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# A Compromise - Adding a Knowledge Requirement to Rule 13b2-2 of the Securities Exchange Act of 1934

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# A COMPROMISE—ADDING A KNOWLEDGE REQUIREMENT TO RULE 13B2-2 OF THE SECURITIES EXCHANGE ACT OF 1934

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## I. INTRODUCTION

The United States Securities and Exchange Commission (SEC) was established to protect investors and support fair and efficient financial markets.[1] The SEC strives to deliver this protection through the enactment of laws and regulations.[2] These laws and regulations seek to provide investors access to basic information about investments.[3] To provide transparency, the SEC mandates public companies disclose certain relevant financial and non-financial information to the public.[4] The SEC, as the primary regulator of the securities market, brings civil actions against individuals who do not abide by the SEC Rules as well as works with the federal government in prosecuting criminal trials.[5]

In 1977, the Foreign Corrupt Practices Act (FCPA) was established to support the SEC's mission of protecting investors.[6] To combat bribery of foreign officials in the practice of business, the FCPA enacted Section 13(b) of the Securities Exchange Act of 1934 (Section 13(b)).[7]

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1. *See generally The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SECURITIES AND EXCHANGE COMM'N., http://www.sec.gov/about/whatwedo.shtml (last visited Oct. 4, 2015) (stating the mission of the U.S. Securities and Exchange Committee).
2. *See generally id.* (stating the purpose of the U.S. Securities and Exchange Committee).
3. *See id.*
4. *See id.*
5. *See id.*
6. *See generally* Pub. L. No. 95-213, Sections 101-204 (91. Stat. 1494) (codified as 15 U.S.C. Sections 78dd-1 to -3).
7. *See id.* (enhancing the 1934 Securities Exchange Act with additional provisions in reaction to extensive bribery of foreign officials).

Generally, Section 13(b) establishes requirements for the financial records, internal controls, and accounting of public companies.[8] Section 13(b) maintains stricter requirements for financial records to allow the public and SEC to easily detect illegal activity as well as to deter the companies from participating in these activities.[9]

Following the establishment of Section 13(b), the Sarbanes-Oxley Act of 2002 (SOX) was passed to provide additional assurance to investors in the securities market.[10] SOX commissioned rules to prohibit officers, and their agents, of public companies from manipulating or coercing auditors of financial statements in order to cause material misstatements.[11] In furtherance of the SOX requirements, the SEC enacted Rule 13b2-2 to clarify and strengthen the requirements of Section 13(b).[12]

Currently, there is a circuit split concerning whether scienter is requisite to finding liability under Rule 13b2-2. "Scienter" is the "mental state embracing intent to deceive, manipulate, or defraud."[13] Only four federal circuits have ruled on this issue, and the majority of ruling appellate courts currently hold that there is not a scienter requirement in Rule 13b2-2.[14] This holding has been established by the Second Circuit in *SEC v. McNulty*, the Seventh Circuit in *McConville v. SEC*, and the Eighth Circuit in *SEC v. Das*.[15] Additionally, the courts find that the SEC upholds this view as well.[16]

The Ninth Circuit initially followed suit and supported the view held by the majority of the appellate courts.[17] However, the Ninth

8. *See* 15 U.S.C.S. Section 78m (focusing on Section 13(b)(2)).

9. *See generally id.*

10. *See generally* SEC Release No. 34-47890 Final Rule (stating Section 303(a) of the Sarbanes-Oxley Act of 2002 requires rules and regulations to be enacted in the public interest for the protection of investors).

11. *See id.* (discussing the Rule's purpose of avoiding improper influence on the conduct of audits as commissioned by the Sarbanes-Oxley Act of 2002).

12. *See generally* 17 C.F.R. 240.13b2-2 (providing the language of Rule 13b2-2 forbidding the manipulation or misleading of auditors in the review of a public company's financial statements).

13. SEC v. Todd, 642 F.3d 1207, 1215 (9th Cir. 2011), *quoting* Ernst & Ernst v. Hochfelder, 425 U.S.185, 193 (1976) (defining "scienter").

14. *See generally* SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1997); McConville v. SEC, 465 F.3d 780 (7th Cir. 2006); SEC v. Das, 723 F.3d 943 (8th Cir. 2013).

15. *See McNulty*, 137 F.3d 732; *McConville*, 465 F.3d 780; *Das*, 723 F.3d 943.

16. *McNulty*, 137 F.3d at 741 (stating Section 13(b) of the 1934 Securities and Exchange Act "contains no words indicating that Congress intended to impose a scienter requirement").

17. Ponce v. SEC, 345 F.3d 722, 738 (9th Cir. 2003) (holding that Section 13(b)(2) was violated because the company failed to keep books and accounts that fairly represented the transaction, not referring to any knowledge or scienter requirement).

Circuit has since changed its view.[18] In 2011, the Ninth Circuit in *SEC v. Todd* held that there is a stricter standard for imposing liability under Rule 13b2-2.[19] This standard is the scienter requirement, which requires the individual to knowingly make misrepresentations to an external financial statement auditor.[20] In *Todd*, the court used the holding in *United States v. Goyal* to provide reasoning for its scienter requirement.[21] The crux of the Ninth Circuit's reasoning is that to not impose a scienter requirement would be to open liability on a wider class of individuals than intended by Congress in the enactment of the rule.[22]

With correct intentions, the Ninth Circuit successfully blurred the lines between "scienter" and "knowledge" when determining whether there is a scienter requirement to find liability under Rule 13b2-2. The court used a mixture of the words "scienter" and "knowledge" and made the requirements to be one and the same; but they are not.[23] It is important to clarify that Rule 13b2-2 does not explicitly state a scienter requirement to find liability, but should require the individual to have knowledge of the misrepresentation. The policy argument of the Ninth Circuit in *Todd* and *Goyal* should not be ignored, but it also should not be used to create a requisite mental component to the rule that Congress did not intend.

In Part II, this Comment will discuss the background behind Section 13(b) and Rule 13b2-2 of the Securities Exchange Act of 1934 as well as the intentions of Congress in enacting them. This Comment will then examine the circuit split on the scienter requirement in Rule 13b2-2. Part III will examine and differentiate the view of the majority of the appellate court circuits with the view of the Ninth Circuit that there is a scienter requirement and its reliance on the *Goyal* decision.

Finally, Part IV will analyze a compromise between the majority and minority views of the appellate court circuits in establishing the difference between scienter and knowledge. As alluded to in the Ninth Circuit opinion, Rule 13b2-2 should have a knowledge requirement, but

18. *See generally Todd*, 642 F.3d 1207.

19. *Id*. at 1219 (stating that the district court correctly applied a "knowingly" standard to Rule 13b2-2).

20. *See id.*, *acknowledging* United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010) (holding that to be liable under Rule 13b2-2 one is required to "knowingly" make incorrect statements).

21. *See id.*, *using Goyal*, 629 F.3d at 916 (reasoning that policy concerns require the establishment of a scienter requirement in Rule 13b2-2).

22. *See id*. at 1219-20 (stating that the court could not loosen the standard set by the statute as it would result in inflicting liability on a broader breadth of conduct than originally intended by Congress).

23. *See id*. generally.

this requirement should be separate and distinct from a scienter requirement.

## II. THERE IS A SUBSTANTIAL NEED TO PROTECT THE PUBLIC IN THE SOPHISTICATED WORLD OF INVESTMENTS

To understand the nuances of the federal appellate court circuit split regarding whether scienter is required to be proven to find liability under Rule 13b2-2, it is important to begin with a discussion of the background leading to the enactment of Section 13(b) and its associated rule, Rule 13b2-2. Subpart II.A of this Comment will begin the discussion with the history of corruption and lack of confidence in the financial markets that resulted in the passing of the Foreign Corrupt Practices Act of 1977, which established Section 13(b) and the Sarbanes-Oxley Act of 2002 and speaks to the intentions of Congress.

Subpart II.B will further develop the insight into Section 13(b) and Rule 13b2-2 with an examination of the language of the legislation. Finally, Subpart II.C of the Comment will reason for the analytical view of the requisite mental state required to find civil liability under Rule 13b2-2.

