SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 201

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RIN 3235–AH47

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

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting 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 amendment clarifies the Commission's standard for determining when accountants engage in ''improper professional conduct'' under Rule 102(e)(1)(ii).

EFFECTIVE DATE: The rule amendment will become effective November 25, 1998.

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SUPPLEMENTARY INFORMATION: The Commission today is adopting an amendment to Rule 102(e).[1]

I. Executive Summary

Under Rule 102(e) of the Commission's Rules of Practice, the Commission can censure, suspend or bar professionals who appear or practice before it.[2] Today, the Commission is amending Rule 102(e) to clarify the Commission's standard for determining when accountants [3] engage in ''improper professional conduct'' under subsection (1)(ii) of the rule.

The Commission's proposal to amend Rule 102(e) was prompted by a recent judicial decision by the U.S. Court of Appeals for the District of Columbia Circuit concerning the conduct of two accountants. The court found that the Commission's opinions in that case had not articulated clearly the ''improper professional conduct'' element of the rule.[4] To address the court's concerns, the Commission published for comment a proposed amendment to Rule 102(e) on June 18, 1998.[5] To give the public additional time to comment on the proposed amendment, the Commission extended the comment period until August 20, 1998.[6]

The proposed amendment articulated three types of violations of applicable professional standards that would constitute ''improper professional conduct.'' The final rule amendment changes the focus of these provisions from types of violations to types of conduct that result in violations of applicable professional standards. Comment letters addressing these provisions generally supported two parts of the Commission's proposal: one, knowing or intentional conduct, including reckless conduct; and, two, repeated instances of unreasonable conduct. The Commission adopts these provisions in substantially the form they were proposed.

Rule 102(e) proceedings may also be based on a third type of conduct: ''highly unreasonable conduct'' that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that ''heightened scrutiny'' is warranted. This part of the final rule amendment differs from the proposed amendment. This provision covers a single instance of serious misconduct that may not rise to the level of intentional or knowing (including reckless) conduct. The changes from the proposed amendment emphasize that this provision applies only to deviations from professional standards—greater than ordinary negligence but less than recklessness—when an accountant knows or should know of a heightened risk. The final rule amendment refers to this situation as ''heightened scrutiny.'' The differences between the proposed amendment and the final amendment are discussed in detail below.

The amendment is intended to reach violations of applicable professional standards that demonstrate that an accountant lacks competence to practice before the Commission. An accountant who acts intentionally or knowingly, including recklessly, or highly unreasonably when heightened scrutiny is warranted, conclusively demonstrates a lack of competence to practice before the Commission. By contrast, when the Commission brings a Rule 102(e) proceeding for repeated instances of unreasonable conduct, it will also have to find that the conduct indicates a lack of competence.

The Commission received 168 comment letters on the proposed amendment to Rule 102(e). A number of commenters, including individual investors, institutional investors, public interest groups, officers and directors of public companies, and academics, supported the proposed amendment. Several certified public accountants (''CPAs'') also expressed their support for the proposed amendment. Most other commenters supported at least some aspects of the proposed amendment. A substantial number of CPAs submitted letters that expressed agreement with an August 1998 memorandum of the American Institute of Certified Public Accountants (''AICPA'') criticizing certain aspects of the proposed amendment. Most of these CPA commenters also expressed their support for the amendment to Rule 102(e) proposed in the AICPA's May 7, 1998 rulemaking petition.[7] In addition, the five largest U.S. accounting firms and members of interested committees of the American Bar Association submitted letters supporting some, but critical of other, aspects of the proposed amendment.

The Commission acted as expeditiously as practicable in adopting this amendment. The Commission wants to address promptly the *Checkosky II* court's concern that the Commission had not clearly articulated its standard for determining when accountants engage in ''improper professional conduct.'' Equally important, the Commission wants to make sure that its processes continue to be protected, and that the investing public continues to have confidence in the integrity of the financial reporting process.

Accurate financial reporting is the bedrock of our capital markets. Accountants play a vital role in assuring issuers' compliance with reporting requirements. The Commission wishes

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

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

[5] Securities Act Release No. 7546 (June 12, 1998), 63 FR 33305 (June 18, 1998) (the ''Proposing Release''). In addition to publishing the Proposing Release in the Federal Register, the Commission also posted it on its Website. The address of the Commission's Website is http://www.sec.gov.

[6] Securities Act Release No. 7555 (July 15, 1998), 63 FR 39054 (July 21, 1998).

[7] On May 7, 1998, the AICPA submitted a rulemaking petition to the Commission proposing a definition for ''improper professional conduct'' under Rule 102(e)(1)(ii). Rulemaking Petition by the AICPA Concerning Rule 102(e) (''AICPA Rulemaking Petition''), SEC File No. 4–410 (May 7, 1998).

to underscore the importance of that role and the need for accountants to comply with the standards of conduct applicable to members of their profession. These professional standards include the overarching requirement that auditors exercise due care in their audit of a company's financial statements. The Commission possesses broad authority, both under the federal securities laws and its own rules, to promote and enforce compliance with professional standards.

Rule 102(e) addresses that category of professional conduct that threatens harm to the Commission's processes. The rule was not intended to cover all forms of professional misconduct. As discussed below,[8] the Commission has separate statutory authority that is available to address and deter professional misconduct that is not encompassed by Rule 102(e), as amended in this release.

The final rule amendment clarifies the Commission's standard for determining when ''improper professional conduct'' occurs under Rule 102(e)(1)(ii). The amendment will allow the Commission to bring the actions it traditionally has brought under Rule 102(e)(1)(ii). Moreover, the purpose served and the relief provided by the rule are forward-looking. For these reasons, the Commission will use this standard in all cases considered after the amendment's effective date, except where a trial before an Administrative Law Judge has already commenced,[9] regardless of when the conduct in question occurred.

II. Background

A. The Importance of Rule 102(e)

Under Rule 102(e), the Commission can censure, suspend or bar professionals who appear or practice before it. 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.[10]

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.'' [11] Courts have recognized that it is appropriate for the Commission to use a remedial rule such as Rule 102(e) to encourage professionals to adhere to professional standards and minimum standards of competence when they practice before the Commission. In adopting the rule, the Commission did not intend to add an ''additional weapon'' to its ''enforcement arsenal,'' [12] but to protect the integrity and quality of 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. One of the most significant roles is in auditing financial statements filed with the Commission. This release focuses particular attention upon the role of auditors in the securities registration and reporting processes under the federal securities laws. The amendment, however, covers all accountants who appear or practice before the Commission.[13]

''Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public.''[14] Various provisions of the federal securities laws require publicly-held companies to file audited financial statements with the Commission.[15] These financial statements must be audited by independent accountants in accordance with generally accepted auditing standards (''GAAS'').[16] 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.[17] The auditor's opinion states whether the audit was conducted in accordance with GAAS, and whether the financial statements present fairly, in all material respects, the financial position of the company as of a specific date and the results of its operations and its cash flows for the year (or other period) then ended, in conformity with generally accepted accounting principles (''GAAP'').[18]

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 every financial statement.[19] Consequently, the Commission must rely on the competence and independence of the auditors who certify, and the 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 ''[t]he duty of accountants to those who justifiably rely on [their] reports.'' [20] The AICPA's Code of Professional Conduct contains the strong statement that ''[t]hose who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public.'' [21] Due care requires auditors to discharge their responsibilities with competence and diligence and consistent with the profession's responsibility to the public. Moreover, GAAS requires that ''due professional care'' be exercised in the performance of audits.[22] 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.[23] An incompetent accountant can damage the Commission's processes

[8] *See* discussion on p.20.

[9] Where a hearing has already commenced, an Administrative Law Judge may use the Rule 102(e) standard adopted today if such use would not unfairly prejudice any party. The Administrative Law Judge may also supplement or re-open the record, if necessary, to give any party so requesting the opportunity to provide particular evidence or briefing on the Rule 102(e) standard.

