

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 210 and 240

[Release No. 34-37594; IC-22162; File No. S7-20-96].

RIN 3235-AG70

### Implementation of Section 10A of the Securities Exchange Act of 1934

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed Rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") today is soliciting comments on proposed rule amendments to implement the reporting requirements in section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 10A requires, among other things, that the auditor of a registrant's financial statements report to the registrant's board of directors certain uncorrected illegal acts of the registrant, and that the registrant notify the Commission that it has received such a report. If the registrant fails to provide that notice, the auditor is required by section 10A to furnish directly to the Commission the report given to the Board. The proposed amendments to the Commission's Exchange Act Rules are intended to implement those reporting requirements. The proposed amendment to Regulation S-X would conform the definition of "audit" in that regulation with the wording in section 10A.

**DATES:** Comments on the proposed amendments should be received on or before October 28, 1996.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. Comment letters should refer to File No. S7-20-96; this file number should be included on the subject line if E-mail is used. All comments will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comments may be posted on the Commission's internet web site (<http://www.sec.gov>).

**FOR FURTHER INFORMATION CONTACT:** Robert E. Burns or W. Scott Bayless, at (202) 942-4400, Office of the Chief Accountant, Mail Stop 11-3, and for investment company issues, Kathleen

Clarke, at (202) 942-0724, Division of Investment Management, Mail Stop 10-6, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing to amend its Exchange Act Rules, 17 CFR 240, by adding Rule 10A-1, and Regulation S-X, 17 CFR 210, by revising Rule 1-02.

#### I. Background

Title III to the Private Securities Litigation Reform Act of 1995, Public Law 104-67, enacted on December 22, 1995, added section 10A to the Exchange Act. This section codifies certain professional auditing standards and imposes expanded obligations on auditors<sup>1</sup> to report in a timely manner certain uncorrected illegal acts<sup>2</sup> to a registrant's board of directors. It further requires the registrant, or if the registrant fails to do so then the auditor, to provide information regarding the illegal act to the Commission.

Section 10A(a) requires that audits of registrants' financial statements include, "in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—"

1. Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

2. Procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

3. An evaluation of whether there is substantial doubt about the registrant's ability to continue as a going concern during the ensuing fiscal year.<sup>3</sup>

Certain procedures in each of these three areas already are required by generally accepted auditing standards

<sup>1</sup> For the purpose of this release, the term "auditor" refers to any independent public or certified public accountant who is performing or has performed an audit of a registrant's financial statements and whose audit report has or will be filed with the Commission in accordance with the federal securities laws or the Commission's regulations. See, e.g., sections 12(b)(1) (J) and (K), 13(a)(2), and 17(e) of the Exchange Act, 15 U.S.C. 78l(b)(1) (J) and (K), 78m(a)(2), and 78q(e), and the Commission's Regulation S-X, 17 CFR § 210. The term "independent accountant" is used in the regulatory text in order to be consistent with existing provisions in Regulation S-X.

<sup>2</sup> Section 10A(f) defines the term "illegal act" broadly to mean "an act or omission that violates any law, or any rule or regulation having the force of law." This definition is consistent generally with *Statement on Auditing Standards No. 54*, "Illegal Acts by Clients," ¶12 (January 1, 1989), AU § 317.02, which states, "the term illegal acts . . . refers to violations of laws or governmental regulations."

<sup>3</sup> Section 10A(a) (1), (2), and (3).

("GAAS")<sup>4</sup> in the United States and are further codified in the *Statements on Auditing Standards* ("SAS")<sup>5</sup> adopted by the Auditing Standards Board ("ASB"), the senior technical body for auditing matters of the American Institute of Certified Public Accountants ("AICPA").<sup>6</sup> The Commission staff historically has worked closely with the ASB. The staff, among other things, attends ASB meetings, reviews and provides the ASB with comments on draft Statements on Auditing Standards, and has periodic meetings with ASB representatives to discuss items on the ASB agenda and other matters of mutual concern. The Commission staff plans to continue these practices.