### *A. The Government Has Promulgated Legislation in Hopes of Enhancing the Integrity of Corporate Executives as Well as the Quality of Financial Reporting*

The SEC evolved because of the international interest in investment in American corporations. Initiated through the passing of the Securities Act of 1933 by Congress, the SEC was designed and implemented in 1934 to facilitate, as an administrative agency, an increase in investor confidence in American markets.[24] In order to do so, the Securities Act called for corporations to provide more reliable information and the corporate executives to act more honestly.[25] Today, the SEC describes its mission as "[protecting] investors, [maintaining] fair, orderly, and efficient markets, and [facilitating] capital formation."[26]

The SEC has five main responsibilities.[27] It is foremost responsible for interpreting and enforcing the securities laws established by the

24. *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 1.

25. *See id*.

26. *See id*.

27. *See id*. (explaining the organization of the SEC).

federal government.[28] Additionally, it is given authority to issue rules as well as amend previously enacted securities rules and regulations.[29] The SEC is responsible for overseeing both the review of securities firms and investment corporations as well as the "private regulatory organizations in the securities, accounting, and auditing fields."[30] Finally, the SEC coordinates federal securities regulation and enforcement with the federal and state authorities.[31]

Ultimately, the SEC seeks to provide investors crucial access to basic information about investments that is both useful and correct.[32] Through its enforcement and legislative authorities, the SEC requires public companies to disclose specified financial and non-financial information to the public through mandatory filings.[33] Additionally, as the administrative agency in charge of the regulation of federal security laws, the SEC, in conjunction with the federal authorities, brings civil and criminal actions against individuals who do not follow the rules and regulations set forth in the Securities Exchange Act of 1933, Securities Exchange Act of 1934, and SOX.[34]

In the hopes of furthering the enhancement of investor confidence, the FCPA was established in 1977 as part of the Securities Exchange Act of 1934.[35] The FCPA sought to fight the bribery of foreign officials in business transactions.[36] Section 13(b) was enacted as a part of the FCPA and Securities Exchange Act of 1934.[37] Section 13(b) establishes requirements for the financial records, internal controls, and accounting of public companies.[38] Section 13(b) establishes these standards to uphold stricter requirements for the financial records of public companies, so that investors and the SEC can more easily detect misrepresentations and fraudulent activities as well as deter public

28. *See id.*
29. *See id*.
30. *See id*.
31. *See id*.
32. *See id*.
33. *See id*.
34. *See id*. (noting the laws that involve the securities industry are the Securities Act of 1933, Securities Act of 1934, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940, Sarbanes-Oxley Act of 2002, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and Jumpstart Our Business Startups (JOBS) Act).
35. *See generally* Pub. L. No. 95-213, Sections 101-204, *supra* note 6; *see also* Pub. L. No. 95-213, Sections 101-204, (91. Stat. 1494) (codified as 15 U.S.C. Sections 78dd-1 to -3) (enhancing the 1934 Securities Exchange Act with additional provisions in reaction to extensive bribery of foreign officials).
36. Pub. L. No. 95-213, Sections 101-204, *supra* note 6.
37. *See id*.
38. *See generally* 15 U.S.C.S. Section 78m (focusing on Section 13(b)(2)).

companies from acting mischievously in the first place.[39]

After the enactment of Section 13(b), SOX was passed in 2002.[40] SOX's mission was to provide additional reassurance to investors in the securities markets.[41] Specifically, SOX focused on the financial reports of public companies.[42] SOX established mandatory guidelines that prohibit executives of public companies, and their agents, from taking action to manipulate or coerce auditors of financial statements in order to cause material financial misstatements.[43] Because of SOX, the SEC enacted Rule 13b2-2 to further clarify and strengthen the requirements set forth in Section 13(b).[44]

### *B. The Statutory Language of Securities Exchange Act of 1934 Section 13(b) and Rule 13b2-2 is the Source of the Confusion*

The statutory language of both Section 13(b) and associated Rule 13b2-2 helps to provide some insight into the meaning of the regulation as well as the intention of Congress in enacting the regulations. However, as seen below, the language of both the regulation and rule does not provide a bright-line standard. This means that some interpretation must be applied to both the regulation and rule. This ambiguity is what has caused discrepancies among the federal circuits regarding the meaning of and requirements established by Rule 13b2-2.

The following is the statutory language of Section 13(b):

> " . . . (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; (B) Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that – (i) Transactions are executed accordance with management's general or specific authorization; (ii) Transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets; (iii) Access to assets is permitted only in accordance with management's general or specific authorization; and (iv) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences; and (C)

39. *See id.*
40. *See generally* SEC Release No. 34-47890, *supra* note 10.
41. *See id*.
42. *See generally* 17 C.F.R. 240.13b2-2, *supra* note 12.
43. *See* SEC Release No. 34-47890, *supra* note 10.
44. 17 C.F.R. 240.13b2-2, *supra* note 12.

> Notwithstanding any other provision of law, pay the allocable share of such issuer of a reasonable annual accounting support fee or fees . . . "[45]

The following is the statutory language of Rule 13b2-2:

> 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 materially false or misleading statement to an accountant in connection with; 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) An audit, review 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 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 coerce, manipulate, mislead, or fraudulently influence 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 pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.[46]

### *C. The SEC Provides Interpretation Regarding the Purpose of Rule 13b2-2*

When Rule 13b2-2 was adopted in response to SOX, the SEC recognized the necessity for clarification. Effective June 2003, the SEC provided its interpretation (SEC Release) of Rule 13b2-2 and its material clauses.[47] In their summary, the SEC stated that the rule applied to individuals who "knew or should have known that [their] action, if successful, could result in rendering the financial statements materially misleading."[48]

The SEC provided further clarification for the phrase "take any action to coerce, manipulate, mislead, or fraudulently influence."[49] The

45. 15 U.S.C. Section 78(m)(b)(2)(A)-(C).
46. 17 C.F.R. 240.13b2-2 (emphasis added).
47. *See* SEC Release No. 34-47890 Final Rule.
48. *See generally id.* (describing violative conduct).
49. *See id., quoting* 17 C.F.R. 240.13b2-2.

SEC first states that the word fraudulently only modified influence and not "coerce," "manipulate," or "mislead."[50] In its discussion, the SEC Release states that some commenters suggested that the word "mislead" should be modified by intent and others suggested that simply any effort to purposefully influence an auditor or alter a disclosure should be in violation.[51] Additionally, the SEC Release states that the words "coerce" and "manipulate" suggest actions such as "pressure, threats, trickery, intimidation, or some other form of purposeful action."[52]

The SEC also provided examples of conduct that would constitute improper influence on an auditor and a violation of Rule 13b2-2.[53] These actions include blackmail, threatening physical violence, and stating the intent to cancel an engagement.[54] Additional actions listed were providing incorrect information and bribes.[55] Although not inclusive, the list provided in the SEC Release is preempted by a statement that any action that violates the rule must be done with knowledge or a reason to know that it would improperly influence an auditor.[56]

Although it seems the SEC Release provides helpful explanation as to what conduct would violate Rule 13b2-2, the SEC Release instead muddles any clarification as to an answer on the topic of a scienter requirement. While the Release discusses the phrase "coerce, manipulate, mislead, or fraudulently influence," the Supreme Court has only defined "manipulation" and "fraud" as requiring scienter.[57] The argument is open as to whether "coercion" and "misleading" require scienter.[58] Additional confusion is added when considering the "knowledge" or "reason to know" modifications prevalent throughout the SEC Release, as knowledge and scienter do not share a legal meaning.[59] The federal appellate courts have since attempted to answer the question of whether scienter is a requisite mental state required in Rule 13b2-2.

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50. *See id.*

51. *See id.* (responding to the proposing release).

52. *See id.* (providing clarification to the language of the rule).

53. *See id.*

54. *See id.* (explaining examples the Commission believes would improperly influence auditors).

