> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

As mandated by the Act, the Commission is proposing rules to implement section 303(a).[3] The proposed rules, in combination with the existing rules under Regulation 13B–2, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. These rules prohibit officers or directors of an issuer,[4] or persons acting under

[1] 17 CFR 240.13b2–1 *et seq.*

[2] Pub. L. 107–204, 116 Stat. 745 (2002).

[3] Section 303 of the Act states:

(a) RULES TO PROHIBIT.—It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

(b) ENFORCEMENT.—In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.

(c) NO PREEMPTION OF OTHER LAW.—The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.

(d) DEADLINE FOR RULEMAKING.—The Commission shall ''

(1) propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules or regulations required by this section, not later than 270 days after that date of enactment.

[4] The proposed rules would be included in Regulation 13B–2 under the Securities Exchange

Continued

their direction, from subverting 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.

II. Discussion of Proposed Rules

A. Introduction

The proposed rules would supplement the rules currently in Regulation 13B–2. The current rules address the falsification of books, records and accounts [5] and false or misleading statements, or omissions to make certain statements, to accountants.[6] Proposed rule 13b2–2(b)(1), which substantially would mirror the language in section 303(a) of the Act, specifically would prohibit officers and directors, and persons acting under their direction, from fraudulently influencing, coercing, manipulating or misleading the auditor of the issuer's financial statements for the purpose of rendering the issuer's financial statements misleading. Proposed rule 13b2–2(b)(2) would provide examples of actions that improperly influence an auditor that could result in ''rendering the issuer's financial statements materially misleading.'' This paragraph also would clarify that such actions should not occur at any time in connection with the professional engagement.

B. Discussion

Proposed rule 13b2–2(b)(1) would address activities by an officer or director of an issuer, or any other person acting under the direction of an officer or director. The Commission has defined the term ''officer'' to include the company's ''president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated.'' [7] The term ''officer'' includes an issuer's chief executive officer and other executive officers.[8]

Should We Amend the Definition of ''Officer'' in Rule 3b–2 To Include Specific References to Additional Individuals and Entities Who May Perform ''Corresponding Functions''? Should We Amend Regulation 13B2 To Craft a Special Definition of a Public Company Officer for the Purposes of that Regulation? If We Amend Rule 3b–2 or Regulation 13B–2, Who Should Be Included or Excluded From the Definition of ''Officer''?

As noted above, proposed rule 13b2–2(b)(1) would cover the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also ''any other person acting under the direction thereof.'' Activities by such ''other persons'' currently may constitute violations of the anti-fraud or other provisions of the securities laws [9] or aiding or abetting [10] or causing [11] an issuer's violations of the securities laws. Section 303(a) and the proposed rule would provide the Commission [12] with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer's financial statements. We interpret Congress' use of the term ''direction'' to encompass a broader category of behavior than ''supervision.''[13] In other words, someone may be ''acting under the direction'' of an officer or director even if they are not under the supervision or control of that officer or director. Such persons might include not only the issuer's employees but also, for example, 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.'' In appropriate 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 who, for example, 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,[14] to not object to an inappropriate accounting treatment, or not to withdraw an issued opinion on the issuer's financial statements. In the case of a registered investment company, persons acting under the direction of officers and directors of the investment company may include, among others, officers, directors, and employees of the investment company's investment adviser, sponsor, depositor, administrator, principal underwriter,

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Act of 1934 (''Exchange Act''). Section 3(a)(8) of the Exchange Act, 15 U.S.C. 78c(a)(8), defines ''issuer'' 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, the term ''issuer'' means the person by whom the equipment or property is, or is to be, used.

[5] 17 CFR 240.13b2–1 states that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Exchange Act. Section 13(b)(2) of the Exchange Act states:

Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

[6] 17 CFR 240.13b2–2 states that no director or officer of an issuer, in connection with an audit or examination of the issuer's financial statements or the preparation of any document or report to be filed with the Commission, directly or indirectly shall (a) make or cause to be made a materially false or misleading statement to an accountant or (b) omit to state, or cause another person to omit to state, any material fact necessary to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant.