[10] 17 CFR 201.102(e)(1)(i), (ii) and (iii).

[11] *Touche Ross & Co.* v. *SEC,* 609 F.2d 570, 582 (2d Cir. 1979).

[12] *Id.* at 579.

[13] *See* 17 CFR 201.102(f)(1) and (2). For example, the Commission has brought Rule 102(e) proceedings against accountants serving as officers of public companies. *See, e.g., In re Terrano,* Securities Exchange Act of 1934 (''Exchange Act'') Release No. 39485 (Dec. 23, 1997), 66 SEC Docket 494 (Jan. 20, 1998); *In re Hersh,* Exchange Act Release No. 39089 (Sept. 18, 1997), 65 SEC Docket 1170 (Oct. 14, 1997); *In re Bryan*, Exchange Act Release No. 39077 (Sept. 15, 1997), 65 SEC Docket 1129 (Oct. 14, 1997).

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

[15] *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).

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

[17] *See* Regulation S–X, 17 CFR 210.2–02 (1997).

[18] *Id.*

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

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

[21] AICPA Professional Standards, Vol. 2 ET section 53.03 (1997).

[22] AICPA Professional Standards, Vol. 1 AU section 230.01 (1997).

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

and erode investor confidence in our markets.[24]

C. The ''Improper Professional Conduct'' Standard Applied to Accountants

The Court of Appeals in *Checkosky II* criticized the Commission for not clearly articulating in that case when an accountant would be deemed to have engaged in ''improper professional conduct'' under Rule 102(e)(1)(ii). The amendment adopted today addresses this concern by specifying three types of conduct that constitute ''improper professional conduct.'' The Commission believes that a finding of ''improper professional conduct'' under Rule 102(e) is warranted only when an accountant lacks competence [25] to practice before the Commission.

Rule 102(e)(1)(ii) has been an effective remedial tool because it covers a range of conduct that demonstrates that a professional is a future threat to the Commission's processes.[26] Accountants who engage in intentional or knowing conduct, which includes reckless conduct, clearly pose this type of future threat. Accountants who engage in certain specified types of negligent conduct also can pose such a future threat.

Rule 102(e)(1)(ii) is not meant, however, to encompass every professional misstep.[27] A single judgment error, for example, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and, therefore, may not pose a future threat to the Commission's processes sufficient to require Commission action under Rule 102(e)(1)(ii).[28]

The Commission believes that a single judgment error that was highly unreasonable and made in circumstances warranting heightened scrutiny, however, conclusively demonstrates a lack of competence to practice before the Commission.[29] Repeated judgment errors may also indicate a lack of competence. Therefore, if the Commission finds that an accountant acted unreasonably in more than one instance (each time resulting in a violation of applicable professional standards), and that this conduct indicates a lack of competence, that accountant engaged in improper professional conduct under the standard adopted today.[30]

The Commission does not seek to use Rule 102(e)(1)(ii) to establish new standards for the accounting profession. The rule itself imposes no new professional standards on accountants. Accountants who appear or practice before the Commission are already subject to professional standards. Indeed, the Commission will only bring Rule 102(e)(1)(ii) proceedings against accountants who violate applicable professional standards in circumstances that demonstrate their lack of competence to practice before the Commission.[31]

III. Discussion of Amendment

A. The Final Rule

The amendment specifies three types of conduct that constitute ''improper professional conduct'' under Rule 102(e)(1)(ii). The amendment states:

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

(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

(B) Either of the following two types of negligent conduct:

(*1*) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(*2*) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

Each section of the final rule amendment refers to a violation of ''applicable professional standards.'' [32] The term ''applicable professional standards'' primarily refers to GAAP, GAAS, the AICPA Code of Professional Conduct, and Commission regulations. Also included are generally accepted standards routinely used by accountants in the preparation of statements, opinions, or other papers filed with the Commission.

The term ''applicable professional standards'' is broad enough to accommodate changes in the body of professional guidance routinely used by accountants. For example, should international accounting standards be adopted, they would become part of accepted professional guidance. Likewise, pronouncements of the Independence Standards Board, or other bodies yet to be established, would come to form part of the professional guidance that accountants routinely use. As the AICPA concluded, the term ''applicable professional standards'' is one ''that professionals are generally familiar with and can understand.'' [33]

B. Intentional or Knowing Conduct, Including Reckless Conduct

Subparagraph (A) of the amendment defines ''improper professional conduct'' to include the most blatant violations of applicable professional standards. The Commission consistently has used Rule 102(e) proceedings to address these types of violations of applicable professional standards.[34]

The Commission is adopting subparagraph (A) of the amendment in

[24] ''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).

[25] By ''competence'' the Commission means not just technical skills, but also an accountant's willingness and ability to adhere to professional standards, including standards of honesty and fair dealing.

[26] *Carter*, 22 SEC Docket at 297. Because the purpose of Rule 102(e)(1)(ii) is to address conduct that demonstrates a future threat to the Commission's processes, the rule is remedial and not punitive in nature.

[27] 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.

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

[28] Such an error, however, may violate applicable professional standards. For example, the AICPA's Code of Professional Conduct and GAAS require accountants to exercise due care. In addition, such an error may result in a violation of the federal securities laws. *See* discussion at p. 20. In either event, the person committing such an error, though not subject to discipline under Rule 102(e), would be exposed to the sanctions available under those other provisions.

[29] *See* Section III.C.1 below.

[30] *See* Section III.C.2 below.

[31] Under Rule 102(e), the Commission has other authority to protect the integrity of its processes from persons who pose a threat of future harm to those processes. For example, the Commission may censure, suspend or bar persons who the Commission finds ''not to possess the requisite qualifications to represent others.'' 17 CFR 201.102(e)(1)(i).

[32] The final rule amendment will not change the Commission's practice of bringing Rule 102(e) proceedings against accountants who lack independence. *See, e.g., In re Goodbread*, Exch. Act Rel. No. 38035 (Dec. 12, 1996), SEC Accounting Rules [Current Binder] (CCH) ¶ 5,061 (Mar. 1997); *In re Iommazzo*, Exch. Act Rel. No. 30733 (May 22, 1992), Accounting Series Releases, [1991–95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,844 (July 19, 1995).

[33] Comment Letter of Richard I. Miller, General Counsel & Secretary, AICPA, at 9 (Aug. 20, 1998) (''AICPA Comment Letter'').

[34] *See, e.g., In re Finkel*, Securities Act Release No. 7401 (Mar. 12, 1997), 64 SEC Docket 103 (Apr. 8, 1997); *In re Basson*, Exchange Act Release No. 35840 (June 13, 1995), 59 SEC Docket 1650 (July 11, 1995); *In re F.G. Masquelette & Co.*, Accounting Series Release 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, 1977), 13 SEC Docket 1113 (Dec. 27, 1977).

substantially the same form as it was proposed. Almost all commenters expressed support for subparagraph (A) of the proposed amendment. Clearly, an accountant who intentionally or knowingly, including recklessly, violates the professional standards conclusively demonstrates a lack of competence to appear before the Commission. Accountants who engage in this type of misconduct pose a future threat to the Commission's processes.

