SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 201

[Release Nos. 33–7546; 34–40089; 35–26884; 39–2364; IA–1726; IC–23250; File No. S7–16–98]

RIN 3235–AH47

Proposed Amendment to Rule 102(e) of the Commission's Rules of Practice

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing an amendment to Rule 102(e) of the Commission's Rules of Practice. Under Rule 102(e), the Commission can censure, suspend or bar persons who appear or practice before it. The proposed amendment clarifies the Commission's standard for determining when accountants engage in ''improper professional conduct'' under Rule 102(e)(1)(ii).

DATES: Comments must be received on or before July 20, 1998.

ADDRESSES: Submit comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC. 20549–6009. Comments can be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–16–98; include this file number on the subject line if E-mail is used. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW., Washington, DC. 20549–6009. Electronically-submitted comment letters will be posted on the Commission's Internet Web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Michael J. Kigin, Associate Chief Accountant, Office of the Chief Accountant, at (202) 942–4400; or David R. Fredrickson, Assistant General Counsel, Office of the General Counsel, at (202) 942–0890.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment an amendment to Rule 102(e).[1]

I. The Purpose of this Release

The purpose of this release is to solicit comments on a proposed amendment to Rule 102(e) of the Commission's Rules of Practice. Under Rule 102(e), the Commission can censure, suspend or bar professionals who appear or practice before it.[2] Specifically, pursuant to the Rule, the Commission can impose a sanction upon a professional whom it finds, after notice and an opportunity for hearing:

(i) Not to possess the requisite qualifications to represent others; or

(ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or

(iii) To have willfully violated, or willfully aided and abetted the violation of, any provision of the Federal securities laws or the rules and regulations thereunder.[3]

In a recent opinion addressing the conduct of two accountants, the U.S. Court of Appeals for the District of Columbia Circuit found that the Commission had not articulated clearly the ''improper professional conduct'' element of the Rule.[4] To address the court's concerns, the Commission is proposing an amendment to the text of Rule 102(e) that clarifies the Commission's standard for determining when accountants engage in ''improper professional conduct.''[5]

II. A Brief Overview of Rule 102(e)

A. The Importance of Rule 102(e)

The Commission adopted Rule 102(e) as a ''means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence.''[6] Courts have recognized that it is appropriate for the Commission to use a disciplinary mechanism such as Rule 102(e) to encourage professionals to adhere to ethical standards and minimum standards of competence.[7] In adopting the Rule, the Commission did not intend to add an ''additional weapon'' to its ''enforcement arsenal''[8] but to protect its system of securities regulation and, by extension, the interests of the investing public.

B. The Important Role of Accountants

Accountants play many roles in the Commission's system of securities regulation. In recognition of the significance of auditors and audited financial statements in the Commission's disclosure process, this release focuses particular attention upon the role of auditors in the securities registration and reporting processes under the federal securities laws. The proposed amendment, however, covers all accountants who appear or practice before the Commission.[9]

''Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public.''[10] Various provisions of the federal securities laws require publicly held companies to file audited financial statements with the Commission.[11] These financial statements must be audited by independent accountants in accordance with generally accepted auditing standards (''GAAS'').[12] The auditor plans and performs the audit to obtain reasonable assurance that the financial statements are free from material misstatement. Commission regulations require the auditor to issue a report containing an opinion on the financial statements.[13] The auditor's opinion states whether the financial statements present fairly, in all material respects, the financial position of the company as of a specific date.[14] The opinion also states whether the results of the company's operations and cash

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[1] 17 CFR 201.102(e).

[2] The Rule addresses the conduct of attorneys, accountants, engineers and other professionals or experts who appear or practice before the Commission. 17 CFR 201.102(e)(2) and (f)(2).

[3] 17 CFR 201.102(e)(1)(i), (ii) and (iii).

[4] *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) (''*Checkosky II*'').

[5] This clarification addresses the conduct of accountants only, and is not meant to address the conduct of lawyers or other professionals who practice before the Commission.

[6] *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979). The AICPA also recognizes that accountants must discharge their duties with competence. *See, e.g.*, AICPA Professional Standards, Vol. 2, ET sec. 56 (1997).

[7] Rule 102(e) was promulgated under the Commission's broad authority to adopt those rules and regulations necessary for carrying out the agency's designated functions and its inherent authority to protect the integrity of the agency's processes. Three U.S. Courts of Appeals have upheld the validity of Rule 102(e). *See Touche Ross; Sheldon v. SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995); *Davy v. SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986). The *Checkosky* opinions held that the Commission had not clearly articulated the ''improper professional conduct'' standard or the rationale for that standard. Also, the *Checkosky* opinions did not decide the issue of the scope of the Commission's authority.

[8] *Touche Ross*, 609 F.2d at 579.

[9] *See* 17 CFR 201.102(f)(1) and (2). The Commission has interpreted ''practice'' before the Commission to include accountants functioning in many roles, including those who serve as officers of public companies. *See, e.g., In re Terrano*, Securities Exchange Act of 1934 (''Exchange Act'') Rel. No. 39485 (Dec. 23, 1997), 66 SEC Docket 494 (Jan. 20, 1998); *In re Hersh*, Exchange Act Rel. No. 39089 (Sept. 18, 1997), 65 SEC Docket 1170 (Oct. 14, 1997); *In re Bryan*, Exchange Act Rel. No. 39077 (Sept. 15, 1997), 65 SEC Docket 1129 (Oct. 14, 1997).