[7] Rule 3b–2 under the Exchange Act, 17 CFR 240.3b–2. A person may be an ''officer'' for purposes of Rule 3b–2 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'' under the Exchange Act has a similar functional and flexible nature. *See* section 3(a)(7) of the Exchange Act, 15 U.S.C. 78c(a)(7), which states, ''The term 'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.''

[8] Rule 3b–7 under the Exchange Act, 17 CFR 240.3b–7, states, ''The term ''executive officer,'' when used with reference to a registrant, means its president, vice president of the registrant 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 registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.''

[9] See, *e.g.*, Section 10(b) of the Exchange Act, 15 U.S.C. 78j, and Rule 10b–5 thereunder, 17 CFR 240.10b–5.

[10] See, *e.g.*, section 20(e) of the Exchange Act, 15 U.S.C. 78t(e).

[11] See, *e.g.*, section 21C of the Exchange Act, 15 U.S.C. 78u–3.

[12] Section 303(b) of the Act states, ''The Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.''

[13] See, *e.g.*, Webster's Dictionary (9th edition), which defines ''direction'' to include not only guidance or supervision of action or conduct but also explicit instruction.

[14] ''An 'unqualified opinion' [or unqualified report] states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.'' AICPA, Statement on Auditing Standards No. (''SAS'') 58, ''Reports on Audited Financial Statements,'' ¶ 10; Codification of Statements on Auditing Standards (''AU'') § 508.10.

custodian, transfer agent, or other service providers.[15]

Should We Define by Rule the Scope of ''Any Other Person Acting Under the Direction'' of an Officer or Director?

Proposed rule 13b2–2(b)(1) addresses ''any action to fraudulently influence, coerce, manipulate, or mislead'' the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading. Much of the conduct addressed by this section, particularly efforts to ''manipulate or mislead'' the auditor, generally would be subject to other provisions of the securities laws and the Commission's regulations, including the existing rules in Regulation 13B–2. The proposed rule, however, would provide an additional means to address conduct to fraudulently influence,[16] coerce, manipulate, or mislead an auditor during his or her examination or review of the issuer's financial statements, including conduct that did not succeed in affecting the audit or review.[17] Types of conduct that the Commission believes might constitute improper influence include, but are not limited to, directly or indirectly:

- 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.

The facts and circumstances of each case, including the purpose of the conduct (as discussed below), would be relevant to determining whether the conduct would violate the proposed rule.

Should the Types of Conduct That Might Constitute Actions To Fraudulently Influence an Auditor Be Set Forth in the Rule? If so, Which Items Listed in the Preceding Paragraph Should Be Included or Excluded? What Additional Types of Conduct, if any, Should Be Included?

Proposed rule 13b2–2(b)(1) would address the improper influence of ''any independent public or certified public accountant'' engaged in the performance of an audit or review of an issuer's financial statements.[18] Prior to the adoption of the Act, similar phrases commonly were used in the securities laws and the Commission's regulations to refer to the accountant providing audit and review services to a Commission registrant. Although the Act, in anticipation of accounting firms registering with the Public Company Accounting Oversight Board (the ''Board''),[19] changed several of these references,[20] such terms continue to appear in certain sections of the securities law[21] and related schedules.[22] We believe that section 303 of the Act includes all accountants[23] engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports[24] to be filed with the Commission. Once firms are required to register with the Board, the term ''independent public or certified public accountant,'' as used in the proposed rule, would include registered public accounting firms[25] and persons associated with such a public accounting firm,[26] as defined in the Act.

Should We Define by Rule the Phrase ''Independent Public or Certified Public Accountant''? The Rules Currently in Regulation 13B–2 Refer to ''Accountant'' as Opposed to ''Independent Public or Certified Public Accountant.'' Should These Rules, or the Proposed Rules, be Changed To Refer to the Same Term? Which Term Should Be Used?