In addition to the requirement in section 10A(a) that auditors perform procedures designed to enhance the detection of fraudulent financial reporting, section 10A(b) contains provisions that would require an auditor to report directly to the Commission

<sup>4</sup> In February 1941, the Commission amended Rule 2-02 of Regulation S-X, 17 CFR § 210.2-02, to require that the independent accountant state in his or her report "whether the audit was made in accordance with generally accepted auditing standards. . . ." Accounting Series Release No. 21 (February 5, 1941). In this release, the Commission defined "generally accepted auditing standards" to mean the application of "generally recognized normal auditing procedures" with professional competence by properly trained persons. The Commission defined "generally recognized normal auditing procedures" to be those normally employed by skilled accountants and those prescribed by authoritative bodies dealing with the subject of auditing, such as accounting societies and governmental bodies having jurisdiction in the area. *Id.* Following this addition to the Commission's rules, the relevant professional committee at the time, the Committee on Auditing Procedure, began a study to determine which auditing standards should be included within "GAAS." In 1948, the membership of the predecessor organization to the American Institute of Certified Public Accountants ("AICPA") approved ten standards as constituting GAAS. See, AICPA, *Codification of Statements on Auditing Standards*, AU § 150.02. These ten standards are supplemented by *Statements on Auditing Standards*, which currently are issued by the Auditing Standards Board of the AICPA.

<sup>5</sup> Currently effective *Statements on Auditing Standards* are published by the American Institute of Certified Public Accountants in the *Codification of Statements on Auditing Standards*. Provisions in the Codification are designated as "AU § . . ." For standards addressing those procedures mandated by section 10A, see SAS 54, "Illegal Acts by Clients" (January 1, 1989), AU § 317; SAS 45, "Related Parties" (September 30, 1983), AU § 334; and SAS 59, 64, and 77 reprinted in "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (January 1, 1989), AU § 341. See also SAS 53, "The Auditor's Responsibility to Detect and Report Errors and Irregularities" (January 1, 1989), AU § 316. The ASB is in the process of re-examining SAS 53, SAS 54, and other auditing standards related to the detection and reporting of financial fraud. References in this release are to auditing standards in effect at the date of this release.

<sup>6</sup> The ASB's 15 members serve on a part-time basis and are appointed for one year terms that may be extended for up to three years.

certain detected illegal acts if the registrant fails to do so.

Under section 10A(b), if, while conducting the audit of the registrant's financial statements, the auditor becomes aware of information indicating that an illegal act (whether or not material to the financial statements) has occurred or may have occurred, then the auditor would be required, in accordance with GAAS, "as may be modified or supplemented from time to time by the Commission," to determine whether it is "likely" that an illegal act has occurred and, if so, its possible effect on the financial statements (including any contingent monetary effects, such as fines, penalties, and damages).<sup>7</sup> The auditor would be required to inform the registrant's management of the illegal act "as soon as practicable." In addition, the auditor must assure him/herself that the registrant's board of directors is adequately informed, by management or otherwise, of any detected illegal act.<sup>8</sup>

Although GAAS contains procedures for similar notification of illegal acts to managements and boards of directors,<sup>9</sup> section 10A(b) contains the additional requirement that these notifications occur "as soon as practicable."<sup>10</sup>

After the auditor determines that the audit committee or the board of directors has been adequately informed of an illegal act and the auditor reaches three specified conclusions, the auditor is required by section 10A(b)(2) to report those conclusions directly to the board of directors "as soon as practicable." The three conclusions set forth in section 10A(b)(2) that trigger the auditor's obligation to report to the board are that:

1. The illegal act has a material effect<sup>11</sup> on the registrant's financial statements,

2. Senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act, and

3. The failure to take remedial action is reasonably expected to warrant either a departure from the auditor's standard audit report,<sup>12</sup> when made, or the auditor's resignation from the audit engagement.<sup>13</sup>