[10] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 810 (1984).

[11] *See, e.g.*, Securities Act of 1933 (''Securities Act'') Schedule A (25)—(27), 15 U.S.C. 77aa(25)—(27); Exchange Act 12(b)(1)(J)—(L), 15 U.S.C. 78*l*(b)(1)(J)—(L).

[12] Regulation S-X, 17 CFR 210.1–02(d) (1997).

[13] *See* Regulation S-X, 17 CFR 210.2–02 (1985).

[14] *Id.*

flows for the year (or other period) then ended, are in conformity with generally accepted accounting principles (''GAAP''), and whether the audit was conducted in accordance with GAAS.[15]

Investors have come to rely on the accuracy of the financial statements of public companies when making investment decisions. Because the Commission has limited resources, it cannot closely scrutinize each of these financial statements.[16] Consequently, the Commission must rely on the integrity of the auditors who certify, and accountants who prepare, financial statements. In short, both the Commission and the investing public rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information.

The Commission and the courts have long acknowledged ''the duty of accountants to those who justifiably rely on [their] reports.''[17] Accountants who issue audit and other reports speak to investors, publicly representing that the accounting and auditing standards of the accounting profession have been followed.[18] An incompetent or unethical accountant can damage the Commission's processes and erode investor confidence in our markets.[19]

III. The Standard Applied to Accountants

A. ''Improper Professional Conduct'' In General

The Court of Appeals in *Checkosky II* criticized the Commission for not clearly articulating when an accountant would be deemed to have engaged in ''improper professional conduct'' under Rule 102(e)(1)(ii). This proposed amendment clarifies that whether an accountant engages in ''improper professional conduct'' is determined first by evaluating whether the accountant violated applicable professional standards. It also specifies the mental state required before an accountant may be sanctioned under the Rule. The proposed amendment covers conduct that the Commission historically has treated as ''improper professional conduct'' under Rule 102(e)(1)(ii).

Rule 102(e)(1)(ii) has been an effective disciplinary and remedial tool because it has been used to address a range of misconduct that poses a future threat to the Commission's processes.[20] Accountants who engage in intentional or knowing misconduct, which includes reckless misconduct, clearly pose this type of future threat. Accountants who engage in negligent misconduct also can pose as great a threat to the Commission's system of securities regulation as accountants who knowingly violate the professional standards.

Rule 102(e)(1)(ii) is not meant, however, to encompass every professional misstep.[21] A harmless judgment error or immaterial mistake does not pose a future threat to the Commission's processes and does not constitute ''improper professional conduct.'' Similarly, the Commission does not seek to use the Rule to establish new standards for the accounting profession.

B. The Proposed Standard

The Rule addresses conduct that fails to meet professional standards. The proposed amendment delineates categories of conduct that constitute ''improper professional conduct'' under Rule 102(e)(1)(ii). These categories are:

(A) An intentional or knowing violation, including a reckless violation, of applicable professional standards;[22] or

(B) Negligent conduct in the following circumstances:

(1) An unreasonable violation of applicable professional standards that presents a substantial risk, which is either known or should have been known, of making a document prepared pursuant to the federal securities laws materially misleading; or

(2) Repeated, unreasonable violations of applicable professional standards that demonstrate that the accountant lacks competence.

1. Intentional or Knowing Violations, Including Reckless Violations

Subparagraph (A) of the amendment defines ''improper professional conduct'' to include the most blatant violations of the professional standards. The Commission consistently has used Rule 102(e)(1)(ii) proceedings to address these types of violations of the professional standards.[23]

Clearly, an accountant who intentionally or knowingly, including recklessly[24], violates the professional standards has engaged in ''improper professional conduct.'' Accountants who engage in this type of misconduct undoubtedly pose the type of future threat to the Commission's system of regulation that requires Commission action.

2. Specific, Negligent Conduct

The proposed amendment also covers specific, negligent violations of the professional standards.[25] The Commission has recognized that ''an incompetent or negligent auditor can do just as much harm to public investors and others who rely on him as one who acts with an improper motive.''[26] For this reason, the Commission has stated that negligent conduct can trigger a Rule 102(e)(1)(ii) proceeding, and has brought Rule 102(e)(1)(ii) proceedings based on negligent conduct.[27]

The Court of Appeals in *Checkosky II* faulted the Commission for not articulating with some degree of

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[15] *Id.*

[16] *See Touche Ross,* 609 F.2d at 580–81.

[17] *In re Carter,* Exchange Act Rel. No. 17595 (Feb. 28, 1981), 22 SEC Docket 292, 298 (Mar. 17, 1981). Cf. *Arthur Young,* 465 U.S. at 817–18.

[18] *See Carter,* 22 SEC Docket at 298.

[19] ''In our complex society, the accountant's certificate * * * can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.'' *U.S. v. Benjamin,* 328 F.2d 854, 863 (2d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[20] *Carter,* 22 SEC Docket at 297. Because Rule 102(e)(1)(ii) is remedial and not punitive in nature, the conduct must be evaluated to determine whether the accountant poses a future threat to the Commission's processes.

[21] As Commissioner Johnson has noted:

A professional often must make difficult decisions, navigating through complex statutory and regulatory requirements, and in the case of accountants, complying with (GAAS) and applying (GAAP). These determinations require the application of independent professional judgment and sometimes involve matters of first impression.