Proposed rule 13b2–2(b)(1) tracks the language in section 303(a) of the Act regarding the improper influence of an accountant ''engaged in the performance of an audit'' of the issuer's financial statements. Both the Commission[27] and the accounting profession[28] have recognized that the need for an auditor to maintain an independent and unbiased attitude begins when the accountant is selected to perform audit

[15] Some of these individuals also would be covered under provisions of the rule tailored to investment companies. *See* section II.C. of this release, *Issues Related to Investment Companies*.

[16] We view ''fraudulently'' as modifying only ''influence.''

[17] It is the act of fraudulently influencing, coercing, manipulating, or misleading the auditor, for the purpose of rendering misleading financial statements, that is unlawful. There is no requirement in section 303(a) of the Act that the purpose be achieved.

[18] Section 303(a) uses the phrase ''independent public or certified accountant,'' which appears, for example, in items 25, 26 and 27 of Schedule A to the Securities Act of 1933. 15 U.S.C. 77aa(25), (26) and (27). Since the passage of the 1933 Act, however, the general reference to ''certified accountant'' has been replaced by ''certified public accountant.'' To avoid any possible confusion, we have used ''certified public accountant'' in the proposed rules.

[19] *See* section 102 of the Act, which provides that beginning 180 days after the Commission determines that the Board, as established by Title I of the Act, is appropriately organized and has the capacity to carry out and enforce the requirements of that title, it shall be unlawful for any person that is not a registered public accounting firm to prepare any audit report with respect to any issuer.

[20] *See, e.g.*, sections 205(b) and (c) of the Act.

[21] *See, e.g.*, section 13(a) of the Exchange Act, 15 U.S.C. 78m(a), and section 8(e) of the Securities Act of 1933 (the ''1933 Act''), 15 U.S.C. 77h(e).

[22] *See, e.g.*, items 25, 26 and 27 of Schedule A of the 1933 Act, 15 U.S.C. 77aa(25), (26) and (27).

[23] The rule would apply regardless of whether the accountant was a certified public accountant. For example, some states require accountants to have years of experience before being deemed to be a CPA. Efforts to mislead such an individual during his or her performance of audit procedures would fall within the proposed rules.

[24] *See, e.g.*, section 404 of the Act, which mandates that the Commission prescribe rules that require (1) each annual report filed under sections 13(a) and 15(d) of the Exchange Act contain a management statement of responsibilities for, and assessment of the effectiveness of, the issuer's internal control structure and procedures for financial reporting, and (2) the auditor to attest to, and report on, the assessment made by management.

[25] Section 2(a)(12) of the Act defines ''registered public accounting firm'' to mean ''a public accounting firm registered with the Board in accordance with this Act.''

[26] Section 2(a)(9)(A) of the Act defines ''person associated with a public accounting firm'' (or with a ''registered public accounting firm'') to mean ''any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report—(i) shares in the profits of, or receives compensation in any other form from, that firm, or (ii) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm.'' The Board, in section 2(a)(9)(B) of the Act, is given limited authority to exempt persons performing only ministerial tasks.

[27] Rule 2–01(f)(5)(ii) of Regulation S–X, 15 CFR 210.2–01(f)(5)(ii), which defines the ''professional engagement period'' to be: ''The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission,'' and states: ''(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and (B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.''

[28] American Institute of Certified Public Accountants (''AICPA'') Code of Professional Conduct, ET § 101.02, which states:

The period of a professional engagement starts when the [AICPA] member begins to perform any professional engagement requiring independence for an enterprise, lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification of the termination of the professional relationship either by the member, by the enterprise, or by the issuance of a report, whichever is later. Accordingly, the professional engagement does not end with the issuance of a report and recommence with the signing of the following year's engagement.

or review services and continues until there is a formal or informal public notification that the professional relationship has ended.[29] To effectuate the intent of Congress, we believe the phrase ''engaged in the performance of an audit'' should be given a broad reading. We believe Congress intended that the phrase encompass the professional engagement period and any other time the auditor is called upon to make decisions regarding the issuer's financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports. The proposed rules, therefore, would apply throughout the professional engagement and after the professional engagement has ended when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports. In limited circumstances, the proposed rules also may apply before the professional engagement period begins. For example, the proposed rules would apply if an officer, director, or person acting under the direction of an officer or director, offers to engage an accounting firm on the condition that the firm either issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards.