If the board of directors receives a report that the auditor has reached these conclusions, then the board has one business day to notify the Commission that it received such a report. If the auditor does not receive a copy of the board's notice to the Commission within that one business day period, then by the end of the next business day the auditor is required to furnish directly to the Commission a copy of the report given to the board (or the documentation of any oral report<sup>14</sup>).<sup>15</sup> The auditor's resignation from the audit engagement does not negate the auditor's obligation to furnish his or her report to the Commission in these circumstances.<sup>16</sup>

Section 10A(c) states that there is no private right of action against auditors based on any findings, conclusions, or statements expressed in their reports to the Commission. It should be noted, however, that this section does not address private rights of action based on, among other things, the auditor's failure to make the required report, the auditor's failure to comply with GAAS or Commission requirements during the conduct of its audit or other work, or for the preparation of any other reports or statements filed with the Commission.

Section 10A(d) subjects auditors to civil money penalties if the Commission finds in a cease and desist proceeding<sup>17</sup>

including contingent liabilities that might be created by the illegal act. See, e.g., SAS 54, ¶ 13, AU § 317.13.

<sup>12</sup> See, SAS 58, "Reports on Audited Financial Statements," ¶ 10, AU § 508.10, for a general discussion of the circumstances that may require the auditor to depart from the standard report and the types of opinions, other than the standard report, that may be expressed by the auditor in various circumstances.

<sup>13</sup> Section 10A(b)(2)(A), (B), and (C). See generally, SAS 54, ¶¶ 18–22, AU § 317.18–.22.

<sup>14</sup> For documentation requirements under GAAS, see, e.g., SAS 54, ¶ 17, AU § 317.17, and SAS 61, "Communication with Audit Committees," ¶ 3 (January 1, 1989), AU § 380.03.

<sup>15</sup> Section 10A(b)(3).

<sup>16</sup> Section 10A(b)(4).

<sup>17</sup> Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101–429, (the "Remedies Act") auditors are subject to the Commission's cease and desist proceedings under section 21C of the Exchange Act but not to civil money penalties under section 21B. Under the Remedies Act, auditors are not subject to temporary cease and desist orders as set forth in section 21C(c)

that the auditor willfully failed to comply with the direct reporting provisions in section 10A. Similar penalties may be imposed on any person who was a cause of such a violation.<sup>18</sup>

Section 10A(e) states that, except for the civil money provisions in section 10A(d), nothing in section 10A shall be held to limit or otherwise affect the authority of the Commission under the Exchange Act.

## II. Discussion of Proposed Rules

### A. Proposed Rule 10A–1.

Proposed Rule 10A–1 is based on the premise that the notice and reports under section 10A are to assist the Commission in performing its enforcement responsibilities and, therefore, will be non-public. Disclosure to the public of registrants' illegal acts will continue to be made in modified audit reports<sup>19</sup> or, when the auditor has resigned, been dismissed, or elected not to stand for re-election, on Form 8–K<sup>20</sup>

of the Exchange Act. Although failure to file a required report may justify disciplinary proceedings under Rule 102(e) of the Commission's Rules of Practice, 17 CFR § 201.102(e), auditors are not subject to civil money penalties in such proceedings.

<sup>18</sup> Under section 10A(d), the determination to impose a civil money penalty on auditors and those causing a violation of the auditor's reporting requirements and the amount of such a penalty are governed by section 21B of the Exchange Act.

<sup>19</sup> For the effect of illegal acts on the audit report, see, SAS 53, ¶¶ 26 and 27, AU § 316.26 and .27, and SAS 54, ¶¶ 18–21, AU § 317.18–.21. See generally, SAS 58, 64, and 79 reprinted in *Reports on Audited Financial Statements* (January 1, 1989), which describes the standard report and the various opinions that may be reflected in the auditor's report. SAS 58, ¶¶ 7–10, AU § 508.07–.10.