Exchange Act Rel. No. 38183 (Jan. 21, 1997), 63 SEC Docket 1948, 1976 (Feb. 18, 1997) (Johnson, Comm'r, dissenting), *rev'd Checkosky II.*

[22] ''Applicable professional standards'' includes such things as generally accepted accounting principles, generally accepted auditing standards, generally accepted attestation standards, the AICPA Code of Professional Conduct, the AICPA Statements on Standards for Consulting Services, the AICPA Statements on Standards for Accounting and Review Services, pronouncements of the Independence Standards Board, and certain of the Commission's rules and regulations.

[23] *See, e.g., In re Finkel,* Securities Act Rel. No. 7401 (Mar. 12, 1997), 64 SEC Docket 103 (Apr. 8, 1997); *In re Basson,* Exchange Act Rel. No. 35840 (June 13, 1995), 59 SEC Docket 1650 (July 11, 1995); *In re F.G. Masquelette & Co,* Accounting Series Rel. No. 68, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 72,087 (June 30, 1982); *In re Weiner,* Exchange Act Rel. No. 14249 (Dec. 12, 1997), 13 SEC Docket 1113 (Dec. 27, 1977).

[24] *See generally SEC v. Blavin,* 760 F.2d 706, 711 (6th Cir. 1985); *Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1023–24 (6th Cir. 1979).

[25] In other instances, the federal securities laws expressly subject auditors to liability without requiring intentional misconduct. For example, the Supreme Court has recognized that Section 11 allows recovery for ''negligent conduct.'' *Herman & MacLean v. Huddleston,* 459 U.S. 375, 384 (1983), *referring to Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 210 (1976).

[26] *In re Checkosky,* Exchange Act Rel. No. 31094 (Aug. 26, 1992), 52 SEC Docket 1389, 1410 (Sept. 15, 1992), *rev'd Checkosky v. SEC,* 23 F.3d 452 (D.C. Cir. 1994) (''*Checkosky I*''), *citing In re Schulzetenberg,* Admin. Proc. 3–6881, slip op. at 2 (Order Denying Motion to Dismiss Nov. 10, 1987)(unpublished opinion).

[27] *In re Gotthilf,* Exchange Act Rel. No. 33949 (April 21, 1994), 56 SEC Docket 1543 (May 10, 1944).

specificity when negligent conduct by an accountant constitutes ''improper professional conduct.'' [28] The proposed amendment provides this specificity. Specifically, subparagraph (B) of the amendment defines ''improper professional conduct'' to include: (1) An unreasonable violation of the applicable professional standards that presents a substantial risk, which is either known or should have been known, of making a document prepared pursuant to the federal securities laws materially [29] misleading; or (2) repeated, unreasonable violations of the applicable professional standards that demonstrate that the accountant lacks competence.

Under this standard, a single violation of the professional standards could constitute ''improper professional conduct'' if the violation presents a substantial risk, which is either known or should have been known, of making a document prepared pursuant to the federal securities laws materially misleading. Under these circumstances, the single violation most likely would be related to a transaction or event as to which any reasonable auditor would give heightened scrutiny.[30] The integrity of the Commission's processes is threatened by an accountant who fails to exercise due professional care with respect to the critical areas of his or her professional responsibilities.

For example, an auditor who failed to verify properly the amount of cash purportedly held in a vault at a branch of a bank, where that amount constituted 61% of the branch's and 45% of the bank's total cash on hand, engaged in improper professional conduct under Rule 102(e)(1)(ii).[31] In this particular matter, at least $400,000 of the $2.7 million cash purportedly on hand had been misappropriated by a bank employee. Although the sum of money misappropriated may not have been quantitatively material to the bank's balance sheet, a Rule 102(e)(1)(ii) proceeding was appropriate. Because a shortage of the total amount of cash actually on hand would impact materially on the bank's pre-tax earnings, the auditor's failure to verify properly the cash on hand could be considered negligent under subparagraph (B)(1) of the proposed amendment since it presented a substantial risk, which should have been known, of making a document prepared pursuant to the federal securities laws materially misleading.[32]

Proposed subparagraph (B)(2) of the amendment would define improper professional conduct to include repeated, unreasonable violations of applicable professional standards that demonstrate that the accountant lacks competence. Repeated, unreasonable violations of the professional standards by an accountant can damage both the Commission's processes and investor confidence in the integrity of financial statements. This level of incompetence calls into question the reliability of any work performed by the accountant. Further, an accountant who engages in this type of misconduct may well benefit from remedial measures before resuming practice before the Commission. Repeated violations would include two or more violations that could occur within one audit [33] or in several audits.[34] Repeated violations also could include a course or pattern of violations regardless of whether the types of violations are similar.

C. The ''Good Faith'' Defense

With respect to defenses to a Rule 102(e)(1)(ii) proceeding, the Commission has never considered the subjective good faith of an accountant to be an absolute defense.[35] Good faith actions of an accountant are more appropriately considered when determining what sanction would be appropriate. For instance, an accountant who acts in good faith, but is unable to conform to the minimum standards of the profession, may benefit from additional training, peer review, supervision and other appropriate remedial action undertaken while suspended from practicing before the Commission or as a condition of future practice before the Commission.