Should Proposed Rule 13b2–2(b)(2) Provide a Specific Definition of ''Engaged in the Performance of an Audit''?

To be actionable under section 303 of the Act, the conduct must be ''for the purpose of rendering [the issuer's] financial statements materially misleading.'' [30] Because the financial statements are prepared by management and the auditor conducts an audit or review of those financial statements, the auditor would not directly ''render [the] financial statements materially misleading.'' Rather, the auditor might be improperly influenced to, among other things, issue an unwarranted report on the financial statements,[31] including suggesting or acquiescing in the use of inappropriate accounting treatments [32] or not proposing adjustments required for the financial statements to conform with generally accepted accounting principles.[33] An auditor also might be fraudulently influenced, coerced, manipulated or misled not to perform audit or review procedures that, if performed, might divulge material misstatements in the financial statements. Other examples of activities that would fall within the proposed rule would be for an officer, director, or person acting under an officer or director's direction, to improperly influence an auditor either not to withdraw a previously issued audit report when required by generally accepted auditing standards,[34] or not to communicate appropriate matters to the audit committee.[35] Proposed rule 13b2–2(b)(2) would make it clear that subparagraph (b)(1) would apply in such circumstances. As noted, the proposed rule would not be limited to the audit of the annual financial statements, but would include, among other things, improperly influencing an auditor during a review of interim financial statements [36] or in connection with the issuance of a consent to the use of an auditor's report.[37] Conducting reviews of interim financial statements and issuing consents to use past audit reports are sufficiently connected to the audit process, and improper influences during those processes are sufficiently connected to the harms that the Act seeks to prevent, that they should be within the scope of the proposed rules. The list of examples in the proposed rule is only illustrative; other actions also could result in rendering the financial statements materially misleading.

Is Subparagraph (b)(2) of the Proposed Rule Helpful or Necessary? Should it Be Deleted? If Subparagraph (b)(2) Should Be Adopted, are the Examples Appropriately Illustrative? Should More, or Fewer, Examples Be Included in the Rule? If so, What Examples Should be Added or Removed?

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. Under the proposed rule, 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 could, if successful, result in rendering financial statements materially misleading.[38]

The Commission is considering strongly other wording changes to make the rule effective in preventing improper influences. There are several changes, individually or collectively, that could accomplish that objective, and we solicit comment on the best approach. For example:

1. Should we replace the statement in subparagraphs (b)(1) and (c) 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. Such language might better indicate that no specific direction by an officer or

[29] Changes in the principal auditor of an issuer's financial statements are reported under item 4 of Form 8–K, 17 CFR 249.308. *See also* item 304 of Regulation S–K, 17 CFR 229.304, and item 304 of Regulation S–B, 17 CFR 228.304.

[30] There is no such requirement for Rule 13b2–1 or Rule 13b2–2.

[31] *See* 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 Cong., 2d Sess., (S.R. 107–205), at 26 (Comm. Print, July 3, 2002), which states that section 303 makes it unlawful for any officer or director of an issuer, or any person acting under the direction of an officer or director, to fraudulently influence, coerce, manipulate, or mislead the auditor of the issuer's financial statements ''for the purpose of rendering the *audit report* misleading.'' (Emphasis added.)

[32] For example, an auditor might be fraudulently influenced to allow an issuer to correct material misstatements over time, or not to restate prior period financial statements, in violation of generally accepted accounting principles.

[33] *See* section 401(a) of the Act, which, among other things, adds section 13(i) to the Exchange Act, which requires that financial statements prepared in accordance with (or reconciled to) generally accepted accounting principles and filed with the Commission reflect all material correcting adjustments identified by a registered public accounting firm.