<sup>20</sup> Item 4 of Form 8–K, 17 CFR § 249.308, Item 304 of Regulation S–K, 17 CFR § 229.304, and Item 304 of Regulation S–B, 17 CFR § 228.304. In summary, these provisions state that a registrant must file a Form 8–K, providing the information required by item 4 of that form, within five business days of the date that the registrant's auditor (or an independent accountant upon whom the auditor expressed reliance in its audit report regarding a significant subsidiary) resigns, declines to stand for re-election, or is dismissed, and within five business days of the date a new auditor is engaged. The registrant is to ask the former auditor to provide the registrant with a letter indicating whether the former auditor agrees with the disclosures in the Form 8–K that reports the termination of the audit engagement and, if not, the respects in which the auditor disagrees. This letter is to be filed with the Commission as an exhibit by amendment to the registrant's Form 8–K within 10 business days of the date that the Form 8–K was filed.

The registrant's Form 8–K must state, among other things: whether the former auditor resigned, was dismissed, or declined to stand for re-election and the date thereof; whether the auditor modified his or her report on the registrant's financial statements for either of the last two fiscal years and, if so, the nature of the modification; whether the decision to change auditors was recommended or approved by the audit committee or board of

Continued

<sup>7</sup> Section 10A(b)(1)(A). See, SAS 54, ¶¶ 10–15. AU § 317.10–.15. Paragraph 11 of SAS 54 sets forth additional audit procedures that might be necessary once the auditor becomes aware of a possible illegal act.

<sup>8</sup> Section 10A(b)(1)(B). See, SAS 54, ¶ 17, AU § 317.17.

<sup>9</sup> See, SAS 54, ¶¶ 10 and 17, AU § 317.10 and .17.

<sup>10</sup> The addition of this time period reflects the original legislative efforts in this area to provide an earlier warning to the SEC of registrants' potential illegal acts than may occur under the current Form 8–K procedures, see note 20 *infra*, and in audit reports. See H.R. Rep. No. 102–890, 102d Cong., 2d Sess. 3 (1992), which contained the predecessor legislation to Section 10A and stated:

This legislation amends the Securities Exchange Act of 1934 (Exchange Act) to improve fraud detection and disclosure with respect to public companies by codifying auditing standards in certain specified areas and by providing a mechanism for earlier warning to the Securities and Exchange Commission of certain illegal acts by registrants.

<sup>11</sup> The auditor should consider both the quantitative and qualitative materiality of the act,

under the Exchange Act and on N-SAR<sup>21</sup> under the Investment Company Act of 1940 (the "Investment Company Act"), among others.

In testifying on prior bills that contained the same reporting requirements, the Commission stated, "[W]e anticipate that reports filed under section 10A would be confidential and exempt from disclosure under the Freedom of Information Act."<sup>22</sup> The Commission further noted,

Premature disclosure of the issuer and auditor reports could, among other things, interfere with the Commission's investigation, deprive the issuer or other persons of the right to a fair trial or impartial adjudication, constitute an unwarranted invasion of privacy, or disclose a confidential source. In addition, issuer and auditor reports under Section 10A might contain confidential commercial or financial information exempt from disclosure under FOIA Exemption 4, 5 U.S.C. 552(b)(4).<sup>23</sup>

The Commission's testimony further states that the direct reporting provisions in the bill might provide an earlier warning of certain illegal acts that could allow the Commission to begin enforcement investigations at an earlier date.<sup>24</sup>

Accordingly, the proposed rule provides that the reports of both the board and the auditor would be non-

directors; whether, in connection with the audits of the financial statements for the two most recent fiscal years, and any subsequent interim period, there were any disagreements between the auditor and the registrant on any matter of accounting principles or practices, auditing scope or procedure, or financial statement disclosure. The Form 8-K also must provide disclosure of any instance within the applicable time period where the former auditor advised the registrant that (1) the internal controls necessary for the registrant to develop reliable financial statements did not exist, (2) information had come to the auditor's attention that led him or her no longer to be able to rely on management's representations, or that made the auditor unwilling to be associated with the registrant's financial statements, (3) there was a need to expand significantly the scope of the audit and, due to the auditor's resignation or for any other reason, the scope was not expanded, or (4) information had come to the auditor's attention affecting the reliability of past audit reports or financial statements and the issue had not been resolved to the auditor's satisfaction prior to the auditor's resignation, dismissal, or declination to stand for reelection.