The Commission also requested comments on what definition of ''recklessness'' is most appropriate. Several commenters suggested that the Commission adopt a definition of ''recklessness'' used in cases brought under Section 10(b) and Rule 10b–5 of the Securities Exchange Act.[35] Although the standards of professional practice are not fraud based, the Commission agrees that, for purposes of consistency under the federal securities laws, ''recklessness'' in subparagraph (A) of the rule amendment should mean the same thing as courts have defined ''recklessness'' to mean under the antifraud provisions. ''Recklessness'' under the antifraud provisions ''is not merely a heightened form of ordinary negligence; it is an 'extreme departure from the standards of ordinary care, * * * which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it.' '' [36] This recklessness standard is a lesser form of intent.[37]

C. Two Specific Types of Negligent Conduct

The final rule amendment also covers two specific types of negligent conduct that result in violations of applicable professional standards.[38] The Commission believes that a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive.[39] For this reason, the Commission has brought Rule 102(e) proceedings based on negligent conduct.[40]

The Court of Appeals in *Checkosky II* faulted the Commission for not articulating with specificity when negligent conduct by an accountant constitutes ''improper professional conduct.'' [41] The final rule amendment provides this specificity. Subparagraph (B) of the amendment defines ''improper professional conduct'' to include two specific types of negligent conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

1. Highly Unreasonable Conduct

The ''highly unreasonable'' standard in subparagraph (B)(1) of the final rule amendment is an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness used in cases brought under Section 10(b) and Rule 10b–5 of the Exchange Act.[42] The ''highly unreasonable'' standard is an objective standard. The conduct at issue is measured by the degree of the departure from professional standards and not the intent of the accountant. The Commission believes that subparagraph (B)(1) describes conduct that poses a threat of future harm to the Commission's processes and conclusively demonstrates that the accountant lacks competence to practice before it.

The proposed rule referred to ''unreasonable'' conduct.[43] The definition the Commission adopts today includes a higher standard. The final standard reflects the Commission's conclusion that a single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and, therefore may not pose a future threat to the Commission's processes sufficient to impose remedial sanctions. The Commission neither accepts nor condones unreasonable, or negligent, accounting or auditing errors. To the contrary, such errors could undermine accurate financial reporting. Moreover, the Commission possesses authority, wholly independent of Rule 102(e), to address and deter such errors through its enforcement of provisions of the federal securities laws that impose liability on persons, including accountants, for negligent conduct.[44]

Many commenters objected to the ''unreasonable'' formulation in this subparagraph of the proposed rule or suggested changes to this subparagraph. Some CPAs and other commenters, for example, expressed concern that the ''unreasonable'' formulation made accountants unfairly vulnerable and liable for acts of ''simple negligence'' and errors in judgment.[45] These commenters maintained that such a standard could restrict accountants' exercise of their best independent judgment, thereby operating to the

[35] *See, e.g.,* Comment Letter of Ernst & Young LLP, at 19–20 (Aug. 20, 1998) (''Ernst & Young Comment Letter''); AICPA Comment Letter, at 8.

[36] *SEC* v. *Steadman,* 967 F.2d 636, 641 (D.C. Cir. 1992) (ellipsis in original) (quoting *Sundstrand Corp.* v. *Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977)); *see also Potts* v. *SEC,* 151 F.3d 810 (8th Cir. 1998) (finding recklessness under the *Steadman* standard in a Rule 102(e) proceeding).

[37] *See Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 193–94 n.12 (1976); *see also Steadman,* 967 F.2d at 641.

[38] 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). *See also* Securities Act section 17(a) (2) & (3), 15 U.S.C. 77q(a)(2) & (3); *Aaron* v. *SEC,* 446 U.S. 680 (1980). In addition, section 21C of the Exchange Act imposes liability when a person is a ''cause'' of a violation ''due to an act or omission the person knew or should have known would contribute to such violation.'' 15 U.S.C. 78u–3.

[39] 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. The amendment adopted today by the Commission, similar to the AICPA Rulemaking Petition, subjects accountants who engage in knowing misconduct as well as a course or pattern of misconduct to Rule 102(e)(1)(ii) proceedings. The amendment adopted today includes two specific types of negligent conduct. The Commission believes that the public interest will be better served by its broader definition of ''improper professional conduct.''

[40] *See, e.g., In re Gotthilf,* Exchange Act Release No. 33949 (April 21, 1994), 56 SEC Docket 1543 (May 10, 1994). *See also Danna* v. *SEC,* No. C–93–4158 (CW), 1994 WL 315877 (N.D. Cal. Feb. 8, 1994).

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

[42] The Commission notes that several cases interpreting the antifraud provisions of the federal securities laws use the phrase ''highly unreasonable'' as part of the definition of recklessness. *See, e.g., Sundstrand,* 553 F.2d at 1045. The Commission does not mean to incorporate that case law by using the term ''highly unreasonable'' in this context. This release defines the ''highly unreasonable'' standard—an intermediate standard higher than ordinary negligence and lower than recklessness—with care and precision. The ''highly unreasonable'' standard adopted today is not scienter-based.

[43] In fact, the proposed rule referred to ''[a]n unreasonable violation.'' At least one commenter correctly pointed out that this formulation implies there may be ''reasonable'' violations of professional standards. Comment Letter of K. Michael Conaway (Aug. 20, 1998). To eliminate this misconception, and to focus on individual competence, the final rule refers to ''unreasonable conduct,'' not ''violations.''

[44] *See, e.g.,* Securities Act section 17(a)(2) & (3), 15 U.S.C. 77q(a)(2) & (3); Exchange Act section 21C, 15 U.S.C. 78u–3; *see also* Securities Act section 11, 15 U.S.C. 77k. Accountants also may be liable for negligent conduct under the laws of various states, and subject to sanction by state accounting boards, *see, e.g.,* Fla. Admin. Code Ann. r. 61H1–36.004 (1998).

[45] AICPA Comment Letter, at 15–16; Comment Letter of Arthur Andersen LLP, at 5 (Aug. 17, 1998) (''Arthur Andersen Comment Letter''); Comment Letter of Robert K. Elliott, Partner, KPMG Peat Marwick LLP, at 10–12 (Aug. 20, 1998) (''KPMG Peat Marwick Comment Letter).

detriment of the financial reporting system.[46]

Creating an undue fear that an isolated error in judgment would result in a 102(e) proceeding could be counterproductive in some limited instances.[47] These concerns are eliminated as to Rule 102(e), or at least alleviated, by raising the threshold for improper professional conduct from one instance of ''unreasonable'' conduct to one instance of ''highly unreasonable'' conduct. Subparagraph (B)(1) of the final rule amendment does not permit the Commission to evaluate actions or judgments in the stark light of hindsight, but focuses instead on what an accountant knew, or should have known, at the time an action was taken or a decision was made. Indeed, three of the five largest accounting firms—who expressed concern that the ''unreasonable'' formulation would chill accountants'' use of their best judgment—suggested that the Commission could appropriately adopt a ''highly unreasonable'' formulation.[48] And, as one commenter pointed out, most state licensing provisions include a ''gross negligence'' standard.[49]

Some commenters questioned whether raising the standard above ordinary negligence was consistent with the purpose of Rule 102(e)(1)(ii) to protect the integrity of the Commission's processes.[50] These commenters strongly argued that a negligence standard is needed because accurate financial statements are essential to the investment decision-making process and auditors play a critical role in maintaining investor confidence in the reliability of financial statements.[51] The heightened standard of ''highly unreasonable'' strikes the appropriate balance between the Commission's need to protect its processes and accountants' ability to exercise judgment. In the Commission's view, the balance is appropriate in part because of the availability of remedies other than Rule 102(e) to address ordinary negligence. The final rule amendment, therefore, is fully consistent with the remedial purposes of Rule 102(e).

The final rule amendment provides that the Commission will bring cases under subparagraph (B)(1) only when an accountant knows or should know that heightened scrutiny is appropriate. The ''heightened scrutiny'' provision is also an objective standard. Again, the touchstone is the reasonable accountant. ''Heightened scrutiny'' would be warranted when matters are important or material, or when warning signals or other factors should alert an accountant of a heightened risk,[52] or as set forth in applicable professional standards.[53] Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence always merit heightened scrutiny. Therefore, if an accountant acts highly unreasonably with respect to an independence issue, that accountant has engaged in ''improper professional conduct.''