D. The AICPA Rulemaking Petition

The American Institute of Certified Public Accountants (''AICPA'') submitted a rulemaking petition to the Commission proposing a definition for ''improper professional conduct'' under Rule 102(e)(1)(ii).[36] The AICPA Rulemaking Petition would define improper professional conduct in a manner that includes a knowing violation and a conscious and deliberate disregard of the professional standards, as well as a course or pattern of misconduct.[37] The Commission, like the AICPA, also is proposing that accountants who engage in knowing misconduct or a course or pattern of misconduct should be subject to Rule 102(e)(1)(ii) proceedings.

The Commission preliminarily believes that the public interest may be better served with the somewhat broader definition of ''improper professional conduct'' proposed in this release. While a harmless judgment error or immaterial mistake should not trigger a Rule 102(e)(1)(ii) proceeding, reckless and specific negligent misconduct may require Commission action to protect the integrity of the Commission's processes and the interests of the investing public. Accordingly, the Commission has determined to seek comment on the proposed amendment contained in this release.

IV. General Request For Comments

The Commission requests that any interested persons submit comments on the proposed amendment to Rule 102(e). The Commission also invites comments on the following specific issues.

The proposed amendment is intended to clarify the definition of ''improper professional conduct.'' Does the proposed amendment achieve this objective? This definition is consistent with how the Commission has applied the ''improper professional conduct'' standard. Would another definition of ''improper professional conduct'' be

[28] *Checkosky II*, 139 F.3d at 224.

[29] Material, as used in this context, means a substantial likelihood of being considered significant by a reasonable investor. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988), *citing TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[30] *Cf.* AICPA Professional Standards, Vol. 1 AU sec. 312 (1997).

[31] *See In re Curtin*, Exchange Act Rel. No. 32519 (June 28, 1993), 54 SEC Docket 1137 (July 20, 1993).

[32] *See also In re Valade*, Exchange Act Rel. No. 4002 (May 19, 1998), 1998 SEC LEXIS 966; *In re Smith*, Exchange Act Rel. No. 37738 (Sept. 27, 1996), 62 SEC Docket 2840 (Oct. 29, 1996); *In re Denton*, Exchange Act Rel. No. 35381 (Feb. 15, 1995), 58 SEC Docket 2294 (Mar. 14, 1995); *In re Lamirato*, Exchange Act Rel. No. 33660 (Feb. 23, 1994), 56 SEC Docket 345 (Mar. 15, 1994).

[33] *See, e.g., In re Childers*, Exchange Act Rel. No. 32505 (June 24, 1993), 54 SEC Docket 1017 (July 13, 1993).

[34] *See, e.g., In re Withers*, Exchange Act Release No. 34537 (Aug. 17, 1994), 57 SEC Docket 1101 (Sept. 13, 1994).

[35] *See In re Haskins & Sells*, Accounting Series Rel. No. 73 (Oct. 30, 1952), [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,092 (June 30, 1982). Similarly, an auditor who is deceived by the client and commits an audit error in reliance upon the deception does not have an automatic defense. *See generally In re Hope*, Accounting and Auditing Enforcement Rel. No. 109A (Aug. 6, 1986), 36 SEC Docket 663, 750–55 (Sept. 10, 1986). *See also In re Ernst & Ernst*, Accounting Series Rel. No. 248 (May 31, 1978), 14 SEC Docket 1276, 1301 and n.71 (June 13, 1978).

[36] Rulemaking Petition by the AICPA Concerning Rule 102(e) (''AICPA Rulemaking Petition''), SEC File No. 4–410 (May 7, 1998).

[37] Under the AICPA Rulemaking Petition, before an accountant can be found to have engaged in ''improper professional conduct,'' the accountant also must pose a current threat to the integrity of the Commission's processes or to the financial reporting system. *See also* Task Force on Rule 102(e) Proceedings, American Bar Association, *Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants*, 52 Bus. Law. 965, 985 (May 1997).

better suited to achieving the Commission's goal of protecting the integrity of its processes? Does the proposed amendment include conduct that should not be considered ''improper professional conduct?'' If yes, what conduct should be excluded? Does the proposed amendment cover all of the conduct that should be considered ''improper professional conduct'' under Rule 102(e)(1)(ii)? If not, what else should be included? The proposed amendment defines ''improper professional conduct'' to include ''reckless'' conduct. Should the Commission use a definition of ''recklessness'' commonly used in cases brought under Rule 10b-5 of the Exchange Act?[38] Would a less rigorous standard of ''recklessness''[39] be more appropriate in the context of a disciplinary rule such as Rule 102(e)(1)(ii) where the purpose of the rule is to protect the integrity of the Commission's processes?

The proposed amendment defines ''improper professional conduct'' to include negligent conduct under two specified circumstances. In order to adequately protect the Commission's processes, should other circumstances be included?

Does the term ''applicable professional standards'' provide adequate guidance to the accounting profession? What weight should be given to the good faith of an accountant at the sanctioning stage of a Rule 102(e)(1)(ii) proceeding?

Any interested person wishing to submit written comments on any of the issues set forth in this release are invited to do so by submitting them in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–16–98 this file number should be included on the subject line if e-mail is used. Comments received will be available for public inspection and copying in the Commission's public reference room at 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet Web site (http://www.sec.gov).

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') on the proposed amendment to Rule 102(e). The IRFA indicates that the proposed amendment would clarify the standard by which the Commission determines whether accountants have engaged in ''improper professional conduct.''