<sup>21</sup> Sub-item 77K of Form N-SAR, 17 CFR § 274.101, requires investment companies filing Form N-SAR to provide the information required by item 4 of Form 8-K. Sub-item 77K of Form N-SAR notes that notwithstanding the requirements in Form 8-K to file more frequently, registrants need only file such information semi-annually in accordance with the requirements of Form N-SAR.

<sup>22</sup> Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, *Concerning H.R. 574, The Financial Fraud Detection and Disclosure Act*, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 1st Sess., 32 (February 18, 1993).

<sup>23</sup> *Id.*, at 32 n. 36.

<sup>24</sup> *Id.*, T1 at 31.

public and exempt from disclosure under the Freedom of Information Act to the same extent as the Commission's investigative records.<sup>25</sup>

Despite the confidential nature of the reports under section 10A, these reporting requirements should improve the quality of public disclosures in Forms 8-K and N-SAR and in audit reports on registrants' financial statements, because it is unlikely that registrants and auditors will make public disclosures that are incompatible with the confidential reports made to the Commission. Also, the direct reporting requirements in section 10A should give auditors additional leverage to prompt management to correct illegal acts and to make appropriate adjustments in their financial statements.

Proposed Rule 10A-1 designates the Commission's Office of the Chief Accountant ("OCA") as the appropriate office to receive the notice provided by any registrant under section 10A(b)(3) and any reports provided by auditors under section 10A(b)(3) or 10A(b)(4). OCA expeditiously will forward copies of the notice or report to all appropriate offices and divisions within the Commission. The notice or report may be provided to other agencies, as appropriate.

Delivery of the notice or report to OCA may occur under proposed Rule 10A-1 in any manner, provided the notice or report is received by OCA within the statutory time period. Currently, the most timely manner of delivery may be through submission of a facsimile,<sup>26</sup> telegraph, or personal delivery. In the future, procedures may be developed for registrants and auditors to deliver confidential information directly to OCA via electronic mail. Proposed Rule 10A-1 would permit use of such means of delivery.<sup>27</sup>

<sup>25</sup> See 5 U.S.C. 552(b)(7), which exempts from disclosure certain "records or information compiled for law enforcement purposes."

<sup>26</sup> The phone number for OCA's facsimile machine currently is (202) 942-9656. Such phone numbers, however, are subject to change without notice and registrants and auditors should verify the accuracy of the number before use.

<sup>27</sup> A similar provision applies to auditors of broker-dealers. See Rule 17a-5(h)(2) under the Exchange Act, 17 CFR § 240.17a-5(h)(2), which states that if, during the course of audit or interim work, the auditor determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or certain other practices and procedures, then the auditor shall call those inadequacies to the attention of the chief financial officer of the broker-dealer, who has the obligation to notify the Commission and the designated examining authority within 24 hours thereafter. If the auditor does not receive a copy of that notice within that 24 hour period, or if the auditor disagrees with the statements in the notice, then the

Proposed Rule 10A-1 sets forth the required contents for a registrant's notice to the Commission. This notice would be in writing and identify the registrant and the auditor, state the date the auditor made its report to the board, and provide a summary of the report. The required summary would describe the act and the potential impact of that act on the registrant's financial statements. This information is consistent with the requirement under GAAS that the auditor's communication with the registrant's audit committee "should describe the act, the circumstances of its occurrence, and the effect on the financial statements."<sup>28</sup> The proposed rule specifically would permit a registrant to provide additional information regarding its view of, and response to, the section 10A report it has received from the auditor.

Regarding reports filed by auditors, proposed Rule 10A-1 would specify that if the report does not identify clearly both the registrant and the auditor, then the auditor must attach that information to the report submitted to OCA.