55. *Id.*

56. *See id.*

57. Paul B. Uhlenhop, *A Trap for the Unwary Attorney, SEC Rule 13b2-2: Improper Influence on Conduct of Audits*,15 SEC. NWS. 1 (Fall 2004).

58. *Id.*

59. *See id.* (recognizing that "[t]he lack of clarity by the SEC in the Release is troublesome.").

### *D. There is a Split Among the Federal Appellate Circuits Regarding a Scienter Requirement in Rule 13b2-2*

Currently, the federal circuit courts are split concerning whether scienter must be proven in order to find civil liability under Rule 13b2-2.[60] Of the four federal circuit courts ruling on this issue, the majority currently hold that there is no scienter requirement to find civil liability under Rule 13b2-2.[61] This holding has been established by the Second Circuit in *McNulty*, the Seventh Circuit in *McConville*, and the Eighth Circuit in *Das*.[62] The Second, Seventh, and Eighth Circuits rely on the plain language of Rule 13b2-2 as well as agency interpretations of Rule 13b2-2 from the SEC.[63]

The Ninth Circuit initially followed suit and supported the view held by the majority of the appellate courts.[64] However, in 2011, the Ninth Circuit changed its stance in *Todd* and held that there is a stricter standard for imposing liability under Rule 13b2-2.[65] This standard was described as a "knowingly" requirement, which requires the individual to knowingly make misrepresentations to an external financial statement auditor.[66] In *Todd*, the court used the holding in *Goyal* to provide reasoning for this requisite mental state required to find liability under Rule 13b2-2.[67] The main argument provided by the Ninth Circuit is that to not impose a knowledge requirement would be to open liability to a wider class of individuals than intended by Congress in the enactment of the rule.[68]

60. *See generally* SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1997); McConville v. SEC, 465 F.3d 780 (7th Cir. 2006); SEC v. Das, 723 F.3d 943 (8th Cir. 2013); SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011).

61. *See generally McNulty*, 137 F.3d 732; *McConville*, 465 F.3d 780; *Das*, 723 F.3d 943.

62. *See McNulty*, 137 F.3d 732; *McConville*, 465 F.3d 780; *Das*, 723 F.3d 943.

63. *McNulty*, 137 F.3d at 741 (stating that Section 13(b) of the 1934 Securities and Exchange Act "contains no words indicating that Congress intended to impose a scienter requirement"); *see also McConville*, 465 F.3d at 789; *Das*, 723 F.3d at 954.

64. Ponce v. SEC, 345 F.3d 722, 737 (9th Cir. 2003) (holding that Section 13(b)(2) was violated because the company failed to keep books and accounts that fairly represented the transaction, not referring to any knowledge or scienter requirement).

65. *Todd*, 642 F.3d at 1219 (stating that the district court correctly applied a "knowingly" standard to Rule 13b2-2).

66. *See id., acknowledging* United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010) (holding that to be liable under Rule 13b2-2, one is required to "knowingly" make incorrect statements).

67. *See id., using Goyal*, 629 F.3d at 916 (reasoning that policy concerns require the establishment of a scienter requirement in Rule 13b2-2).

68. *See id*. at 1219-20 (stating that the court could not loosen the standard set by the statute as it would result in inflicting liability on a broader breadth of conduct than originally intended by Congress).

## III. IS THERE A SCIENTER REQUIREMENT IN RULE 13B2-2?

Subpart III.A of this comment discusses the opinion held by the majority of ruling circuit courts. The Second Circuit in *McNulty*, Seventh Circuit in *McConville,* and Eighth Circuit in *Das* all support the view that no requisite mental component is required to violate Rule 13b2-2.[69] These circuits defer to the evidence of congressional intent and statements of the SEC in holding that there is no scienter requirement in Rule13b2-2.[70] Subpart III.B then contrasts the appellate court's majority opinion with that of the Ninth Circuit. In *SEC v. Todd,* the Ninth Circuit overruled their opinion in *Ponce v. SEC* and held, through the adoption of reasoning from *Goyal*, that there is a scienter requirement to violate Rule 13b2-2.[71] The Ninth Circuit supports their decision with the policy rationale of limiting the scope of the rule.[72]

### *A. The Majority of Appellate Court Circuits Hold that There is no Scienter Requirement in Rule 13b2-2*

The most recent discussion of the scienter requirement in Rule 13b2-2 began in 1997 with the *McNulty* case.[73] Several corporations owned and controlled by Robert McNulty raised $78 million through security offerings.[74] A portion of this money was redirected to McNulty and other companies controlled by him.[75] During this time, John Shanklin was both an officer and director of two McNulty companies and responsible for their financial records and governmental filings.[76]

The complaint alleged that the diversion of this money was not accurately disclosed in the company's financial records and SEC filings.[77] In fact, the SEC asserted that Shanklin, in his employment

69. *See generally* SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1997); McConville v. SEC, 465 F.3d 780 (7th Cir. 2006); SEC v. Das, 723 F.3d 943 (8th Cir. 2013).

70. *See generally McNulty*, 137 F.3d 732; *McConville*, 465 F.3d 780; *Das*, 723 F.3d 943.

71. *See generally* Ponce v. SEC, 345 F.3d 722, 737 (9th Cir. 2003); *see also Todd*, 642 F.3d at 1219, *acknowledging Goyal*, 629 F.3d at 916 n.6 (holding that to be liable under Rule 13b2-2, one is required to "knowingly" make incorrect statements).

72. *Todd*, 642 F.3d at 1219, *using Goyal*, 629 F.3d at 916 (reasoning that policy concerns require the establishment of a scienter requirement in Rule 13b2-2).

73. *See generally McNulty*, 137 F.3d 732 (hearing a case discussing the scienter requirement in Rule 13b2-2 in 1997 by the United States Court of Appeals for the Second Circuit).

74. *See id.* at 734 (discussing the offerings provided through private and public channels).

75. *See id*.

76. *Id*. (stating that Shanklin was the vice president, chief executive officer, and operating officer of Auto Giant, Inc. and president, chief executive officer, operating officer, and administrative officer of Auto Depot, Inc.).

77. *Id*. (alleging that the company's books "misrepresented or falsely concealed material transactions").

capacity, "knew, or recklessly failed to know" that the financial statements either misrepresented or masked material transactions.[78] If proven accurate, these allegations would violate Rule 13b2-2.[79]

In their analysis, the Second Circuit stated that a lack of scienter could not act as a defense against any claims under Section 13 of the Securities Exchange Act of 1934.[80] The court reasoned that this holding was consistent with previous precedent of the Second Circuit as well as the SEC's interpretive regulations.[81] Because of the absence of any clear intent by Congress establishing a scienter requirement in Rule 13b2-2, the court recognized that the SEC's interpretive regulations should be entitled to deference.[82] Additionally, the court believed that the absence of a scienter requirement in Rule 13b2-2 was intended because a "knowing requirement" was only first mentioned in 1988 when Congress amended the rule in order to allow for criminal liability.[83]

In support of the Second Circuit's holding in *McNulty*, the Seventh Circuit followed suit and held that a civil violation of Rule 13b2-2 does not require scienter.[84] In this instance, Akorn Incorporated (Akorn) was a pharmaceutical manufacturing company that began using a new accounts receivable software program.[85] Instead of integrating the old software with the new, Akorn ran the program separately, which caused issues in determining the amount of the corporation's accounts receivables.[86] This challenge was voiced to the board of directors by Akorn's auditor, Deloitte and Touche, LLP; however, Rita McConville,

78. *See id*. (relying on Shanklin's responsibility for the internal financial records and SEC filings).

79. *Id*. (claiming violation of Sections 10(b), 13(a), and 13(b) of the Securities Exchange Act of 1934).

80. *Id*. at 740 (supporting the district court's ruling that the lack of a requisite mental requirement is not a defense to a Section 13(b) claim).

81. *Id*. at 740-41, *mentioning* SEC v. Koenig, 469 F.2d 198, 200 (2d. Cir. 1972) (upholding Section 13(b) liability without reference to scienter).

82. *Id*. at 741 (referencing that the rule "contains no words indicating that Congress intended to impose a 'scienter' requirement"); *see also* Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984) (requiring deference to an administrative agency's interpretation); Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 417-18 (1945) (requiring deference to an administrative agency's interpretation of its own regulation).