The proposed amendment focused on conduct presenting ''a substantial risk, which is either known or should have been known,'' of making a document filed with the Commission ''materially misleading.'' At least one commenter questioned whether the phrase was overbroad.[54] Other commenters correctly noted that the Commission's standard should not depend on the impact of a violation on financial statements filed with the Commission.[55] The proper focus should be on the conduct itself, rather than on the risk of harm posed by the conduct.[56]

This change from the proposed rule amendment is consistent with the purpose of Rule 102(e)(1)(ii) to protect the Commission's processes from accountants who lack competence to appear before it. The final rule amendment addresses this issue by focusing on the behavior of an accountant under the facts and circumstances presented at the time. The standard does not permit judgment by hindsight, but rather compares the actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation.

One commenter stated that filing a materially false or misleading document with the Commission should be a ''threshold requirement'' for a finding of improper professional conduct.[57] The Commission disagrees. The Commission does not need to show that the accountant's behavior actually caused harm; an accountant can demonstrate a lack of competence even if his conduct did not result in the filing of a false or misleading document. An auditor who fails to audit properly under GAAS—whether recklessly or highly unreasonably—should not be shielded because the audited financial statements fortuitously turn out to be accurate or not materially misleading. For example, the financial statements of a large company's subsidiary that have been audited by an accountant who acted recklessly or highly unreasonably in violation of GAAS may not be material to the consolidated financial statements filed by the company with the Commission. In that situation, the

[46] Most investors and users of financial statements, however, disagreed. *See* Comment Letter of Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, TIAA-CREF, at 4 (July 16, 1998); Comment Letter of Josh S. Weston, Chairman of the Board, Automatic Data Processing, Inc. (Aug. 24, 1998) (''Weston Comment Letter''); Comment Letter of Dr. John H. Nugent (Aug. 11, 1998) (''Nugent Comment Letter''); Comment Letter of Kurt N. Schacht, Chief Legal Officer, State of Wisconsin Investment Board, at 1 (July 20, 1998); Comment Letter of Laurence A. Tisch, Co-Chairman of the Board and Co-Chief Executive Officer, Loews Corporation (July 8, 1998); Comment Letter of Steven Alan Bennett, Senior Vice President and General Counsel, Banc One Corporation, at 2 (July 21, 1998). Moreover, commenters from one state board of accountancy supported the proposed standard. Comment Letter of Martha P. Willis, Division Director, State of Florida, Department of Business and Professional Regulation (Aug. 21, 1998).

[47] However, such an error could have legal consequences. *See* discussion on p. 20.

[48] Comment Letter of J. Michael Cook, Chairman and Chief Executive Officer, and Phillip R. Rotner, General Counsel, Deloitte & Touche LLP, at 6 (''Deloitte & Touche Comment Letter''); Ernst & Young Comment Letter, at 24; Comment Letter of PricewaterhouseCoopers, at 7 (Aug. 20, 1998) (''PricewaterhouseCoopers Comment Letter'').

[49] Comment Letter of Wayne A. Kolins, National Director of Accounting and Auditing, BDO Seidman LLP, at 9 (Aug. 19, 1998) (citing Uniform Accounting Act section 10(5)). The Commission is not adopting a ''gross negligence'' standard because courts have not interpreted the term uniformly. The Commission does not want to adopt a standard that has already been subject to varying interpretations. Fairness to accountants and sound public policy is furthered by using new terminology—the ''highly unreasonable'' standard—which is defined in this release with precision and clarity. However, the term ''gross negligence'' is often used—like the Commission's use of the phrase ''highly unreasonable''—as an intermediate standard between ordinary negligence and recklessness.

[50] Weston Comment Letter; Comment Letter of William B. Patterson, Director, Office of Investments, AFL–CIO, at 2 (Aug. 10, 1998) (''AFL–CIO Comment Letter''); *see also* Comment Letter of Patricia D. McQueen, Vice President, Advocacy, Financial Reporting & Disclosure, and Jonathan J. Stokes, Vice President, Professional Conduct Program, Association for Investment Management and Research, at 3 (Aug. 18, 1998).

[51] *See* Weston Comment Letter; AFL–CIO Comment Letter, at 2; Nugent Comment Letter; BancOne Comment Letter, at 2; TIAA–CREF Comment Letter, at 3.

[52] *See, e.g., In re Hope,* Accounting and Auditing Enforcement Release No. 109A (Aug. 6, 1986), 36 SEC Docket 663, 750–55 (Sept. 10, 1986).

[53] *Cf.* AICPA Professional Standards, Vol. 1 AU sections 312 and 316 (1997).

[54] PricewaterhouseCoopers Comment Letter, at 5. *See also* AICPA Comment Letter, at 17.

[55] Comment Letter of John M. Liftin, Chair, Committee on Federal Regulation of Securities, and Richard H. Rowe, Chair, Committee on Law and Accounting, ABA Section of Business Law, at 12 (Aug. 19, 1998).

[56] *See* Comment Letter of William T. Allen, at 3 (July 10, 1998) (''Allen Comment Letter'') (suggesting this approach).

[57] PricewaterhouseCoopers Comment Letter, at 5.

accountant has demonstrated a lack of competence.

Some commenters contended that the Commission should not have special rules for accountants. These commenters claimed further that, when compared to the standard applied to lawyers, the proposed rule ''discriminates'' against accountants.[58] As explained earlier, the amendment to Rule 102(e) focuses on accountants in response to the *Checkosky II* decision and the need to assure the protection of the Commission's financial reporting process. As noted, this release does not address the conduct of lawyers.

2. Repeated Instances of Unreasonable Conduct

Subparagraph B(2) of the final rule amendment addresses ''[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards.'' Repeated instances of unreasonable conduct by an accountant, each resulting in a violation of applicable professional standards, can damage both the Commission's processes and investor confidence in the integrity of financial statements. Most commenters who addressed the issue supported the notion of bringing Rule 102(e) proceedings against accountants who engage in repeated instances of negligent conduct.[59]

The term ''unreasonable,'' as distinguished from the term ''highly unreasonable'' used in subparagraph B(1), connotes an ordinary or simple negligence standard. The lower standard of culpability is justified in this instance because the repetition of the unreasonable conduct may show the accountant's lack of competence to practice before the Commission. If an accountant fails to exercise reasonable care on more than one occasion, the Commission's processes may be threatened. More than one violation of applicable professional standards ordinarily will indicate a lack of competence.

A few commenters raised questions about what would constitute ''repeated instances'' of unreasonable conduct.[60] ''Repeated instances'' means more than once. The term ''repeated'' may encompass as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits. For example, if an auditor fails to gather evidential matter for more than two accounts, or certifies accounting inconsistent with GAAP in more than two accounts, that conduct constitutes ''repeated instances'' of unreasonable conduct. By contrast, a single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute a violation of this subparagraph. Certification of accounting inconsistent with GAAP in two or more situations, however, may indicate an accountant's basic unfamiliarity with the standards of the profession, which may constitute improper professional conduct under subparagraph B(2).

The Commission recognizes that ''repeated instances'' may not always demonstrate a lack of competence to practice before the Commission. Although the Commission believes that more than one instance of unreasonable conduct will ordinarily indicate a lack of competence, unlike subparagraphs (A) and (B)(1), this subparagraph requires the Commission to make a specific finding that the conduct indicates a lack of competence. The finding is based on an evaluation of the conduct itself and does not require a separate evidentiary basis. This finding is required because two isolated violations of applicable professional standards, for example GAAS, may not pose a threat to the Commission's processes.