Proposed Rule 10A-1 makes it clear that providing the notice or report in accordance with section 10A and the proposed rule does not, in any way, affect the obligations of the registrant and the auditor to file and make all applicable disclosures required by the Commission's rules, including, without limitation, Forms 8-K and N-SAR, and of the auditor to comply with GAAS reporting requirements.<sup>29</sup> Similarly, the proposed rule states that the confidential nature of the notice and the report to the Commission does not diminish a registrant's or auditor's obligations to make full disclosures required by the Commission's rules, forms, reports, or disclosure items, or by applicable professional standards.

#### *B. Proposed Rule 1-02(d).*

The proposed amendment would conform the definition of "Audit (or examination)" in Rule 1-02(d) of Regulation S-X with section 10A, by noting that audits of the financial statements of Commission registrants should be performed in accordance with generally accepted auditing standards as

auditor must inform the Commission and the designated examining authority of the material inadequacy within the next 24 hours.

<sup>28</sup> SAS 54, ¶ 17, AU § 317.17.

<sup>29</sup> In addition, one of the membership requirements of the SEC Practice Section of the AICPA is that members notify registrants in writing of the cessation of an auditor-client relationship. The member also is required to send a copy of that notification to the Commission's Office of the Chief Accountant.

may be modified or supplemented by the Commission.

### III. Investment Companies

Section 10A and proposed Rule 10A-1 apply to all audits required pursuant to the Exchange Act, including those prepared on behalf of investment companies that have reporting obligations under the Exchange Act.<sup>30</sup> The Commission requests comment whether the proposed reporting requirements under Rule 10A-1 need to be modified to reflect the operations of investment companies.

### IV. General Request for Comments

The Commission seeks comments from all interested persons wishing to address any aspect of the proposed rules.

The Commission also is requesting comments on whether the proposed amendments, if adopted, would have an adverse impact on competition or would impose a burden on competition that is neither necessary nor appropriate in furthering the purposes of the Securities Act of 1933 and the Exchange Act. Comments in this regard will be considered by the Commission in complying with its responsibilities under section 23(a) of the Exchange Act.<sup>31</sup>

### V. Cost/Benefit Analysis

Comments are requested related to any costs or benefits associated with the proposed rules. The costs of complying with proposed Rule 10A-1, which is intended to carry out the purposes of new section 10A of the Exchange Act, are expected to be *de minimis*. Such costs for a registrant may include converting the information in the auditor's report to the board into a notice that conforms to the rule and delivering that notice, via facsimile or otherwise, to the Commission's Office of the Chief Accountant. Costs for the auditor may include assuring that the report to the board identifies the registrant, as required by the proposed rule, and the cost of delivering that report, via facsimile or otherwise, to the Commission's Office of the Chief Accountant.

Benefits would include an earlier warning to the Commission of possible illegal acts by registrants and potential improvements in public disclosures in Forms 8-K and N-SAR regarding changes in registrants' auditors and in audit reports that are modified due to registrants' illegal acts.

### VI. Summary of Regulatory Flexibility Analysis

An Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603 concerning proposed Rule 10A-1. The analysis notes that the proposed rule is intended to implement the reporting requirements of section 10A of the Exchange Act.

As discussed more fully in the analysis, the proposed rule would affect small entities, as defined by the Commission's rules, but would affect small entities in the same manner as other registrants. The analysis notes that alternatives that provide for different means of compliance for small entities or which exempt small entities from the proposed rules would not be consistent with the statutory requirements. Moreover, the cost of complying with the proposed rule should be *de minimis*, even for small registrants.

Written comments are encouraged with respect to any aspect of the analysis. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis if the proposed rules are adopted. A copy of the analysis may be obtained by contacting Robert E. Burns, Chief Counsel, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Mail Stop 11-3, 450 Fifth Street, N.W., Washington, D.C. 20549.

### VII. Paperwork Reduction Act

Proposed Rule 10A-1 contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501 *et seq.*] and the Commission has submitted the proposed rules to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507(d). The title for the collection of information is "Amendments to Implement Exchange Act Section 10A."