[34] *See, e.g.*, SAS 1, ''Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,'' AU § 561.

[35] *See, e.g.*, section 204 of the Act, which adds section 10A(k) to the Exchange Act and requires each registered public accounting firm to report certain matters to the audit committee, and AICPA, SAS 61, ''Communication With Audit Committees'' (as amended by SAS 89 and SAS 90).

[36] *See* Rule 10–01(d) of Regulation S–X, 17 CFR 210.10–01(d).

[37] *See, e.g.*, section 7(a) of the Securities Act of 1933, 15 U.S.C. 77g, which states in part, ''If any accountant * * * is named as having prepared or certified any part of the registration statement, the written consent of such person shall be filed with the registration statement''; Rule 436 under the Securities Act of 1933, 17 CFR 230.436.

[38] We believe that the mental state requirements of the proposed 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 (Feb. 15, 1979); 44 **Federal Register** 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 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.''

director is required to violate the proposed rules.

2. Should the word ''fraudulently'' in subparagraphs (b)(1) and (c)(2) be replaced with the word ''improperly'' or some other word to convey a mental state short of scienter?

3. Should the phrase in subparagraphs (b)(1) and (c)(2) that ''if the person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading'' be replaced with ''for the purpose of, or have the effect of, rendering the financial statements materially misleading'' or some other phrase to convey that proving a particular purpose or intent is not required?

C. Issues Related to Investment Companies

In contrast to other issuers, investment companies generally have contracts with service providers that perform virtually all of the management, administrative, and other services necessary to the investment company's operations, including preparation of the financial statements. These entities may include an investment company's investment adviser, sponsor, depositor, trustee, and administrator. For registered investment companies and business development companies,[39] the proposed prohibition on improper influence on the conduct of audits would cover not only officers and directors of the investment company itself, but also officers and directors of the investment company's investment adviser, sponsor, depositor, trustee, and administrator.[40] We are also proposing to amend existing rule 13b2–2 to cover officers and directors of these entities.[41]

Is it Necessary or Appropriate To Expressly Extend the Prohibition on Improper Influence on the Conduct of Audits, and Existing Rule 13b2–2, to Officers and Directors of the Investment Company's Service Providers? If so, Which Service Providers Should Be Covered?

III. General Request for Comments

We invite any interested person wishing to submit written comments on the proposed rules to do so. We specifically request comments from investors, accounting firms and registrants. We solicit comment on each component of the proposal.

[39] Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act of 1940. See 15 U.S.C. § 80a-2(a)(48) (defining business development companies).

[40] Proposed rule 13b2–2(c)(2).

[41] Proposed rule 13b2–2(c)(1).

IV. Paperwork Reduction Act

The Paperwork Reduction Act is not applicable to the proposed rules because they do not impose any collection of information requirements.

V. Costs and Benefits

The proposed rules implement a Congressional mandate. We recognize, however, that any implementation of the Act likely will result in costs and benefits and have an effect on the economy.

Because much of the conduct addressed by Section 303(a) and the proposed rules generally was prohibited under provisions of the securities laws that existed before enactment of the Sarbanes-Oxley Act, we do not anticipate that the proposed rules would increase significantly costs for issuers or accounting firms. Nonetheless, the Act and proposed rules might prompt some issuers to adopt procedures or guidelines that would assure additional care would be used by an issuer's officers and directors, and others acting under their direction, in communicating with auditors of the issuer's financial statements. For example, some issuers might require that more discussions include members of senior management or the issuer's legal counsel. Because no particular procedures related to such communications are required, and the nature and scope of those procedures are likely to vary among issuers, it is difficult to provide an accurate cost estimate.

As noted above, in some circumstances the proposed rules might apply before the professional engagement period begins. For example, the proposed rules would apply if an officer, director, or person acting under the direction of an officer or director, offers to engage an accounting firm on the condition that the firm either issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards. We believe, however, that such conduct would not be permitted under existing laws and regulations and, accordingly, the proposed rules should not result in a significant increase in costs for issuers.