83. Pub. L. No. 100-418, Section 5002, 102 Stat. 1415, (1988) (codified at 15 U.S.C. Section 78m(b) (1994).

84. *See generally* McConville v. SEC, 465 F.3d 780 (7th Cir. 2006) (hearing a case regarding the scienter requirement in Rule 13b2-2 in 2006 by the Seventh Circuit).

85. *Id*. at 783 (stating that in 2000 Akorn initiated its use of the new J.D. Edwards software, but did not transfer the previously tacked accounts from the old Macola software).

86. *See id*. (stating that the auditor identified a "misapplication of credits and payments to customers' accounts, and failure to collect outstanding balances effectively and efficiently").

Akorn's Chief Financial Officer (CFO), downplayed it.[87]

The un-integrated software packages resulted in a major discrepancy with Akorn's largest customer, Cardinal Health.[88] At the end of 2000, Cardinal Health believed that they had a credit balance of $800,000 with Akorn, while Akorn believed that Cardinal Health owed them $4 million.[89] With the knowledge of such an inconsistency, Akorn did not change their financial records and made a press release that they had made $2 million in profit for the first quarter of 2001.[90]

By April of 2001, Akorn and Cardinal Health settled on the amount of the accounts receivable, which resulted in Akorn increasing its allowance for doubtful accounts by $7.5 million in its Form 10-Q.[91] As a result, the SEC charged McConville, because of her responsibility as CFO in filling Akorn's financial documents, with violating SEC Rules 10b-5, 13b2-1, and 13b2-2.[92]

In its analysis, the Seventh Circuit applied the same logic as the Second Circuit in holding that there is no scienter requirement in Rule 13b2-2.[93] The court stated that as long as it is supported by evidence, the SEC should be afforded deference in regards to interpreting the rules of the Securities and Exchange Act of 1934.[94] The court should not only give deference to the Commission, but also uphold the Commission's interpretation unless there is "clear congressional intent" in opposition.[95] Further, the Seventh Circuit stated that in the absence of clear congressional intent, the regulation's interpretation should be upheld

87. *See id*. (stating that Deloitte & Touche, LLP sent a letter warning the board of the anticipated issues in the financial statements); *see also id*. (stating that McConville drafted a report declaring that an effort to fix the issue was already underway and they planned to reconcile all the accounts completely by August 2000).

88. *See id*. (noting that because of the concerns of the auditors voiced to the board of directors and the un-integrated accounting systems, Akorn's financial department was already in a frenzy when the billing discrepancy between Akorn and Cardinal Health arose).

89. *See id*. (explaining that the difference in the two amounts was almost $5 million and a result of Cardinal Health's accounts receivable invoices going back to 1999, which is when the old software system of Macola was used).

90. *See id*. at 784 (explaining that McConville claimed the press release to be accurate, despite the dispute, and assured that there was no material money owed from wholesalers past due because the balances were offset by credits).

91. *See id*. at 785-86 (stating that the Form 10-K/A acknowledged that the $7.5 million increase in allowance for doubtful accounts should have been recorded in the 10-Q for the fourth quarter of 2000, not 2001, and that once the financial statements were corrected, the $2 million profit announced in the press release turned out to be a $2.4 million loss).

92. *Id*. at 789.

93. *See generally id*.

94. *See id*. at 786 (stating that the court is required to give "highly deferential, conclusive effect to the Commission's factual findings" as long as they are supported by recorded evidence).

95. *See id*., *citing* United States v. Mead Corp., 533 U.S. 218, 227 (2001).

unless the Commission's interpretation is "arbitrary, capricious, or manifestly contrary to the statute."[96]

In 2013, the Eighth Circuit joined the majority of appellate circuit courts in holding there is no scienter requirement in Rule 13b2-2.[97] Vinod Gupta was the Chief Executive Officer (CEO) of infoUSA.[98] As CEO, Gupta frequently traveled by jet, received payments for the purchase and upkeep of his yacht as well as payments for a variety of other personal expenditures.[99] However, infoUSA did not sufficiently disclose the perquisites as well as the related party transactions that occurred in regards to their CEO.[100]

The SEC brought a civil action against the CFOs of infoUSA, Stormy Dean and Rajnsh Das, for falsifying their financial records, certifying false reports filed with the SEC, and providing their auditor with false information under Rule 13b2-2.[101] In its opinion, the court took notice of the split in holdings between the circuits and stated, "[we] agree with the analysis of our sister circuits in *McConville* and *McNulty*."[102] The court began its analysis with the plain language of the rule and then noted that it believed substantial deference should be afforded to the SEC's interpretation of the rule.[103]

96. *Id*., *quoting* Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984).

97. *See generally* SEC v. Das, 723 F.3d 943 (8th Cir. 2013) (hearing a case on the scienter requirement in Rule 13b2-2 in 2013 by the United States of Appeals for the Eighth Circuit).

98. *Id*. at 946 (stating that Vinod Gupta "lived a life of luxury").

99. *Id*. (noting that Gupta received the benefits of supplementary income and benefits without recognizing the extra income and paying the additional taxes, and that the employees of the company thought that this was acceptable because Gupta founded the company as well as enhanced its value).

100. *Id*. (stating that the SEC did not agree with the views of the infoUSA employees because the corporation was publicly traded and the supplementary income received by Gupta should have been disclosed by the corporation).

101. *Id*. at 946-47 (stating that the SEC brought civil action against Dean and Das for securities fraud under Exchange Act Section 10(b) and Rule 10b-5, falsifying records and books under Exchange Act Section 13(b)(5), misleading auditors under Rule 13b2-1 and Rule 13b2-2, aiding in filling false filings to the SEC under Rules 12b-30 and 13a-1, and certifying false reports under Rule 13a-14).

102. *Id*. at 954 (regarding Rule 13b2-1 specially, but continuing to follow the same logic as applied by the Second and Seventh Circuits in reasoning that there is no scienter requirement in Rule 13b2-2).

103. *Id*. at 954-56 (ultimately declining to adopt the Ninth Circuit's holding that Rule 13b2-2 requires the SEC to prove that the actor acted knowingly in their falsification).

### *B. The Minority of Appellate Court Circuits Hold that There is a Scienter Requirement in Rule 13b2-2*

In 2003, the Ninth Circuit first considered the issue of a scienter requirement in Rule 13b2-2 in the case of *Ponce v. SEC*.[104] Russell Ponce was a Certified Public Accountant (CPA) and American Aircraft Corporation's (AAC) independent auditor.[105] Ponce acted as AAC's auditor from 1988 to 1991 and had a significant role in AAC's reporting and auditing.[106] As their auditor, Ponce assisted in valuing the assets and expenses of AAC on their financial statements.[107]

The SEC brought civil actions against AAC under SEC Sections 13(a) and 13(b)(2) as well as the accompanying rules.[108] The SEC claimed that Ponce "willfully aided, abetted, and caused" AAC in violating these rules.[109] The violations occurred because of the overvaluation of the license designs and the "mischaracterization" of expenses.[110] In holding that AAC and Ponce violated SEC Section 13(b), the court did not mention any scienter requirement associated with SEC Section 13(b)(2) or Rule 13b2-2.[111]

However, in 2011 the Ninth Circuit changed its stance regarding a scienter requirement in Rule 13b2-2.[112] In *Todd*, the Ninth Circuit reversed its holding in *Ponce*.[113] In *Todd*, the SEC brought actions

104. *See generally* Ponce v. SEC, 345 F.3d 722 (9th Cir. 2003) (hearing a case regarding a violation of Section 13(b)(2) and Rule 13b-2 in the United States Court of Appeals for the Ninth Circuit).

105. *Id*. at 725-26.

106. *Id*. at 726 (stating that the SEC's assertions against Ponce resulted from Ponce's actions regarding his responsibility for and role in AAC's reporting and auditing).

107. *Id*. (noting in the SEC allegations that the violations occurred from Ponce's involvement with valuing AAC's licenses and identifying "tooling and prototype expenses as inventory" on the financial statements of AAC).