The Supporting Statement to the Paperwork Reduction Act submission notes that the proposed rule is intended to implement the reporting requirements found in recently enacted section 10A of the Exchange Act, and that the proposed rule would have a negligible effect on the annual reporting and cost burden of Commission registrants. As discussed above, the notice provided by the registrant would

contain the minimum amount of information necessary to identify the registrant and the auditor, indicate the date the auditor provided the report to the board of directors as specified in section 10A, and summarize the report given to the board. The summary would be based on information required to be given to the board of directors under GAAS. The auditor's report, furnished only in the event that the registrant does not fulfill its reporting responsibilities, would consist only of the report given to the board of directors and, if necessary, additional information to identify clearly the registrant and the auditor.

Potential respondents are entities with reporting obligations under the Exchange Act and their auditors, although it is anticipated that the reporting requirements under section 10A rarely will be triggered. On those rare occasions when the reporting requirement is triggered, it is estimated that the total recordkeeping and reporting burden, beyond that directly required by the statute, would not exceed one hour per respondent.

As notices must be filed by a registrant within one day of receiving a report from its auditor, and the auditor must file its report (if necessary) the next day, there are essentially no recordkeeping or retention requirements.

Filing the notices and reports, when necessary, is required by section 10A of the Exchange Act and therefore is mandatory. As explained above, however, the notices and reports will be kept confidential while the Commission has an enforcement interest in the information contained in those notices and reports.

Pursuant to 44 U.S.C. § 3506(c)(2)(B), the Commission requests comments concerning: whether the proposed collection of information is necessary for the proper performance of the function of the Commission, including whether the information shall have practical utility; on the accuracy of the Commission's estimate of the burden of the proposed collection of information; on the quality, utility, and clarity of the information to be collected; and whether the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology, may be minimized.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission,

<sup>30</sup> See sections 13(a) and 15(d) of the Exchange Act, 15 U.S.C. 78m(a) and 78o(d), and section 30(a) of the Investment Company Act, 15 U.S.C. 80a-29(a). Form N-SAR requires investment companies to file information with the Commission about their operations, including audited financial information. Rule 30a-1 under the Investment Company Act, 17 CFR § 270.30a-1, provides that investment companies filing annual reports on Form N-SAR are deemed to have satisfied the reporting requirements of sections 13(a) and 15(d) under the Exchange Act and section 30(a) under the Investment Company Act.

<sup>31</sup> 15 U.S.C. 78w(a).

Office of Information and Regulatory Affairs, Washington, D.C. 20503, and also should send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549 with reference to File No. S7-20-96. The Office of Management and Budget is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to the Office of Management and Budget is best assured of having its full effect if the Office of Management and Budget receives it within 30 days of publication.

#### List of Subjects

##### 17 CFR Part 210

Accounting, Reporting and recordkeeping requirements, Securities.

##### 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

#### Text of Proposed Rulemaking Amendments

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

### **PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

1. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77aa(25), 77aa(26), 78j-1, 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), unless otherwise noted.

2. By revising § 210.1-02(d) to read as follows:

#### **§ 210.1-02 Definitions of terms used in Regulation S-X (17 CFR part 210).**

\* \* \* \* \*

(d) *Audit (or examination)*. The term *audit (or examination)*, when used in regard to financial statements, means an examination of the financial statements by an independent accountant in accordance with generally accepted auditing standards, as may be modified or supplemented by the Commission, for the purpose of expressing an opinion thereon.

\* \* \* \* \*

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

3. The authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78j-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, and 80b-11, unless otherwise noted.

4. By adding § 240.10A-1 to read as follows:

#### **§ 240.10A-1 Notice to Commission of issuers' illegal acts.**

(a)(1) If any issuer with a reporting obligation under the Act receives a report requiring a notice to the Commission in accordance with section 10A(b)(3) of the Act, 15 U.S.C. 78j-1(b)(3), the issuer shall provide such notice to the Commission's Office of the Chief Accountant within the time period prescribed in that section. The notice may be provided by facsimile, telegraph, personal delivery, or any other means, *provided* it is received by the Office of the Chief Accountant within the required time period.