Potential benefits of the proposed rules include increased investor confidence in the integrity of the audit process and, in turn, in the reliability of reported financial information. One of the most important factors in the successful operation of our securities markets is the trust that investors have in the reliability of the information used to make voting and investment decisions.[42]

Section 303(a) and the proposed rules are designed to provide added assurance that the full-disclosure purposes of the securities laws are fulfilled,[43] and to help restore the faith of America's investors in the integrity of the audit process and in the reliability of reported financial information. If section 303 of the Act and the proposed rules lead to increased investor confidence in financial reporting, they also may facilitate capital formation. An increased willingness of investors to participate in the securities markets might result in issuers being able to lower their cost of capital.

VI. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to the proposed revisions to rule 13b2–2 of Regulation 13B–2. The proposals would implement the statutory prohibition on officers and directors of an issuer, and persons acting under

[42] *See* Accounting Series Release No. 296 (Aug. 20, 1981), which states in part: (T)he capital formation process depends in large part on the confidence of investors in financial reporting. An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest. The quality of information disseminated in the securities markets and the continuing conviction of individual investors that such information is reliable are thus key to the formation and effective allocation of capital. Accordingly, the audit function must be meaningfully performed and the accountant's independence not compromised.

[43] *See, e.g.*, H.R. Rep. No. 1383, 73rd Cong., 2d Sess., 11 (1934), which states: Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.

This House Report also includes a letter from the Executive Assistant of the Committee on Stock List for the New York Stock Exchange, which recognizes management's need for accurate financial information and then states: [U]nder the conditions of today, the next object in order of importance has become to give stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments. * * * The exchange is interested in the accounts of companies as a source of reliable information for those who deal in stocks. It is not sufficient for the stock exchange that the accounts should be in conformity with law or even that they should be conservative; the stock exchange desires that they should be fully and fairly informative. *Id.* at 12.

their direction, improperly influencing the conduct of an audit or review of the issuer's financial statements.

A. Reasons for, and Objectives of, the Proposed Rules

The purpose of the proposed rules is to implement section 303(a) of the Act. The proposed rules would prohibit officers and directors of issuers, including ''small businesses,'' and persons acting under their direction, from improperly influencing an accounting firm's audit or review of the issuer's financial statements. Today, it could be alleged generally that such conduct violated the anti-fraud or other provisions of the securities laws or aided and abetted or caused the issuer's violations of those sections. The proposed rules, and section 303(a) of the Act, would provide the Commission with an additional means to address such conduct and are intended to enhance the credibility of financial statements.

B. Legal Basis

We are proposing the amendments under the authority set forth in sections 3(a) and 303 of the Act; Schedule A and sections 5, 6, 7, 8, 10 and 19 of the 1933 Act; Sections 3, 10A, 12, 13, 14, 15, 17 and 23 of the Exchange Act; and Sections 6, 8, 20, 30, 31 and 38 of the Investment Company Act of 1940.

C. Small Entities Subject to the Proposed Rules

The proposals would affect small registrants that are small entities. Exchange Act Rule 0–10(a) [44] and 1933 Act Rule 157 [45] define a company to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that approximately 2,500 companies are small entities, other than investment companies.

For purposes of the Investment Company Act, Rule 0–10 [46] defines ''small business'' to be an investment company with net assets of $50 million or less as of the end of its most recent fiscal year. We estimate that approximately 225 investment companies meet this definition.

D. Reporting, Recordkeeping and Other Compliance Requirements

The enactment of section 303(a) of the Act and the adoption of the proposed rules might result in some issuers adopting more detailed procedures for communications between the company and the accounting firm that audits the company's financial statements. These procedures might increase costs associated with compliance with the securities laws.

At this time, we cannot estimate the likely burden that would be incurred by small businesses, although we assume the burden would be minor for most issuers.