The IRFA sets forth the statutory authority for the proposed amendment. The IRFA also discusses the effect of the proposed amendment on small entities. The IRFA states that approximately 1000 accounting firms can or do appear or practice before the Commission. While most of this practice is conducted by the ''Big Six'' firms, which are not small entities, many smaller firms do practice before the Commission. However, the Commission does not collect information about revenues of accounting firms, which information generally is not made public by the firms, and therefore cannot determine how many of these are small entities for purposes of the analysis. In any event, the proposed amendment should have little or no impact on small entities because the proposal simply clarifies the Commission's standard for determining when accountants engage in ''improper professional conduct.''

The IRFA states that the proposed amendment would not impose any new reporting, recordkeeping or compliance requirements, and the Commission believes that there are no rules that duplicate, overlap or conflict with the proposed amendment.

The IRFA discusses the various alternatives considered to minimize the effect on small entities, including: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the Rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the Rule, or any part thereof, for small entities. The Commission believes it would be inconsistent with the purposes of the Rule to exempt small entities from the proposed amendment. Different compliance or reporting requirements for small entities are not necessary because the proposed amendment does not establish any new reporting, recordkeeping or compliance requirements. The proposed amendment is already designed to clarify the current standard employed in Rule 102(e)(1)(ii), and the Commission does not believe it is feasible to further clarify, consolidate or simplify the Rule for small entities. Finally, the proposal does use a performance standard, not a design standard, to specify what conduct is expected of accountants; the Commission does not believe different performance standards for small entities would be consistent with the purposes of the Rule.

The IRFA solicits comments generally, and in particular, on the number of small entities that would be affected by the proposed amendment and the existence or nature of the effect. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[40] the Commission is also requesting information regarding the potential impact of the proposed amendment on the economy on an annual basis—in particular, whether the proposed amendment is likely to have an annual effect on the economy of $100 million or more. Commenters should provide empirical data to support their views.

A copy of the IRFA may be obtained by contacting David R. Fredrickson, Office of the General Counsel, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

VI. Cost-Benefit Analysis

The Commission requests the views of commenters about any costs or benefits associated with the proposed amendment. The Commission anticipates several benefits from the amendment. The amendment will provide clearer guidance to accountants. Members of the accounting profession will better understand the standard the Commission uses to determine ''improper professional conduct'' and thus conduct themselves accordingly. Also, the clarifying amendment will make it easier for the Commission, its administrative law judges and the courts to administer the Rule, which will further benefit the integrity of the Commission's processes. The Commission anticipates no costs associated with the proposal.

Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact of its rules on competition. Moreover, section 2(b) of the Securities Act, section 3(f) of the Exchange Act and section 2(c) of the Investment Company Act of 1940 (''Investment Company Act'') require the Commission, when engaged in

[38] *See, e.g., Mansbach, SEC v. Steadman,* 967 F.2d 636, 641–642 (D.C. Cir. 1992) (both citing *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977)).

[39] *See, e.g., Saba v. Compagnie Nationale Air France,* 78 F.3d 664, 668 (D.C. Cir. 1996), *citing Farmer v. Brennan,* 511 U.S. 825, 836–37 (1994); *see generally* W. Keeton, *et al., Prosser and Keeton on the Law of Torts* (''Prosser''), sec. 34 at 213–214; (5th ed. 1984); *Restatement (Second) of Torts* sec. 500, comment (a) (1965).

[40] 5 U.S.C. 801 *et seq.*

rulemaking that requires a public interest finding, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. The Commission requests data on what effect, if any, the proposed amendment would have on efficiency, competition and capital formation.

VII. Statutory Authority

The Commission is proposing the amendment to the Rule pursuant to its authority under section 19(a) of the Securities Act, section 23(a) of the Exchange Act, section 20(a) of the Public Utility Holding Company Act of 1935, section 319(a) of the Trust Indenture Act of 1939, section 211(a) of the Investment Advisers Act of 1940 and section 38(a) of the Investment Company Act.

Text of Amendment

List of Subjects in 17 CFR Part 201

Administrative practice and procedure, Investigations, Securities.

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

PART 201—RULES OF PRACTICE

1. The authority citation for Part 201, Subpart D continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77h-1, 77j, 77s, 77u, 78c(b), 78d-1, 78d-2, 78*l*, 78m, 78n, 78o(d), 78o-3, 78s, 78u-2, 78u-3, 78v, 78w, 79c, 79s, 79t, 79z-5a, 77sss, 77ttt, 80a-8, 80a-9, 80a-37, 80a-38, 80a-39, 80a-40, 80a-41, 80a-44, 80b-3, 80b-9, 80b-11, and 80b-12 unless otherwise noted.

2. Amend § 201.102 by adding paragraphs (e)(1)(iv) to read as follows:

§ 201.102 Appearance and practice before the Commission.

(e) *Suspension and disbarment.*—(1) *Generally.* * * *

(iv) With respect to persons licensed to practice as accountants, ''improper professional conduct'' under § 201.102(e)(1)(ii) means:

(A) An intentional or knowing violation, including a reckless violation, of applicable professional standards; or

(B) Negligent conduct in the following circumstances:

(*1*) An unreasonable violation of applicable professional standards that presents a substantial risk, which is either known or should have been known, of making a document prepared pursuant to the federal securities laws materially misleading; or

(*2*) Repeated, unreasonable violations of applicable professional standards that demonstrate that the accountant lacks competence.

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Dated: June 12, 1998.

By the Commission.

Jonathan G. Katz,

Secretary.