D. Authority

Some commenters questioned the Commission's authority to adopt a negligence standard under Rule 102(e). As stated in the Proposing Release, Rule 102(e) was promulgated under the Commission's broad authority to adopt those rules and regulations necessary for carrying out its designated functions,[61] and its inherent authority to protect the integrity of its processes. As the Supreme Court has held, ''the validity of a regulation promulgated [under an agency's general rulemaking authority] will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.' ''[62]

Three U.S. Courts of Appeals have upheld the validity of Rule 102(e).[63] As the U.S. Court of Appeals for the Second Circuit recognized:

> [Rule 102(e)] represents an attempt by the Commission to protect the integrity of its own processes. It provides the Commission with the 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. As such the Rule is 'reasonably related' to the purposes of the securities laws.[64]

One district court has explicitly held that the Commission's Rule 102(e) authority is not limited to instances of intentional misconduct or bad faith.[65]

Some commenters either referred to, or echoed, concerns expressed in the separate opinions of two judges of the U.S. Court of Appeals for the D.C. Circuit in *Checkosky I* questioning the Commission's authority to use a negligence standard for ''improper professional conduct'' under Rule 102(e).[66] One judge suggested that, if the Commission were to determine that an accountant's negligence was a *per se* violation of Rule 102(e), the Commission may be exceeding the scope of its authority and engaging in the substantive regulation of the accounting profession.[67] Similarly, a number of commenters suggested that adoption of a simple negligence standard would exceed the Commission's authority and encroach on the responsibilities of state boards of accountancy and professional organizations.

Although the Commission believes that it has the authority to do so, the Commission is not adopting a ''simple'' or ''mere'' negligence standard. Instead, the Commission is adopting a standard under which two specific types of negligent conduct that result in a

[58] *See, e.g.*, AICPA Comment Letter, at 21–23; Ernst & Young Comment Letter, at 18–19; KPMG Peat Marwick Comment Letter, at 6–8; Arthur Andersen Comment Letter, at 7–8.

[59] *See, e.g.*, Allen Comment Letter, at 1.

[60] Ernst & Young Comment Letter, at 21–22 (suggesting that the term ''repeated'' include more than two violations); KPMG Peat Marwick Comment Letter, at 13; *see also* Comment Letter of Terry Warfield, PricewaterhouseCoopers Research Scholar, Associate Professor, University of Wisconsin (Aug. 1, 1998).

[61] *See* Securities Act section 19(a), 15 U.S.C. 77s(a), Securities Exchange Act section 23(a), 15 U.S.C. 78w(a), Public Utility Holding Company Act of 1935 section 20(a), 15 U.S.C. 79t(a), Trust Indenture Act of 1939 section 319(a), 15 U.S.C. 77sss(a), Investment Advisers Act of 1940 section 211(a), 15 U.S.C. 80b–11(a), and Investment Company Act section 38(a), 15 U.S.C. 80a–37(a).

[62] *Mourning* v. *Family Publication Services, Inc.*, 411 U.S. 356, 369 (1973) (quoting *Thorpe* v. *Housing Authority of the City of Durham*, 393 U.S. 268, 280–81 (1969)).

[63] *See Touche Ross*, 609 F.2d at 582; *Sheldon* v. *SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995); *Davy* v. *SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986); *see also Potts*, 151 F.3d 810.

[64] *Touche Ross*, 609 F.2d at 582 (quoting *Mourning*, 411 U.S. at 369).

[65] *See Danna* v. *SEC*, No. C–93–4158 (CW), 1994 WL 315877 (N.D. Cal. Feb. 8, 1994).

[66] The *Checkosky* decisions held that the Commission had not clearly articulated the ''improper professional conduct'' standard or the rationale for that standard. The *Checkosky* opinions did not decide the issue of the scope of the Commission's authority. One judge in *Checkosky II* wrote a separate opinion to state her disagreement with the *dictum* in *Checkosky I* questioning the Commission's authority to ensure that the professionals who practice before it adhere to minimal levels of competence.

[67] *Checkosky I*, 23 F.3d at 459 (opinion of Silberman, J.).

violation of applicable professional standards are considered a future threat to the Commission's processes. The Commission is neither broadly regulating the accounting profession nor preventing accountants from functioning in numerous areas of their professions. Instead, the Commission is protecting the integrity and quality of its processes, and this it emphatically believes—in the public interest and for the protection of investors—it has the power to do.

In addition, the standard adopted today imposes no new professional responsibilities on accountants. Instead, the final rule amendment permits the Commission to bring proceedings against accountants when their violations of professional standards threaten the Commission's processes. The Commission is not attempting to police accountants' conduct in any area other than as it affects the operation of the federal securities laws.

One other judge in *Checkosky I* suggested that the Commission's authority to adopt a negligence standard under Rule 102(e)(1)(ii) might be limited by substantive provisions of the federal securities laws, such as the antifraud provision of Exchange Act Section 10(b).[68] Some commenters contended that the Commission could not therefore adopt a definition of ''improper professional conduct'' that did not require that the accountant acted with ''scienter,'' the mental state required under the Exchange Act's antifraud provisions.[69]

The definition of ''improper professional conduct'' that the Commission adopts today does not require scienter in every instance. The Commission believes this is necessary because Rule 102(e) protects the integrity of the Commission's processes; it is not an enforcement remedy or a weapon against fraud.[70] As noted above, accountants who engage in two specific kinds of negligent conduct can pose as great a threat to the Commission's processes as accountants who knowingly violate professional standards. As one commenter noted, ''the Commission's power to regulate professional standards should not be limited by the considerations of scienter that are appropriate in a jurisprudence built on common law definitions of fraud.'' [71] In addition, as another commenter noted, the federal securities laws impose liability for negligent conduct, as well as for conduct undertaken with scienter.[72] As this commenter noted, there are other policy reasons for the Commission to apply a negligence standard to accountants who practice before the Commission.[73]

E. A ''Good Faith'' Defense

The Commission does not consider the subjective good faith of an accountant to be an absolute defense under Rule 102(e)(1)(ii).[74] Subjective good faith is inconsistent with a finding of knowing or intentional, including reckless, conduct. Moreover, a Rule 102(e) proceeding based on the particular types of negligence covered in the final rule amendment does not require any subjective inquiry into the accountant's intent; subparagraphs (B)(1) and (B)(2) of the final rule amendment are objective standards. The Commission may, however, consider the accountant's good faith when determining what sanctions would be appropriate.

IV. Summary of Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis (''IRFA'') on the proposed amendment to Rule 102(e) was published in the proposing release. The IRFA indicated that the proposed amendment would clarify the standard by which the Commission determines whether accountants have engaged in ''improper professional conduct.'' No comments were received on the IRFA. The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C. 604 on the amendment to Rule 102(e). The following summarizes the FRFA.

The FRFA discusses the need for the rule amendment. Rule 102(e) currently authorizes the Commission to censure an accountant or deny, temporarily or permanently, an accountant's privilege of appearing or practicing before the Commission, if the accountant lacks character or integrity, or has engaged in unethical or ''improper professional conduct.'' The existing rule does not define ''improper professional conduct.''

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's opinions in the case had not articulated clearly the ''improper professional conduct'' element of the Rule. To address the court's concerns, the Commission is clarifying the Commission's standard for determining when accountants engage in ''improper professional conduct.''

The FRFA explains that the rule amendment is designed to protect the integrity of the Commission's processes. By clarifying the standards applied in determining ''improper professional conduct,'' the amendment will help the Commission, its administrative law judges, and the courts apply the rule fairly and consistently. The amendment will also give practitioners additional guidance about the standards for proceedings under Rule 102(e).

The FRFA explains that the notice of proposed rulemaking indicated how a copy of the IRFA could be obtained, and that no one requested a copy of the IRFA. The IRFA, and the summary of the IRFA that appeared in the notice of proposed rulemaking, also solicited 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. No commenters discussed either the IRFA generally or the number of small entities that would be affected by the proposed amendment.