(2) The notice specified in paragraph (a)(1) of this section shall be in writing and:

(i) Shall identify the issuer (including the issuer's name, address, phone number, and file number assigned to the issuer's filings by the Commission) and the independent accountant (including the independent accountant's name and phone number, and the address of the independent accountant's residence or principal office);

(ii) Shall state the date that the issuer received from the independent accountant the report specified in section 10A(b)(2) of the Act, 15 U.S.C. 78j-1(b)(2);

(iii) Shall provide a summary of the independent accountant's report, including a description of the act that the independent accountant has identified as a likely illegal act and the potential impact of that act on all affected financial statements of the issuer or those related to the most current three year period, whichever is shorter; and

(iv) May provide additional information regarding the issuer's views of and response to the independent accountant's report.

(3) Provision of the notice in paragraphs (a)(1) and (a)(2) of this section does not relieve the issuer from its obligations to comply fully with any other reporting requirements, including, without limitation:

(i) The filing requirements of Form 8-K, § 249.308 of this chapter, and Form

N-SAR, § 274.101 of this chapter, regarding a change in the issuer's certifying accountant and

(ii) The disclosure requirements of item 304 of Regulation S-B or item 304 of Regulation S-K, §§ 228.304 and 229.304 of this chapter.

(b)(1) Any independent accountant furnishing to the Commission a copy of a report (or the documentation of any oral report) in accordance with section 10A(b)(3) or section 10A(b)(4) of the Act, 15 U.S.C. 78j-1(b)(3) or 78j-1(b)(4), shall provide that report (or documentation) to the Commission's Office of the Chief Accountant within the time period prescribed by the appropriate section of the Act. The report (or documentation) may be provided to the Commission's Office of the Chief Accountant by facsimile, telegraph, personal delivery, or any other means, *provided* it is received by the Office of the Chief Accountant within the time period set forth in section 10A(b)(3) or 10A(b)(4) of the Act, 15 U.S.C. 78j-1(b)(3) or 78j-1(b)(4), whichever is applicable in the circumstances.

(2) If the report (or documentation) provided to the Office of the Chief Accountant in accordance with paragraph (b)(1) of this section does not clearly identify both the issuer (including the issuer's name, address, phone number, and file number assigned to the issuer's filings with the Commission) and the independent accountant (including the independent accountant's name and phone number, and the address of the independent accountant's residence or principal office), then the independent accountant shall place that information in a prominent attachment to the report (or documentation) and shall provide that attachment to the Office of the Chief Accountant at the same time and in the same manner as the report (or documentation) is provided to that Office.

(3) Provision of the report (or documentation) by the independent accountant as described in paragraphs (b)(1) and (b)(2) of this section does not replace, or otherwise satisfy the need for, the newly engaged and former accountants' letters under items 304(a)(2)(D) and 304(a)(3) of Regulation S-K, §§ 229.304(a)(2)(D) and 229.304(a)(3) of this chapter, respectively, and under items 304(a)(2)(D) and 304(a)(3) of Regulation S-B, §§ 228.304(a)(2)(D) and 228.304(a)(3) of this chapter, respectively, and does not limit, reduce, or affect in any way the independent accountant's obligations to comply fully with all other legal or professional

responsibilities, including, without limitation, those under generally accepted auditing standards and the rules or interpretations of the Commission that modify or supplement those auditing standards.

(c) Notices and reports furnished to the Office of the Chief Accountant in accordance with paragraphs (a) and (b) of this section shall be non-public and exempt from disclosure pursuant to the Freedom of Information Act to the same extent and for the same periods of time that the Commission's investigative records are non-public and exempt from disclosure under, among other applicable provisions, 5 U.S.C. 552(b)(7) and § 200.80(b)(7) of this chapter. The preceding sentence shall not relieve, limit, delay, or affect in any way, any issuer's or independent accountant's obligations to provide all public disclosures required by law, by any Commission disclosure item, rule, report, or form, or by any applicable accounting, auditing, or professional standard.

By the Commission.

Dated: August 22, 1996.

Margaret H. McFarland,

*Deputy Secretary.*

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