Separate Statement of Commissioner Norman S. Johnson

I write separately to address what I consider to be the plain import of the two decisions of the United States Court of Appeals for the District of Columbia Circuit in *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994) (*Checkosky I*), and *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) (*Checkosky II*).[1] In today's release, the Commission proposes to adopt a negligence standard under Rule 102(e) of our Rules of Practice, a matter of crucial importance to the accountants who practice before us.[2] As Judge Randolph observed:

> A proceeding under Rule 2(e) threatens ''to deprive a person of a way of life to which he has devoted years of preparation and on which he and his family have come to rely.'' Henry J. Friendly, ''*Some Kind of Hearing,*'' 123 U. Pa. L. Rev. 1267, 1297 (1975). It is of little comfort to an auditor defending against such charges that the Commission's authority is limited to suspending him from agency practice. For many public accountants such work represents their entire livelihood. Moreover, when one jurisdiction suspends a professional it can start a chain reaction.

Checkosky I, 23 F.3d at 479 (opinion of Randolph, J.).

With all due respect to my esteemed colleagues, today's release reflects precisely the same sort of overly aggressive approach that led to the Commission's two stinging defeats in *Checkosky*. The consequences of overreaching in this area might well be severe. If the Commission selects an insupportable standard many of the worst offenders of Rule 102(e) may escape sanction altogether. Prudence would seem to dictate a much more cautious approach than that taken in today's release.

Because I believe that the Commission lacks the authority to adopt a negligence standard, I must dissent. *See Checkosky I*, 23 F.3d 452; *Checkosky II*, 139 F.3d 221. Even apart from the *Checkosky* decisions, adoption of a negligence standard would contravene public policy.

Some background is in order.

I.

Respondents in *Checkosky* were two accountants who audited the financial statements of Savin Corporation in the early 1980's. The Commission brought charges against the accountants in 1987, and in 1992 affirmed an Administrative Law Judge's decision finding violations of Rule 102(e). *See David J. Checkosky*, Release No. 34–31094, 1992 SEC LEXIS 2111 (Aug. 26, 1992). In its first opinion, the Commission found that Savin's financial statements were false in that the company improperly capitalized certain expenses for research and development rather than recording them in their entirety as expenses in the years incurred. *Id.* These violations were based on finding that the auditors, in violation of Generally Accepted Auditing Standards (GAAS), had improperly permitted Savin to capitalize these expenditures and falsely certified that Savin's financial statements set forth its financial condition in accordance with Generally Accepted Accounting Principles (GAAP).[3] *Id.*

In *Checkosky I*, the D.C. Circuit remanded the case because it was unable to discern from the Commission's opinion the basis for the Commission's action other than the finding that the accountants had violated GAAS and falsely certified that the financial statements set forth the financial condition of the company in accordance with GAAP. 23 F.3rd at 454. The Court held that the Commission was authorized to promulgate Rule 102(e) as a means to protect the integrity of its processes, but each of the three judges (Judges Silberman, Randolph and a district court judge sitting by designation, Judge Reynolds) issued a separate opinion.

Judges Silberman and Randolph both questioned the Commission's ability to impose sanctions under Rule 102(e) for misconduct not rising to the level of scienter, i.e., misconduct that is only negligent.[4] Judge Silberman explained that:

[1] The weight the Commission must attach to the views of the D.C. Circuit cannot be overstated. Under the jurisdictional provisions of the securities laws, every respondent in a Commission administrative proceeding has the option of appealing an adverse outcome to the D.C. Circuit. *See, e.g.*, 15 U.S.C. 77i(a) & 78y(a)(1).

[2] Rule 102(e) was formerly designated Rule 2(e). There are no substantive differences between the two rules.

[3] Commissioner Roberts concurred in the majority's finding that respondents violated GAAS and had misapplied GAAP, but dissented from the finding that these errors amounted to ''improper professional conduct'' under Rule 102(e)(1)(ii). 1992 SEC LEXIS 2111, at *47. In Commissioner Roberts' view respondents' conduct did not provide a sufficient basis for a finding that they would threaten the Commission's processes. *Id.* at *48.

[4] Senior District Judge Reynolds disagreed with the circuit judges' conclusion that ''improper

Continued

If the purpose of Rule 2(e) is to protect the integrity of administrative processes, then sanctions for improper professional conduct under 2(e)(1)(ii) are permissible only to the extent that they prevent the disruption of proceedings. Punishment for mere negligence, so the argument goes, extends beyond this realm of protective discipline into general regulatory authority over a professional's work.

23 F.3d at 456. Judge Silberman further suggested that the Commission could not legitimately adopt a negligence standard under Rule 102(e) because that might amount to ''a *de facto* substantive regulation of the profession.'' 23 F.3d at 459; *see also* 23 F.3d 460 (suggestion that Commission adoption of negligence standard might be arbitrary and capricious).

Judge Randolph also questioned the Commission's ability to adopt a negligence standard. In Judge Randolph's view, the ''Commission's authority under Rule 2(e) must rest on and be derived from the statutes it administers,'' such as Section 10(b) of the Exchange Act that requires scienter. *See* 23 F.3d at 466–69. Judge Randolph also extensively discussed an earlier Commission decision that rejected a negligence standard under Rule 102(e) in a case involving lawyers, *William R. Carter*, 47 S.E.C. 471 (1981). *See* 23 F.3d at 480–87. In Judge Randolph's view, the reasoning of *Carter* was equally applicable to accountants, and precluded the Commission from adopting a negligence standard under Rule 102(e). *See* 23 F.3d at 483–87.