108. *Id*. at 737 (stating that the SEC's allegations involved Sections 13(a) and 13(b)(2)).

109. *Id*. (qualifying that the charges included claims against Ponce for "willfully [aiding], [abetting], and [causing] AAC" to violate Section 13(b)(2)).

110. *Id*. (noting in the SEC allegations that the violations occurred from Ponce's involvement with valuing AAC's licenses and identifying "tooling and prototype expenses as inventory costs" on the financial statements of AAC).

111. *Id*. (concluding that Section 13(b)(2) was violated because AAC did not maintain "books, records, and accounts that accurately and fairly reflected the transactions and disposition of AAC's assets" and not mentioning any requisite mental intent such as scienter in their holding).

112. *See generally* SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011) (considering allegations of violating Rule 13b2-2, among others, by the SEC in the United States Court of Appeals for the Ninth Circuit in 2011).

113. *See id*. at 1219 (stating that a "knowing" standard was properly applied as a requisite mental state in violating Rule 13b2-2); *Compare with Ponce*, 345 F.3d at 737 (holding the actor liable under Section 13(b)(2) without regards to a knowledge or intent).

against the executives of Gateway Incorporated (Gateway).[114] Named parties included John Todd and Robert Manza, former Gateway financial executives, and Jeffrey Weitzen, Gateway's former President and CEO.[115] The SEC stated that Gateway misrepresented transactions with their clients VenServ, AOL, and Lockheed Martin on their financial statements.[116] Gateway recognized income from a $21 million incomplete transaction with VenServ, improperly disclosed a one-time $72 million transaction with AOL, and incorrectly recognized a $47.2 million lease-back transaction with Lockheed Martin as revenue.[117]

Regarding the above transactions, the SEC alleged that the executives falsified the corporation's financial statements in the third quarter of 2000.[118] The allegations stated that the executives falsified the records in order to improve their financial position in attempts to hit financial analysts' "earnings and revenue expectations."[119] Todd, Manza, and Weitzen all made formal representations to Gateway's auditors, PricewaterhouseCoopers (PwC), which stated that the financial statements conformed to the General Accepted Accounting Principles (GAAP) and assured continued revenue growth.[120] The United States District Court for the Southern District of California granted Todd, Manza, and Weitzen's motion for summary judgment on the Rule 13b2-

114. *See id.* at 1212.

115. *Id*. at 1212-13 (noting that Weitzen was Gateway's former CEO, Todd was the company's former CFO, and Manza was the former controller as well as the company's highest ranking CPA).

116. *See generally id.* at 1213-14 (discussing the disputed transactions with three of Gateway's customers, Lockheed Martin, VenServ, and AOL.).

117. *See id*. (noting the specifics of each disputed transaction. The Lockheed Martin transaction involved Gateway recording $47.2 million in gross revenue from a sale of assets, not manufactured or sold by Gateway, to Lockheed Martin, which was in return leased back by Gateway. Not only did the recognition of income depart GAAP standards, but the recognition of gross revenue from the sale of fixed assets departed from the policy standards set by Gateway as well. The VenServ transaction involved Gateway booking revenue of $21 million from an incomplete transaction. The revenue should not have been recognized because VenServ was not obligated to pay Gateway until Gateway had referred a certain amount of customers to them. The AOL transaction involved proper recognition of a one-time transaction between the two parties of $72 million, but Gateway did not properly disclose the specifics around the transaction allowing the public to believe the revenue would continue).

118. *Id*. at 1212 (stating that the SEC brought action against Gateway and its executives alleging that they "unlawfully misrepresented" the company's financial position in the third quarter of the year).

119. *See id.*

120. *Id*. at 1213 (distinguishing that Todd and Manza signed the management representation letter sent to PwC for the third quarter of 2000 certifying that the financial statements were fairly "prepared" and "[conformed] with generally accepted accounting principles [GAAP]) and that Todd and Weitzen assured analysts during a conference call that Gateway was "experiencing accelerated revenue growth").

2 claims.[121]

The District Court stated that its reasoning for granting the summary judgment motion stemmed from the fact that no evidence was provided to prove that neither Todd, Manza, nor Weitzen signed the management representation letter or made the statements regarding accelerated revenue growth knowing that the corporation had falsified their financial statements.[122] Although reversing the summary judgment as granted for the claims against Todd and Manza, the Appellate Court stated that the District Court correctly applied a "knowingly" standard to Rule 13b2-2.[123]

In its support of the District Court, the Ninth Circuit primarily relied on support from *Goyal*.[124] *Goyal* involved criminal allegations made by the SEC against the Network Associates, Inc. (NAI) and its former CFO in using non-GAAP accounting methods to recognize sales revenue from the corporation's largest distributor in order to meet the revenue projections for the quarter.[125] The SEC ultimately accused Prabhat Goyal with "willfully and knowingly" making misrepresentations to NAI's auditor, PwC.[126] The court held that there was a mandatory "knowingly" requirement to find liability under Rule 13b2-2.[127]

Although the *Goyal* standard was in regards to criminal liability under Rule 13b2-2, the Ninth Circuit in *Todd* applied it to civil liability as well.[128] The court in *Todd* stated that the District Court properly imposed a "knowingly" standard because there is a distinct difference

121. *Id*. at 1212 (stating that the SEC was appealing the district court's ruling to grant summary judgment on the part of Todd, Manza, and Weitzen).

122. *Id*. (noting that the district court found no evidence that Weitzen signed the representation letter for the auditor's knowing that Gateway falsified its financial position and stating that the appellate court was reversing the order granting summary judgment in the matters of Todd and Manza because there was enough evidence to support the theory that Todd and Manza "at least recklessly misrepresented revenue related to the Lockheed [and VenServ] transaction[s]").

123. *Id*. at 1219 (stating that the district court correctly applied a "knowing" standard to Rule 13b2-2, which the SEC "failed to distinguish from intent to mislead").

124. *See generally id*. at 1219-20 (recognizing that *Goyal* provided the rule for the court to follow, that "to be liable, one must 'knowingly" make false statements.'"); *See also* United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010).

125. *Goyal*, 629 F.3d at 913 (additionally recognizing that the jury found Goyal guilty of securities fraud and making false filings with the SEC).

126. *Id*. at 916, *quoting* United States v. Tarallo, 380 F.3d 1174, 1189 (9th Cir. 2004) (defining "willfully and knowingly" to require that the actions were "voluntarily and knowingly wrongful").

127. *See id*. (stating that the government had to provide evidence that Goyal knew the statements he made to PwC were false).

128. *See generally Todd*, 642 F.3d 1207.

between "knowingly" and "intent to mislead."[129] The court stated in dictum that the SEC does not require strict liability but did intend to find liability under the rule in situations of negligence.[130] The court stated that the knowledge requirement "requires that [the defendant] 'was aware of the falsification and did not falsify through ignorance, mistake, or accident.'"[131]

Additionally, the *Todd* court focused on the policy reasoning in *Goyal* in determining that there is a "knowingly" requirement in Rule 13b2-2.[132] The Ninth Circuit strongly advocated that it could not interpret the statutory rule to not have a requisite mental state because to do so would make the scope of liability imposed by the Rule too broad.[133] Specifically, the court stated that not requiring an actor to "knowingly" violate Rule 13b2-2 would "impose liability on a broader range of conduct than Congress intended."[134]

## IV. AS APPLIED TO RULE 13B2-2, SCIENTER AND KNOWLEDGE SHOULD NOT BE ONE AND THE SAME

Subpart IV.A of this comment analyzes the three potential avenues that courts can take in resolving the question of whether there is a scienter requirement in Rule 13b2-2. Traditionally, the courts could follow the appellate circuit court's majority view that there is not a scienter requirement to finding liability under Rule 13b2-2, or the courts could follow the current minority view of the appellate circuit courts that legislators intended there to be a scienter requirement to finding liability under Rule 13b2-2. However, the appellate circuit courts could also choose a third option—to set a new standard.