The FRFA also discusses the effect of the amendment on small entities. The FRFA 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 Five'' firms, which are not small entities, many smaller firms do practice before the Commission. The Commission does not, however, collect information about revenues of accounting firms, which information generally is not made public by the

[68] *See Checkosky I,* 23 F.3d at 469 (opinion of Randolph, J.).

[69] *See, e.g.,* Arthur Andersen Comment Letter, at 2–3; KPMG Peat Marwick Comment Letter, at 6.

[70] Commissioner Johnson's dissent misconstrues the distinction between an enforcement remedy and a remedy that protects the integrity of the Commission's processes. Rule 102(a) does not cease to protect the Commission's processes simply because those processes are designed, in turn, to protect investors or because the Commission, in deciding what type of proceeding to bring, may sometimes consider whether it is more appropriate to bring a Rule 102(e) proceeding than an enforcement action. Rule 102(e) protects the integrity of the Commission's processes because it seeks to assure that professionals who prepare filings made with the Commission have the competence to prepare filings that comply with applicable requirements.

[71] *See* AFL–CIO Comment Letter, at 3.

[72] *See* Comment Letter of Joel Seligman, Dean and Samuel M. Fegtly Professor of Law, College of Law, University of Arizona, at 2–3 (Aug. 11, 1998).

[73] *Id.* at 3.

[74] *See In re Haskins & Sells,* Accounting Series Release 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 Release 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). To the extent that *dictum* in *In re Logan,* 10 S.E.C. 982 (1942), can be read to provide for a good faith defense, the Commission believes the standard adopted today is preferable.

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 Commission's standard provides a remedy for certain violations of the accountants' own professional standards and does not impose any new standards of conduct.

The FRFA notes that the amendment would not impose any new reporting, recordkeeping or compliance requirements. The FRFA 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 FRFA notes that two commenters suggested that the proposed rule could have an adverse effect on small accounting firms and/or small public companies. The Commission believes that it has addressed the concern that a simple negligence standard might raise fees or discourage auditors from practice by raising the standard in the final amendment. Finally, the FRFA notes that one commenter contended that the proposed amendment would not impose a disproportionate impact on small entities, and that another commenter wrote that the level of competence expected of a professional must be an absolute standard, regardless of the entity's size.

A copy of the FRFA 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.

V. Cost-Benefit Analysis

The Commission requested comments on any costs or benefits associated with the proposed amendment. No commenters offered any specific cost or benefit estimates. Several commenters, however, discussed the costs and benefits of the proposed amendment in general terms.

One commenter suggested that the ''costs associated with the proposed amendment appear to outweigh its potential benefits,'' [75] but offered no data to support the view. The commenter did describe the costs of the proposed amendment as ''costs associated with a decisional standard that fails to provide professionals with adequate notice of the conduct which could be subject to sanction,'' and costs created by the ''exposure of auditors to sanction based on a single negligent mistake,'' which the commenter believed ''would introduce an overly conservative bias into the financial reporting process.'' [76]

This commenter's concern that the proposed rule's use of a simple negligence standard would impose costs was shared by other commenters. Three commenters suggested that adoption of a simple negligence standard would, among other things, cause audit fees to increase.[77] Likewise, one of these commenters and one other commenter suggested that the proposed rule's use of a negligence standard would discourage competent practitioners from pursuing careers in public company auditing.[78]

The Commission does not believe that the final rule amendment imposes these costs. First, the Commission believes that the standard it adopts today defines with precision when an accountant's conduct will subject the accountant to Rule 102(e) proceedings. In fact, the clarification of the Commission's standard for ''improper professional conduct'' is one of the benefits of this final rule amendment. Second, these commenters' concern that accountants will be held liable for a single negligent mistake is addressed by the final rule amendment. As described above, the Commission is not adopting a standard that reaches single acts of simple negligence.

One commenter argued that the proposed rule's costs outweighed its benefits because it applied to ''CPAs and CPA firms whose past errors are not necessarily a precursor of future substandard practice.'' [79] The Commission believes that the final rule amendment only reaches accountants whose past violations demonstrate a lack of competence to practice before the Commission.

According to this commenter, the ''elimination of individuals and firms whose audit services are unreliable will undoubtedly have a beneficial effect in preventing future investor losses.'' [80] Weighed against this benefit, this commenter identified the costs of bringing Rule 102(e) proceedings and the costs ''associated with depriving the public of the services of qualified auditors.'' [81] This commenter stated that the number of accounting firms providing auditing services to public companies has declined sharply in the last 20 years and that there is no assurance that a further decline might not lead to increased audit fees.[82]

These comments seem directed at the costs and benefits of Rule 102(e) as a whole. The Commission only sought comment on the costs and benefits of its proposal to clarify ''improper professional conduct,'' not the costs and benefits of Rule 102(e). Moreover, the Commission has adopted a standard that is designed to reach only those accountants who lack competence to practice before the Commission. The rule amendment should not therefore ''deprive'' the public of the service of ''qualified auditors.'' The Commission therefore believes that the costs and benefits described by the commenter will not be affected by the particular standard adopted.

The Commission anticipates several benefits from the final rule 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.'' Also,

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[75] *See* AICPA Comment Letter, at 30.

[76] *Id.* at 30–31.

[77] *See* Comment Letter of R. Fogg (Aug. 12, 1998); Comment Letter of James Backus (Aug. 13, 1998) (''Backus Comment Letter''); Comment Letter of Kyle E. Carrick (Aug. 20, 1998) (''Carrick Comment Letter'').

[78] *See* BDO Seidman Comment Letter, at 9; Backus Comment Letter.

[79] *See* ABA Comment Letter, at 7; *see also* BDO Seidman Comment Letter, at 9 (stating that proposed amendment ''makes no distinction between professionals who have erred and those who are likely to err again'').

[80] *Id.*; *see also* BDO Seidman Comment Letter, at 9.

[81] *Id.*

[82] ABA Comment Letter, at 7.

the clarified 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 notes that its standard requires in the first instance that the accountant violate applicable professional standards. Therefore, the rule imposes no obligation that accountants are not already subject to. Rather, the amendment merely clarifies that when the Commission finds that an accountant has violated the applicable professional standards in circumstances meeting one of three standards of culpability, that accountant has engaged in ''improper professional conduct.'' The Commission also notes the existence of state accountancy boards, which can discipline accountants for violations of professional standards.

In addition, the federal securities laws and state law causes of action may provide for sanctions against accountants for related conduct. Therefore, accountants are already subject to liability and disciplinary schemes that encourage accountants to comply with applicable professional standards. After careful consideration of the comments received, the Commission continues to believe that the amendment will impose no costs.

VI. Efficiency, Competition and Capital Formation

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 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 requested data on what effect, if any, the proposed amendment would have on efficiency, competition and capital formation. No specific data was received in response to this request. One commenter asserted that the rule as proposed would cause ''the steps and costs to take a company public'' to escalate.[83] This commenter did not, however, provide any detail or explanation of why the proposed rule would cause this effect.

The Commission anticipates no effect on capital formation or efficiency, as the rule amendment clarifies an existing standard. Further, because the rule change applies equally to all accountants who practice before the Commission, and because it clarifies an existing standard, there should be no anti-competitive effect. In any event, the Commission believes that any burden on competition imposed by this amendment is necessary and appropriate in furtherance of the purpose of the Exchange Act.

VII. Statutory Authority

The Commission is adopting 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 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, 78l, 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) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or (B) Either of the following two types of negligent conduct:

(*1*) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(*2*) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

* * * * *

By the Commission.

Dated: October 19, 1998.

Margaret H. McFarland,

Deputy Secretary.