On remand, the Commission's majority opinion did not directly address the mental state question posed by the Court. *David J. Checkosky*, Release No. 34–38183, 1997 SEC LEXIS 137 (Jan. 21, 1997). While the majority found that the accountants had behaved recklessly, it insisted that any deviation from GAAP or GAAS, including purely negligent deviations, could violate Rule 102(e), and that the accountants' recklessness was relevant only to the choice of sanctions. *Id*. I dissented from the Commission's second *Checkosky* opinion because of my belief that ''improper professional conduct'' requires proof of scienter, which includes recklessness.[5] 1997 SEC LEXIS 137, at *48.

On appeal in *Checkosky II*, the D.C. Circuit again reversed. The Court again found that the Commission had again failed to offer an adequate explanation of its interpretation of Rule 102(e). 139 F.3d at 222 (referring to the ''multiplicity of inconsistent interpretations'' in the Commission's opinion). Because of the Commission's ''persistent failure to explain itself'' and ''the extraordinary duration of these proceedings,'' the Court declined to give the Commission a third chance to explain itself, and instead invoked the extremely rare remedy of remanding the case with instructions to dismiss. 139 F.3d at 222 & 227.

More importantly for today's release, the D.C. Circuit in *Checkosky II* again questioned the Commission's ability to adopt a negligence standard under Rule 102(e)(1)(ii). 139 F.3d at 225. The Court appeared to reaffirm its previous statements about the limits of the Commission's authority in disciplining securities professionals subject to Rule 102(e), remarking that ''adoption of a negligence standard might be *ultra vires*'' because it might amount to ''a back-door expansion of [the Commission's] regulatory oversight powers.'' *Id*. (citing *Checkosky I*, 23 F.3d at 459).[6]

II.

As explained above, the *Checkosky* opinions preclude us, as a practical matter, from adopting a negligence standard. Even were the situation otherwise, public policy considerations also call for rejection of a negligence standard. *See, e.g., David J. Checkosky*, Release No. 34–38183, 1997 SEC LEXIS 137, at *48 (Jan. 21, 1997) (dissenting opinion of Commission Johnson). In my view, ''improper professional conduct'' in Rule 102(e)(1)(ii) requires proof of scienter.

Our system of securities regulation is based on disclosure. To ensure that Commission filings and other statements made to the investing public are truthful and accurate, we have to rely in large part on the work of talented, well-trained professionals. Accordingly, I fully agree with former Chairman Williams' statement that we would be unable to administer effectively the securities laws if those ''involved in the capital raising process were not routinely served by professionals of the highest integrity and competence, well-versed in the requirements of the statutory scheme Congress has created.'' *Keating, Muething & Klekamp*, 47 S.E.C 95, 120 (1979) (concurring opinion of Chairman Williams); *see also Touche, Ross & Co.* v. *SEC*, 609 F.2d 570, 580–81 (2d Cir. 1979) (because of limited resources, ''the Commission necessarily must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly''). On the other hand, I also believe that the Commission has a limited mandate under Rule 102(e) for determining who may ''practice'' before us, and that we must exercise a high degree of self-restraint in this area.

As to accountants, the very nature of their responsibilities within our disclosure system mandates restraint. Accountants, like other securities professionals subject to Rule 102(e), must make difficult judgment calls, navigating through complex statutory and regulatory requirements. In addition, accountants are required to follow GAAS and to apply GAAP. These determinations demand the application of independent professional judgment and often involve matters of first impression.

The Commission itself recognized the importance of these principles in *Carter*, when it asserted that, in order to assure the exercise of a professional's ''best independent judgment,'' the professional ''must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of (losing) the ability to practice before'' us. 47 S.E.C. at 504. Equating negligence with ''improper professional conduct'' will impair relationships between professionals and their clients. If such an adverse impact occurs, our ability to rely on these professionals to enhance compliance with the securities laws will be crippled. I share the view endorsed by the Commission in *Carter* that professionals ''motivated by fears for their personal liability will not be consulted on difficult issues.'' *Id*.

Securities professionals owe a duty to serve the interests of their clients. To discharge this duty, professionals must enjoy the cooperation and trust of their clients. Indeed, in construing *Carter*, Judge Randolph observed:

(W)ithout a scienter requirement, lawyers would slant their advice out of fear of incurring liability, and management therefore would not consult them on difficult questions. I cannot see why this sort of reasoning would not apply as well to auditors. I recognize that although companies need not retain outside counsel, they are legally compelled to ''consult'' independent accountants * * * . This creates an obligation on the part of management to cooperate with and provide information to the auditor. * * * There are, however, degrees of cooperation. Encouraging management to be completely candid with its

professional conduct'' under Rule 102(e)(1)(ii) required proof of scienter. 23 F.3d at 493–95.

[5] *See Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (defining recklessness as '''highly unreasonable''' conduct involving '''an extreme departure from the standards of ordinary care'''); *see also, e.g., Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979) (following *Sundstrand*).

[6] This point is made clear by the concurring opinion, in which Judge Henderson expressly disagreed with the majority's discussion of this issue. *See* 139 F.3d at 227.

auditor about difficult accounting issues may be just as desirable as encouraging management to consult candidly with outside lawyers, and for similar reasons.

Checkosky I, 23 F.3d at 485.