Subpart IV.B of this Comment will discuss a new, third avenue for the circuits to consider. Currently, when referring to a requisite mental state in Rule 13b2-2, the courts treat "knowledge" as having the same meaning as "scienter." This confusion has not only muddled the distinction between the two concepts but also helped to cause the discrepancy in views between the circuits. Not only are the connotations

129. *See id*. at 1219 (stating that knowledge and an intent to mislead can be distinguished); *see also* United States v. Watkins, 278 F.3d 961, 968-69 (9th Cir. 2002) (noting that knowledge about falsification cannot prove an intent to mislead).

130. *Id*. (stating that the SEC acknowledges that the rule does not "create a strict liability regime," but does seek to provide a standard to punish for negligence).

131. *Id*., *quoting* United States v. Reyes, 577 F.3d 1069, 1080 (9th Cir. 2009).

132. See generally *id*. at 1219-20.

133. *See generally id*.

134. *See id*. (stating the court could not loosen the standard set by the statute as it would result in inflicting liability on a broader breadth of conduct than originally intended by Congress).

of the words separate, but the denotations are as well. It will be recommended that Rule 13b2-2 should have a knowledge requirement, but this requirement should be separate and distinct from a scienter requirement.

### *A. There are Three Potential Theories to Follow When Considering Whether There is a Requisite Mental State in Rule 13b2-2*

There are three avenues the appellate circuit courts can take when deciding the question of whether there is a requisite mental state required to find liability under Rule 13b2-2. When answering the question, courts can either stick with the status quo, side with the unpopular opinion, or analytically look at the totality of the circumstances and chart their own territory.

First, the circuit could follow the opinion of the majority of ruling federal court circuits. This opinion is that no requisite mental state needs to be proven for a court to find liability under Rule 13b2-2. The Second Circuit in *McNulty*, Seventh Circuit in *McConville*, and Eighth Circuit in *Das* all support the view that there is no requisite mental component to violations of Rule 13b2-2.[135] As this first option is the popular view, there are many strong arguments that support adopting this interpretation of Rule 13b2-2.

Choosing to not require a requisite mental state to find liability under Rule 13b2-2 is by far the "easier" opinion. A major compelling reason to support not recognizing a requisite mental state comes from the plain language of the rule. Rule 13b2-2 states that one must not "make or cause to be made" or "omit to state or cause another person to omit to state."[136] In reference to these actions the rule does not mention or even allude to an individual "making" or "omitting" with knowledge or intent to deceive. Because rules are meant to provide courts with the necessary information to allow them to determine whether an individual's actions violate the law, it can be argued that Congress did not intend for the courts to require one to act either knowingly or with intent. This reading of the plain language of the rule is supported by the legislative interpretation of the rule.

As interpreted by the majority of ruling appellate circuit courts, the SEC's interpretation of Rule 13b2-2 does not read a scienter requirement as a requisite mental state in violating Rule 13b2-2. Because Rule 13b2-

135. *See generally* SEC v. McNulty, 137 F.3d 732 (2d. Cir. 1997); McConville v. SEC, 465 F.3d 780 (7th Cir. 2006); SEC v. Das, 723 F.3d 943 (8th Cir. 2013).

136. 17 C.F.R. 240.13b2-2, *supra* note 12.

2 enumerates the four actions of coercing, manipulating, misleading, and fraudulently influencing, and the Supreme Court has found only two of them to require scienter, the courts believe that scienter is not required in order to find liability under the rule. Additionally, in the SEC Release, scienter was not mentioned.[137]

Second, the appellate circuit courts could follow the opinion held by the minority of ruling federal appellate circuit courts. This opinion requires that the mental requisite state of scienter be proven for a court to find liability under Rule 13b2-2. The Ninth Circuit described this standard as requiring an individual to knowingly make misrepresentations to an external financial statement auditor.[138] However, only the Ninth Circuit in *Todd* supports the reading of a scienter requirement into Rule 13b2-2. Because neither the majority of federal circuits, nor the government, currently support a requisite mental state in order to find liability under Rule 13b2-2, the reasons to support this reading must be compelling.

The compelling arguments supporting the reading of a scienter requirement into Rule 13b2-2 are the plain language of the rule and policy. Although Rule 13b2-2 does not mention or allude to any required knowledge or intent regarding the "making" or "omitting" of materially false statements to auditors, the rule does in fact have language implicating a requisite mental state. Rule 13b2-2 states that no person should "*coerce, manipulate, mislead, or fraudulently influence*" an auditor though their actions.[139]

Intent is implied in the general connotation associated with words such as "coerce" and "manipulate." One cannot accidently coerce or manipulate another. One must have knowledge of their actions and intend to change or influence the actions of another to have coerced, manipulated, or misled another. Therefore, Congress must have intended for the courts to recognize that in order to violate Rule 13b2-2 there must be some sort of requisite mental state required.

Additionally, policy supports the reading of scienter into Rule 13b2-2. When Rule 13b2-2 was enacted in response to SOX, the legislation was intended to help enhance investor confidence as well as curb corporate corruption. In pursuit of this goal, the SEC intended to punish those who knowingly or intentionally acted with the result of a

137. *See* SEC Release No. 34-47890 Final Rule, *supra* note 10.

138. *Todd*, 642 F.3d at 1219, *acknowledging* United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010) (holding that to be liable under Rule 13b2-2, one is required to "knowingly" make incorrect statements).

139. 17 C.F.R. 240.13b2-2, *supra* note 12.

detriment to investor confidence. The SEC never intended the rule to find individuals liable who acted mistakenly. Therefore, the SEC must have intended for some sort of requisite mental state to be read into Rule 13b2-2 to find liability.

A scienter requirement would set a high standard for this requisite mental state. Such a requirement is necessary to avoid finding liable a wider class of individuals than intended by the SEC in the enactment of the rule. As discussed in the SEC Release, the SEC did not intend to require strict liability regarding the rule, but it did intend to find liability in situations where the conduct was at least "knowingly". A scienter requirement would not only eliminate any strict liability, but further eliminate the chance of finding liability of a wider group of individuals than originally intended by the SEC.

However, both the majority and minority opinions of the ruling federal circuits come with drawbacks. Although the popular opinion, not reading a requisite mental state into Rule 13b2-2 to find liability has some strong disadvantages. The interpretation in the SEC Release states that the Commission did not intend strict liability under the rule, as it states an actor must knowingly or have reason to know that his actions would improperly influence an auditor. Therefore, some requisite mental state must be proven to find liability under Rule 13b2-2. Additionally, policy dictates that liability should be limited to the category of actors intended by the SEC. To accomplish this goal some requisite mental state must be required.

Reading a scienter requirement into Rule 13b2-2 poses its own difficulties. Even though policy dictates limiting the net of liability resulting from the rule, it also dictates promoting the good of the whole. As the rule was implemented to deter corporate corruption and enhance investor confidence, it will not be able to accomplish these goals if liability under the rule is severely limited by the high standard of a scienter requirement.

Although the language of Rule 13b2-2 does not produce strict liability, the SEC did not intend the high standard of scienter to be read into the rule. In its interpretation, the SEC never mentioned a scienter standard but did in fact discuss that the actor must act with knowledge or must have reason to know their action would improperly influence the auditor. Because of the difference in legal meaning between scienter and knowledge, and because the interpretation used only the word knowledge, the SEC must not have intended the courts to read a requisite mental state as extreme as a scienter requirement into Rule 13b2-2.

Therefore, the appellate circuit courts could decide to follow neither the majority nor minority of federal circuit courts. The circuits could decide to establish their own standard or to clarify and expand the opinions of either the majority or minority of circuits. Because there are strong arguments against both the opinions of the majority and minority of federal circuit courts, the courts should choose this third avenue when deciding the question of whether a scienter requirement should be read into Rule 13b2-2.

### *B. A Knowledge Requirement, Separate and Distinct from Scienter, Should be the Requisite Mental State Read into Rule 13b2-2*

The federal circuit courts should decide to follow neither the majority nor minority federal court opinions. Because of the general description of the requisite mental state required in Rule 13b2-2 as scienter, the intentions of Congress and the SEC have been clouded. This has caused not only the circuit split regarding a scienter requirement in Rule 13b2-2, but also confusion as to the rule's separate implications in civil and criminal cases. In the case of civil liability under Rule 13b2-2, a scienter requirement should be differentiated from a knowledge requirement.