Dissenting Statement of Commissioner Norman S. Johnson

Although I have the deepest respect for my esteemed colleagues, I must dissent from the Commission's decision to issue today's release.[1] Despite the good faith demonstrated by my colleagues throughout this difficult rulemaking process, I believe that the Commission is repeating past mistakes by again attempting to ''push the envelope'' of its permissible authority under Rule 102(e) of our Rules of Practice, which governs the ability of professionals to practice before the Commission. In my view, the Commission's release disregards the plain import of the two *Checkosky* decisions of the United States Court of Appeals for the District of Columbia Circuit.[2] The release amends our Rule of Practice 102(e) so that an accountant's single act of negligence may amount, under some circumstances, to ''improper professional conduct,'' with the likely result of depriving an accountant of his or her livelihood.[3]

The more than 150 comment letters we have received—the overwhelming majority of them highly critical of the most important part of the proposal—demonstrate that Rule 102(e) is a matter of crucial importance to the accountants

[83] *See* Carrick Comment Letter.

[1] The standard contained in today's release (the ''Standard'') was adopted at an open meeting of the Commission on September 23, 1998. *See SEC Defines ''Improper Professional Conduct'' by Accountants*, 1998 WL 649370 (S.E.C.) (News Release Sept. 23, 1998).

[2] *See Checkosky* v. *SEC*, 23 F.3d 452 (D.C. Cir. 1994) (''*Checkosky I*''); *Checkosky* v. *SEC*, 139 F.3d 221 (D.C. Cir. 1998) (''*Checkosky II*''). 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).

[3] Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities Act Release No. 33–7593 (October 19, 1998) (the ''Release''). Before the recodification of the Commission's Rules of Practice in 1995, Rule 102(e) was formerly designated Rule 2(e). There are no substantive differences between the two rules. When directly quoting pre-1995 materials, I have left references to ''Rule 2(e)'' intact; otherwise all references to the former Rule 2(e) appear as ''Rule 102(e).''

who practice before the Commission.[4] As Judge Randolph observed in *Checkosky:*

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.'' * * * 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.[5]

As nature abhors a vacuum, so does the Commission: its intentions regarding the expansion of its Rule 102(e) authority have quickly become apparent. Within days of the adoption of the new standard on September 23, 1998, the Commission announced a major new initiative to address improper accounting practices.[6] It is clear to me that the Commission intends for the expanded Rule 102(e) authority it has arrogated to itself in today's release to be an important enforcement weapon in this new initiative.

The proponents of the amendment claim that it is significantly more protective of accountants than the standard set forth in the Commission's June 1998 proposing release.[7] I disagree. I think that the proposed standard will not preclude the Commission from instituting Rule 102(e) proceedings for simple negligence.

For close to thirty years, I have followed the Commission's Rule 102(e) proceedings indeed, long ago I wrote two articles on the subject.[8] In my view, today's release represents another wrong turn in the Commission's Rule 102(e) jurisprudence. Previous wrong turns resulted in the two *Checkosky* opinions by the D.C. Circuit. Rule 102(e) differs fundamentally from the securities laws enforced by the Commission. The purpose of the securities laws is to protect investors, while the professed purpose of Rule 102(e) is to protect the integrity of the Commission's administrative processes. Under today's proposal, Rule 102(e) will be just another weapon in the Commission's enforcement arsenal. The use of Rule 102(e) as just another enforcement tool eliminates the underpinning of those few Court decisions that have upheld, in the most general terms possible, the Commission's ability even to promulgate Rule 102(e). Thus, the Commission's ability to bring any Rule 102(e) proceeding—under any standard, against even the most egregious violators—may now be in jeopardy. Even assuming the Commission has adequate authority to promulgate Rule 102(e), both *Checkosky* opinions indicate that the Commission lacks authority to adopt the sort of negligence standard contained in the Release. Under *Checkosky*, the Commission may only discipline professionals under Rule 102(e) when scienter, including recklessness, is shown.[9]

My long-standing interest in the Commission's Rule 102(e) jurisprudence, as well as my deep-rooted objections to the rule's expansive and improper uses, leads me to set forth my dissenting views at some length and in the following order:

- Because it is impossible to evaluate fairly today's release without consideration of the Commission's past missteps, I outline the history of Rule 102(e) in the first section.
- Next, in the second section, I discuss the *Checkosky* case, including the D.C. Circuit's two reversals of Commission opinions.
- In the third section, I explain the basis for my view that the Commission lacks legal authority even to promulgate Rule 102(e), and that, in any event, the Commission lacks the legal authority to adopt a negligence standard under Rule 102(e).
- In the fourth section, I demonstrate that the Standard is vague, and that it does not comply with the mandate of both *Checkosky I* and *Checkosky II* that we adopt a clear standard.
- In the fifth section, I set forth the various reasons why—even assuming adequate legal authority and clarity—it is not in the public interest for the Commission to adopt the Standard.
- Next, in the sixth section, I question whether the Commission gave adequate notice in its Proposing Release that it might adopt certain aspects of today's release.
- Finally, in the seventh section, I set forth the likely ways in which the Commission will seek to expand its Rule 102(e) authority in the future.

I. ''Administrative Oaks'' and ''Legislative Acorns'': A Brief History of Rule 102(E)

In one of its landmark securities decisions restricting the growth of implied private actions under the federal securities laws, the Supreme Court remarked that Rule 10b–5 was ''a judicial oak which has grown from little more than a legislative acorn.'' [10] The Commission's use of Rule 102(e) to regulate professional conduct might similarly be described as an ''administrative oak'' growing out of a ''legislative acorn.'' There is no express statutory provision authorizing the Commission to discipline professionals; instead, a handful of courts have upheld the Commission's promulgation of Rule 102(e) as impliedly proper because the rule is '' 'reasonably related' to the purposes of the securities laws.'' [11] I fully subscribe to the views of a distinguished predecessor, Commissioner Roberta Karmel, who observed in a Rule 102(e) case almost twenty years ago that ''[t]he administrative implication of

[4] *See, e.g.*, Richard I. Miller, General Counsel & Secretary, American Institute of Certified Public Accountants (''AICPA''), Comment Letter (''CL'') 84; Arthur Andersen LLP, CL 98; Ernst & Young, LLP, CL 100; *see also* John M. Liftin, Chair, Committee on Federal Regulation of Securities, and Richard H. Rowe, Chair, Committee on Law and Accounting, American Bar Association, Section of Business Law (''ABA''), CL 81.

[5] *Checkosky I*, 23 F.3d at 479 (Randolph, J.) (quoting Henry J. Friendly, ''*Some Kind of Hearing*'', 123 U. Pa. L. Rev. 1267, 1297 (1975)). Almost without exception, the comment letters bear out Judge Randolph's remarks, indicating that even if an accountant receives ultimate vindication, the mere bringing of charges of ''improper professional conduct'' by the Commission may well have a ''career-crippling'' effect. *See* Arthur Andersen, CL 98 at 1 & 5–6; *see also, e.g.*, J.D. Fluno, Vice Chairman, W.W. Grainger, Inc., CL 75; ABA, CL 81 at 11.

[6] Remarks by SEC Chairman Arthur Levitt, *The ''Numbers Game''*, New York University Center for Law and Business (Sept. 28, 1998) <http://www.sec.gov/news/speeches/spch220.txt>; SEC Press Release 98–95 (Sept. 28, 1998) <http://www.sec.gov/news/press/98–95.txt> (announcing ''a major address on the state of accounting'' that will express Commission ''concern that the quality of financial reporting in corporate America is eroding and * * * [will] present an action plan that calls on the entire financial community to remedy the problem''); *see* Jube Shiver Jr., *SEC to Crack Down on Inflated Earnings*, L.A. Times, Sept. 29, 1998, at B1; *see also* Saul Hansell, *S.E.C. Crackdown on Technology Write-Offs*, N.Y. Times, Sept. 29, 1998, at C1.

[7] Proposed Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities Act Release No. 7546, 1998 WL 311988 (S.E.C.) (June 12, 1988), 63 Fed. Reg. 33305 (June 18, 1998) (the ''Proposing Release'').