Accountants and attorneys are members of ''ancient professions,'' regulated according to rigorous ethical rules enforced by professional societies and, in the case of accountants, state licensing boards. I simply do not believe that we should recast negligent violations of an accounting standard as improper professional conduct under the Commission's Rules of Practice. That is not an appropriate role for this Commission. Difficult ethical and professional responsibility concerns are generally matters most appropriately dealt with by professional organizations or, in certain cases, malpractice litigation. Nor do I believe that mere misjudgments or negligence establishes either professional incompetence warranting Commission disciplinary action or the likelihood of future danger to the Commission's processes.

* * * * *

For all these reasons, I believe that the Commission lacks the authority to adopt a negligence standard under Rule 102(e). Likewise, the Commission may only hold a professional liable for ''improper professional conduct'' only if scienter is proven. I urge accountants and trade groups directly subject to Rule 102(e), as well as any others who have an interest in Rule 102(e), to submit their views on this important matter. It is my most fervent hope that the Commission receives an abundance of comment letters responding to this release.

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DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 165

[CGD07–98–023]

RIN 2115–AE84

Regulated Navigation Area; San Juan Harbor, San Juan, PR

AGENCY: Coast Guard, DOT.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Coast Guard proposes to establish a permanent regulated navigation area in San Juan Harbor in the vicinity of La Puntilla in San Juan, PR. This regulated navigation area is needed to protect personnel and vessels moored at Coast Guard Base San Juan from the hazards created by the wakes of passing vessel traffic. By establishing this permanent regulation, the Coast Guard expects to reduce the risk of personnel injury and property damage.

DATES: Comments must be received on or before August 17, 1998.

ADDRESSES: Comments should be mailed to Commanding Officer, U.S. Coast Guard, Marine Safety Office, P.O. Box 9023666, San Juan, PR 00902–3666. Comments will become part of this docket and will be available for inspection or copying at the above address.

FOR FURTHER INFORMATION CONTACT: LT D.R. Xirau, Assistant Chief Port Operations Department, USCG Marine Safety Office San Juan at (787) 729–6800, ext 320.

SUPPLEMENTARY INFORMATION:

Request for Comments

The Coast Guard encourages interested persons to participate in this rulemaking by submitting written views, data, or arguments. Persons submitting comments should include their names and addresses, identify this rulemaking [CGD07–98–023], and the specific section of this proposal to which each comment applies and give the reason for each comment. The Coast Guard requests that all comments and attachments be submitted in an 8″ X 11″ unbound format suitable for copying and electronic filing. If this is not practical, a second copy of any bound material is requested. Persons requesting acknowledgment of receipt of comments should enclose a stamped, self-addressed postcard or envelope. The Coast Guard will consider all comments received during the comment period. It may change this proposal in view of the comments received.

The Coast Guard plans no public hearing. Persons may request a public hearing by writing to Commanding Officer, Marine Safety Office San Juan at the address under **ADDRESSES**. The request should include the reasons why a hearing would be beneficial. If the Coast Guard determines that the opportunity for oral presentations will aid this rulemaking, it will hold a public hearing at a time and place announced by a later notice in the **Federal Register**.

Background and Purpose

These proposed regulations create a regulated navigation area requiring all vessels to maintain minimum steerageway in the vicinity of Coast Guard Base San Juan. These proposed regulations are necessary to provide for the safety of personnel and the protection of vessels that are moored alongside the piers at Coast Guard Base San Juan. Coast Guard Base San Juan is located at La Puntilla in Old San Juan, at a junction of major channels in the San Juan Harbor. The Coast Guard believes that a significant risk exists under current conditions because wakes cause damage to vessels and the piers, and create major safety hazards to personnel working onboard moored vessels.

The vessels most affected by wakes at Base San Juan are 110-foot Coast Guard patrol boats and other smaller vessels. Heavy wakes have caused moored vessels to roll up to 15 degrees without warning. This places Coast Guard personnel working onboard these vessels at higher risk of injury due to the unexpected movement brought on by wakes. Moreover, while heavy equipment and supplies are being moved on a vessel, a sudden roll could cause the load to be dropped or the personnel carrying the load to lose their balance, possibly resulting in serious injury. There have been many ''near miss'' incidents which could have proven fatal if personnel had been directly involved, including heavy hatches secured in the open position being jarred loose by strong wakes and slamming shut without warning.

Heavy wakes also cause damage to property at Coast Guard Base San Juan. Vessel hulls, cleats, stanchions, and gangways have been bent or parted. Piers have deteriorated more rapidly due to the added stresses of vessels affected by wakes. In addition, electrical shore ties and fueling hoses have been pulled loose, creating very hazardous situations. By establishing a minimum steerageway in the vicinity of La Puntilla, the risks to personnel and property inherent to wakes will be minimized.

Additionally, beginning in June 1998, five Coast Guard patrol boats will be relocated to Coast Guard base San Juan. After this relocation, there will be a total of eight Coast Guard vessels permanently stationed in San Juan. The construction of new piers to accommodate the additional vessels will commence prior to the end of Fiscal Year 1998. These proposed regulations will also serve to minimize hazards during the construction, which is expected to take one year to complete.

Regulatory Evaluation

This proposal is not a significant regulatory action under section 3(f) of Executive Order 12866 and does not require an assessment of potential costs and benefits under section 6(a)(3) of that order. It has been exempted from review by the Office of Management and