#### 1. Both the Legal Definition of Knowledge as well as the Plain Meaning of the Words Incorporated Within Help to Explain how a Knowledge Standard Would be Implemented in Rule 13b2-2

In regard to Rule 13b2-2, reading knowledge, and not scienter, as the requisite mental state to establish liability would clarify the implications and applicability of the rule in many ways. Concerning its application in Rule 13b2-2, the courts recognize knowledge to "[require] that [the defendant] was aware of the falsification and did not falsify through ignorance, mistake, or accident."[140] The Supreme Court has recognized "scienter" to be the "mental state embracing intent to deceive, manipulate, or defraud."[141]

To clarify and illuminate the differences between scienter and knowledge, their legal definitions can further be explained. As individuals violating the rule would more than likely be corporate

140. *Goyal*, 629 F.3d at 916, *quoting* United States v. Reyes, 577 F.3d 1069, 1080 (9th Cir. 2009) (defining knowledge).

141. *Todd*, 642 F.3d at 1215, *quoting* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (defining scienter).

employees and officials without a legal background, the legal definitions of knowledge and scienter would best be explained by using the plain/dictionary meaning of the words incorporated. This not only provides insight into the meaning of the knowledge standard but also additional assistance in the future implementation of the knowledge standard in Rule 13b2-2.

As previously stated, courts recognize knowledge to "[require] that [the defendant] was aware of the falsification and did not falsify through ignorance, mistake, or accident."[142] Merriam-Webster's Dictionary provides additional meaning to the legal definition of the word knowledge that helps to provide support to a knowledge standard in Rule 13b2-2. Awareness is having or showing realization, perception, or knowledge of a fact or situation.[143] Ignorance is having a lack of understanding, knowledge, or education.[144] To mistake is to make a wrong judgment of the character or ability of something.[145] Acting by accident is with the lack of intention or necessity.[146]

As noted, the Supreme Court has recognized "scienter" to be "the mental state embracing intent to deceive, manipulate, or defraud."[147] However, four additional plain meanings help to define the words incorporated within the legal meaning of scienter. An action is intended when it is a clearly formulated or planned event.[148] To deceive is to make [someone] believe something that is not true.[149] To manipulate is to use or change [numbers, information, etc.] in a skillful way or for a particular purpose.[150] To defraud is to trick or cheat someone or something in order to get money or to use fraud in order to get money from a person, an organization, etc.[151] Finally, to commit fraud is to use

142. *Goyal*, 629 F.3d at 916, *quoting Reyes*, 577 F.3d at 1081 (defining knowledge).

143. *See generally Aware*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/aware (2015) (paraphrasing the definition of "aware").

144. *See generally Ignorance*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/ignorance (2015) (paraphrasing the definition of "ignorance").

145. *See generally Mistake*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/mistake (2015) (paraphrasing the definition of mistake).

146. *See generally Accident*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/accident (2015) (paraphrasing the definition of "accident").

147. SEC v. Todd, 642 F.3d 1207, 1215 (9th Cir. 2011), *quoting* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (defining "scienter").

148. *See generally Active*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/action (2015) (paraphrasing the definition of "action").

149. *See generally Deceive*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/deceive (2015) (paraphrasing the definition of "deceive").

150. *See generally Manipulate*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/manipulate (2015) (paraphrasing the definition of "manipulate").

151. *See generally Defraud*, Merriam-Webster's Online Dictionary, https://www.merriam-

deceitful methods to procure something of worth from another.[152]

As shown through the clarification of the definitions of knowledge and scienter, applying the standard of knowledge to Rule 13b2-2 would increase the benchmark to impose liability above no requisite mental state but still below the high standard of scienter. To violate Rule 13b2-2, individuals must be cognitively conscious that their actions could wrongly influence an auditor's actions and/or decisions but do not have to have the devious intentions to influence the auditor. This would eliminate any liability for those who simply misunderstood, misspoke, or non-negligently made a mistake. Additionally, although the rule would not require individuals to intentionally act, it would still apply to those who did.

### 2. Implementing a Knowledge Standard in Rule 13b2-2 is Supported by the Language of the Rule, the SEC's Interpretation of the Rule, and Policy

Why implement a knowledge standard when considering liability under Rule 13b2-2? A knowledge standard should be read into Rule 13b2-2 for many reasons. First, the policy argument of limiting the liability imposed by rules to that intended by the rule maker requires that Rule 13b2-2 not impose strict liability on actors. Second, the language of Rule 13b2-2 describes the actions that would violate the rule as those that require at least a minimum level of a requisite mental state. Third, the interpretation of Rule 13b2-2 in the SEC Release explicitly explains that for actions to be considered within the jurisdiction of the rule the actor must have knowledge or reason to know that their actions could improperly influence an auditor.

First, policy dictates that the Commission's intentions in enacting Rule 13b2-2 to not establish strict liability be upheld. This requires that a requisite mental state be required to find liability under Rule 13b2-2. For innocent conduct such as mistakes and misunderstandings to not be considered conduct violative of Rule 13b2-2, a requisite mental standard must be required. This will help limit the kinds of conduct found violative, therefore limiting the scope of liability of Rule 13b2-2.

The Ninth Circuit focused heavily on a policy argument. The court focused on limiting the span of liability of Rule 13b2-2 by adding a knowledge requirement to the rule. Policy dictates that Rule 13b2-2

webster.com/dictionary/defraud (2015) (paraphrasing the definition of "defraud").

152. *See generally Fraud*, Merriam-Webster's Online Dictionary, https://www.merriam-webster.com/dictionary/fraud (2015) (paraphrasing the definition of "fraud").

cannot be interpreted without a requisite mental state because it would make Rule 13b2-2 too broad and similar to strict liability, which was not intended by Congress or the Commission as explained in the SEC Release. Specifically, the court in *Todd* stated that by not requiring an actor to act with knowledge or reason to know that their actions could improperly influence auditors would "impose liability on a broader range of conduct than Congress intended."[153]

When Rule 13b2-2 was enacted in response to SOX, the legislation was intended to help enhance investor confidence as well as curb corporate corruption. In pursuance of this goal, the SEC intended to punish those who knowingly or intentionally acted with the result of a detriment to investor confidence. The SEC never intended the rule to find individuals liable who acted mistakenly. Therefore, the SEC must have intended for some sort of requisite mental state to be read into Rule 13b2-2 to find liability.

A requisite mental state is necessary to avoid finding liability on a wider class of individuals than intended by the SEC in enacting the rule. However, a scienter requirement would set too high of a standard for this requisite mental state. A scienter requirement would not only eliminate any strict liability, but also further require that any conduct be done with deceitful intent to violate the rule.

A scienter requirement would not only limit the scope of liability under Rule 13b2-2, but also set an extremely high standard to prove liability. Such a standard would make it difficult for individuals to be found liable, therefore ensuring that the conduct Congress intended to deter and punish is not disciplined. A knowledge standard would provide a successful compromise by limiting the scope of liability and still allow the rule to be effective by not establishing such a high standard for prosecutors to prove liability.

Second, the language of the law requires that at least a knowledge standard be read into Rule 13b2-2. The majority of ruling federal appellate courts argue that Section 13(b) of the Securities Exchange Act of 1934 does not "[contain] words indicating that Congress intended to impose a scienter requirement."[154] However, the language in Rule 13b2-2 was enacted to further clarify and support Section 13(b) and therefore should be provided equal weight in the argument. Further, the language

153. SEC v. Todd, 642 F.3d 1207, 1219 (9th Cir. 2011) (stating that the court could not loosen the standard set by the statute, as it would result in inflicting liability on a broader breadth of conduct than originally intended by Congress).

154. SEC v. McNulty, 137 F.3d 741 (2d. Cir. 1997) (arguing for not reading a scienter requirement to find liability under Rule 13b2-2).

of Rule 13b2-2 does in fact contain words that allude to Congress' intent to impose at least a minimum requisite standard.