E. Duplicative, Overlapping or Conflicting Federal Rules

We are not aware of any federal rules that conflict with the proposed rules. The improper conduct directly addressed in section 303(a) and the proposed rules, however, also under certain circumstances may constitute violations of the existing rules in Regulation 13B–2 or other sections of the securities laws. We were directed by Congress to perform this rulemaking, and section 303(c) of the Act expressly states that rules adopted under the section are in addition to and do not preempt or supersede any other rule or regulation.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

1. The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities;

2. The clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities;

3. The use of performance rather than design standards; and

4. An exemption from coverage of the proposed amendments, or any part thereof, for small entities.

Section 303(a) of the Act does not provide an exemption for small businesses. The section does provide, however, that the rules adopted by the Commission should be ''as necessary and appropriate in the public interest and for the protection of investors.'' We are inclined to apply the proposals to small business issuers. We believe investors in small companies, just as investors in large companies, would want and benefit from the added confidence in reported financial information that comes from knowing that efforts to fraudulently influence the performance of the audit have been prohibited.

We are using a performance standard rather than a design standard. In addition, Congress has dictated the timetable for this rulemaking.

We request comment on whether it is feasible to further clarify, consolidate, or simplify the proposed rules for small entities.

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. Specifically, we request comments regarding the number of small entities that may be affected by the proposed rules and the existence or nature of the potential impact on those small entities.

Commenters are requested to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules.

VII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

For the purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[47] we are requesting information regarding the impact of the proposed rules on an annual basis. Commenters should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act [48] requires us, when adopting rules under the Exchange Act, to consider the impact on competition of any rule we adopt. Section 2(b) of the 1933 Act,[49] section 3(f) of the Exchange Act,[50] and section 2(c) of the Investment Company Act of 1940,[51] require us, when engaging in rulemaking where we are required to consider or determine whether the action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

The proposed rules would prohibit improper influences on auditors in connection with their reviews and

[44] 17 CFR 240.0–10(a).

[45] 17 CFR 230.157.

[46] 17 CFR 270.0–10.

[47] Pub. L. 104–121, title II, 110 Stat. 857 (1996).

[48] 15 U.S.C. 78w(a)(2).

[49] 15 U.S.C. 77b(b).

[50] 15 U.S.C. 78c(f).

[51] 15 U.S.C. 80a–2(c). 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.

audits of financial statements filed with the Commission. The proposals, therefore, should enhance investor confidence in the audit process and in the quality of information available to them, and lead to a more efficient market.

Because of the nature of the proposed rules, we do not believe that they would impose any burden on competition. They prohibit equally all officers and directors of public companies (and persons acting under their direction) from improperly influencing the auditor.

As noted in the cost-benefit section, if section 303 of the Act and the proposed rules lead to increased investor confidence in financial reporting, they also may facilitate capital formation. An increased willingness of investors to participate in the securities markets might result in issuers being able to lower their cost of capital. The possible effects of the proposed rules on efficiency, competition, and capital formation, however, are difficult to quantify. We request comment on these matters in connection with our proposed rules.

VIII. Statutory Authority

We are proposing the new rules under the authority set forth in sections 3(a) and 303 of the Act; Schedule A and sections 5, 6, 7, 8, 10 and 19 of the 1933 Act; Sections 3, 10A, 12, 13, 14, 15, 17 and 23 of the Exchange Act; and Sections 6, 8, 20, 30, 31 and 38 of the Investment Company Act of 1940.

Text of Proposed Rules and Amendments

List of Subjects in 17 CFR Part 240

Securities.

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.13b2–2 is revised to read as follows:

§ 240.13b2–2 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 pursuant 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) 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.

Dated: October 18, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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DEPARTMENT OF DEFENSE

Department of the Army; Corps of Engineers

33 CFR Part 334

United States Navy Restricted Area, Radio Island, Beaufort, NC

AGENCY: United States Army Corps of Engineers, DoD.

ACTION: Notice of proposed rulemaking and request for comments.

SUMMARY: The U.S. Army Corps of Engineers is proposing regulations to establish a restricted area in the vicinity of Radio Island, Beaufort, North Carolina. These regulations will enable the Navy to enhance security for Navy property, vessels, and personnel. The