Rule 13b2-2 states that an individual must not "take any action to coerce, manipulate, mislead, or fraudulently influence" auditors.[155] For conduct to be coercive, manipulative, misleading, or fraudulently influencing it requires a requisite mental state from the actor. An actor cannot coerce another into acting a certain way unless they have knowledge that their words or actions will influence the other to respond in a certain way.

Similarly, to mislead another, an actor must be cognitively aware that their conduct or words will result in another believing something is the truth, resulting in conduct desired by the actor. The same type of knowledge prefaces manipulation and fraudulent influence as well. This is a result of coercion, manipulation, misleading, and fraudulently influencing being "active" actions, which require that an actor knowingly act in a certain way. Therefore, the violative actions require a requisite mental state.

So, the Commission and Congress must have intended for at least a knowledge standard to be read into Rule 13b2-2. Without this minimum standard of a requisite mental state, the conduct described in Rule 13b2-2 would not occur. Therefore, knowledge is a necessity for Rule 13b2-2 to be violated. Additionally, although the rule does not use the term knowledge or the phrase that an actor must act knowingly, the SEC's interpretation of the rule does.

Finally, the interpretation of Rule 13b2-2 as discussed in the SEC Release requires that for an actor to violate Rule 13b2-2 the actor must have knowledge or reason to know that their actions could improperly influence an auditor. From beginning to end, the SEC Release both explicitly and implicitly supports the reading of a requisite mental state, more specifically knowledge, into Rule 13b2-2. This is evidenced through its enumerated examples and establishment of the Commission's use of the phrase knew or had reason to know.

The first page of the SEC Release states that the newly revised rule was not intended by the Commission to impose a "new scienter requirement" on Rule 13b2-2.[156] The use of the word "new" connotes something additional, or different. Therefore, for there to be a "new scienter requirement" there had to be some "old" scienter requirement, or at least minimal requisite mental state required of the rule.

155. 17 C.F.R. 240.13b2-2, *supra* note 12.

156. SEC Release No. 34-47890 Final Rule, *supra* note 10

In the SEC Release, the Commission also stated that the rule applied to individuals who "knew or should have known that [their] action, if successful, could result in rendering the financial statements materially misleading."[157] The Commission requiring an actor to have knowledge or a reason to know their actions could have such an effect is equivalent to a knowledge requirement. This statement by the Commission explicitly states that they intended a knowledge requirement to be read into Rule 13b2-2. Further, because the Commission did not explain that the actor must also have the intent for their actions to have such an effect, they distinguished any required requisite mental state from scienter.

The further clarification provided by the Commission for the phrase "take any action to coerce, manipulate, mislead, or fraudulently influence" indicated additional support for the implementation of a knowledge standard into Rule 13b2-2.[158] The SEC Release states that the words "coerce and manipulate" suggests actions such as "pressure, trickery, intimidation, or some other form of purposeful action."[159] The conduct enumerated by the Commission connotes actions, which require that the actor act knowingly. One cannot pressure, trick, or intimidate without knowing or having reason to know that they are doing so.

The Commission also provided examples of conduct that could trigger improper influence on an auditor and therefore a violation of Rule 13b2-2. These actions include blackmail, threatening physical violence, claiming the intent to cancel an engagement, providing incorrect information and bribes.[160] Not only do these actions require that the actor act with knowledge of the effect that their conduct could have on an auditor, but the SEC Release also preempted the listed actions by a statement that they intended violative conduct to be done with knowledge or a reason to know that it would improperly influence an auditor.

The reasons for applying a knowledge standard to Rule 13b2-2 are numerous. The policy argument of limiting the liability imposed by rules to that intended by the rule maker requires that Rule 13b2-2 does not impose strict liability on actors. However, the high standard of scienter would limit the liability too extremely. A knowledge standard would limit the scope of liability and protect against imposing too high a requirement for proving liability.

157. *Id.* (describing violative conduct).
158. *See id.*, *quoting* 17 C.F.R. 240.13b2-2.
159. *Id.* (providing clarification to the language of the rule).
160. *Id.*

Not only does policy demand a knowledge standard in Rule 13b2-2, but the language of Rule 13b2-2 also supports it. Rule 13b2-2 describes actions that would violate the rule as those that require at least a minimum level of a requisite mental state. Actions such as coercion, manipulation, fraudulent influence, and misleading require that an actor act with knowledge of the repercussion of their actions to violate the rule. Finally, the interpretation of Rule 13b2-2 in the SEC Release explicitly explains that for actions to be considered within the jurisdiction of the rule the actor must have knowledge or reason to know that their actions could improperly influence an auditor.

Further, the legal definition of knowledge and the plain/dictionary meaning of the words incorporated will help courts to understand and implement this standard. As applicable to Rule 13b2-2, for an actor to have knowledge or reason to know that their conduct could improperly influence an auditor they must be "aware of the falsification and did not falsify through ignorance, mistake, or accident."[161] The plain meanings within this phrase further help explain the standard of violative conduct in Rule 13b2-2 to potential violators as well as provide courts with additional factors to analyze in applying the knowledge standard.

## V. CONCLUSION

It is important to find a solution to the current circuit split concerning whether scienter is requisite to finding liability under Rule 13b2-2 because of the implications the reading of the Rule can have and has had on the actors in the financial market. The deference given to the SEC's interpretation of Rule 13b2-2 in the SEC Release is too strong of evidence to stray far from the opinion held by the majority of appellate circuit courts. This majority opinion, supported in *McNulty*, *McConville*, and *Das*, states that a scienter requirement should not be read into Rule 13b2-2. However, the policy reasoning established in *Goyal* that Congress did not intend to establish liability on a wide range of conduct, which supports the minority opinion of the Ninth Circuit in *Todd* reading a scienter requirement into Rule 13b2-2, cannot be ignored.

The SEC did not intend to establish the high standard that scienter as a requisite mental state requires to prove liability under Rule 13b2-2. As recognized by the courts in the Ninth Circuit, the SEC did not want any official who simply made a mistake in their representations to auditors to be found liable. The Ninth Circuit also recited that to not

161. United States v. Goyal, 629 F.3d 916 (9th Cir. 2010), *quoting* United States v. Reyes, 577 F.3d 1069, 1080 (9th Cir. 2009) (defining knowledge).

impose a requirement of a requisite mental state would be to open liability to a wider class of individuals than intended by Congress in the enactment of the rule.

Congress's intent to limit the range of liability is evidenced in the SEC Release through its continued effort to explain that an actor must have knowledge or at least a reason to know that his conduct could improperly influence auditors. It is also supported through the example of intentional conduct provided in the SEC Release that the Commission wanted to specify as actions that would violate the rule. Therefore, a compromise needs to be made.

Because the issue stems from the courts treating scienter and knowledge as having the same legal meaning, clearly differentiating the standards from one another would pave the way for agreement among the courts. As alluded to in the *Todd* opinion, Rule 13b2-2 should have a knowledge requirement, but this requirement should be separate and distinct from a scienter requirement. This distinction is most evident in the legal meaning of the terms and the plain/dictionary meaning of the words incorporated. It is also supported in the SEC Release and the dicta in all the appellate courts.

Having knowledge or reason to know the actor's conduct could improperly influence the auditor, as described in the SEC Release, is distinct from having the "mental state embracing intent to deceive, manipulate, or defraud" that scienter requires.[162] A knowledge requirement would not only support the SEC's interpretation of Rule 13b2-2, but also encourage the undertone in the majority of ruling federal court opinions, which is that the courts realize Rule 13b2-2 does not provide strict liability but that it does not require scienter either.

Additionally, reading a knowledge requirement into Rule 13b2-2 will support policy by sparing those officials who simply made a mistake in their representations, calculations, and/or disclosures, while still allowing for liability to be established on a broader class of individuals than the stricter standard of liability under a scienter requirement would.

162. SEC v. Todd, 642 F.3d 1207, 1215 (9th Cir. 2011), *quoting* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (defining "scienter").