[8] *See* Norman S. Johnson, *The Dynamics of SEC Rule 2(e): A Crisis for the Bar,* 1975 Utah L. Rev. 629; Norman S. Johnson, *The Expanding Responsibilities of Attorneys in Practice Before the SEC: Disciplinary Proceedings Under Rule 2(e) of the Commission's Rules of Practice*, 25 Mercer L. Rev. 637 (1974).

[9] *See Robert D. Potts*, Exchange Act Release No. 39126, 1997 WL 690519 (S.E.C.), at *12 (Sept. 29, 1997) (Commissioner Johnson, concurring), *aff'd on other grounds*, 151 F.3d 810 (8th Cir. 1998); *David J. Checkosky*, Exchange Act Release No. 38183, 1997 WL 18303 (S.E.C.), at *14 (Jan. 21, 1997) (Commissioner Johnson, dissenting), *rev'd*, *Checkosky II*, 139 F.3d 221.

[10] *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 732, 737 (1975).

[11] *Checkosky I,* 23 F.3d at 455 (Silberman, J.) (quoting *Touche Ross & Co.* v. *SEC,* 609 F.2d 570, 582 (2d Cir. 1979)); *see also, e.g.,* Daniel L. Goelzer & Susan Ferris Wyderko, *Rule 2(e): Securities and Exchange Commission Discipline of Professionals,* 85 Nw. U. L. Rev. 652, 652 (1991) (lawyers and accountants ''are not subject to direct regulation under the federal securities laws,'' and their licensing and discipline is ''largely a matter committed to state licensing bodies and professional associations'').

prosecutorial remedies under federal legislation is rife with the same evil'' possessed by ''judicial implication of private rights of action.'' [12] In my view, the same disfavor the Supreme Court has enunciated towards implied private rights of action is equally applicable—and probably more so—to implied prosecutorial remedies such as those the Commission utilizes under Rule 102(e).[13]

The Commission first promulgated Rule 102(e) in 1935.[14] In its initial form, the rule contained a requirement that attorneys be admitted to practice before the Commission (as was then required of attorneys and accountants who sought to represent persons before the Internal Revenue Service).[15] In 1938, however, the Commission struck the admission requirement, and since then the rule's only use has been to permit the Commission to censure, suspend or disbar professionals.[16]

Although Rule 102(e) has caused a great deal of controversy since its inception,[17] it was only used sparingly

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[12] *Keating, Muething & Klekamp*, 47 S.E.C. 95, 111 (1979) (Commissioner Karmel, dissenting). Unfortunately, Commissioner Karmel dissented in the context of a settled enforcement action, so there was no opportunity for judicial review of the issues she raised. Several commentators have suggested that attempts to evade appellate review are a hallmark of the Commission's Rule 102(e) jurisprudence. *See, e.g.*, Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers: New Remedies* v. *Old Policies*, 22 Del. J. Corp. L. 537, 552–53 (1997); Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 S.M.U. L. Rev. 225, 271 (1996).

[13] *See Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979); *see also, e.g.*, *Central Bank* v. *First Interstate Bank*, 511 U.S. 164 (1994); *Keating*, 47 S.E.C. at 111 & 116 n.35 (Commissioner Karmel, dissenting). The Supreme Court has approved the use of implied ancillary remedies, such as when the Commission seeks, e.g., disgorgement as a remedy in a typical enforcement action, but that situation seems readily distinguishable from Rule 102(e), in which both the cause of action and its remedy are implied. *Cf. Franklin* v. *Gwinnett County Public Schools*, 503 U.S. 50 (1992) (approving implied remedy to express cause of action).

[14] *See Touche Ross & Co.* v. *SEC*, 609 F.2d 570, 578 n.13 (2d Cir. 1979) (''*Touche Ross*''); Harold Marsh, Jr., *Rule 2(e) Proceedings*, 35 Bus. Law. 987, 987 (1980).

[15] Marsh, *supra* note 14, 35 Bus. Law. at 987.

[16] *Id.* Although Rule 102(e) reaches all types of professionals who might practice before the Commission, including engineers or expert witnesses, there have been only a few cases in the rule's 63-year history that did not involve either a lawyer or an accountant.

[17] The following is a sampling of the literature discussing the Commission's use of Rule 102(e), the vast bulk of it extraordinarily critical—particularly when one discounts articles by Commission officials defending policies they themselves have helped formulate and administer. (I find it ironic that the number of law review articles discussing Rule 102(e) dwarfs the number of actual federal court decisions construing it by a factor of approximately 10 to 1). *See, e.g.*, Roberta S. Karmel, *Regulation by Prosecution: The Securities and Exchange Commission* vs. *Corporate America* 173–83 (1982); ABA, *Statement of Policy Adopted by ABA Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance of Clients with Laws Administered by the Securities and Exchange Commission*, 31 Bus. Law. 543, 545 (1975); ABA Task Force on Rule 102(e) Proceedings, *Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants*, 52 Bus. Law. 965 (1997); David H. Barber, *Lawyer Duties in Securities Transactions Under Rule 2(e): The* Carter *Opinions*, 1982 B.Y.U. L. Rev. 513; Arthur Best, *Shortcomings of Administrative Agency Lawyer Discipline*, 31 Emory L.J. 535 (1982); Judah Best, *In Opposition to Rule 2(e) Proceedings*, 36 Bus. Law. 1815 (1981); Dennis J. Block & Charles J. Ferris, *SEC Rule 2(e)—A New Standard for Ethical Conduct or an Unauthorized Web of Ambiguity*, 81 Cap. U. L. Rev. 501 (1982); John C. Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach*, 28 Vand. L. Rev. 19 (1975); Michael P. Cox, *Regulation of Attorneys Practicing Before Federal Agencies*, 34 Case W. Res. L. Rev. 173 (1984); Joseph C. Daley & Roberta S. Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 Emory L.J. 747 (1975); Mitchell F. Dolin, *SEC Rule 2(e): After* Carter-Johnson: *Toward a Reconciliation of Purpose and Scope*, 9 Sec. Reg. L.J. 331 (1982); James R. Doty et al., *The Professional as Defendant*, in 23rd Annual Institute on Securities Regulation 681 (PLI Corp. Law & Practice Course Handbook Series No. B4–6978, 1991); Robert A. Downing & Richard L. Miller, Jr., *The Distortion and Misuse of Rule 2(e)*, 54 Notre Dame Law. 774 (1979); Robert W. Emerson, *Rule 2(e) Revisited: SEC Disciplining of Attorneys since* In re Carter, 29 Am. Bus. L.J. 155 (1991); Ralph C. Ferrara, *Administrative Disciplinary Proceedings Under Rule 2(e)*, 36 Bus. Law. 1807 (1981); Ted J. Fiflis, *Choice of Federal or State Law for Attorneys' Professional Responsibility in Securities Matters*, 56 N.Y.U. L. Rev. 1236 (1981); Monroe H. Freedman, *A Civil Libertarian Looks at Securities Regulation*, 35 Ohio St. L.J. 280 (1974); Ray Garrett, Jr., *Social Responsibility of Lawyers in Their Professional Capacity*, 30 U. Miami L. Rev. (1976); Daniel L. Goelzer, *The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession*, 52 Brook. L. Rev. 1057 (1987); Stuart C. Goldberg, *Policing Responsibilities of the Securities Bar: The Attorney-Client Relationship and the Code of Professional Responsibility—Considerations for Expertizing Securities Attorneys*, 19 N.Y.L.F. 221 (1973); Paul Gonson, *Disciplinary Proceedings and Other Remedies Available to the SEC*, 30 Bus. Law. 191 (1975); Kent Gross, *Attorneys and Their Corporate Clients: SEC Rule 2(e) and the Georgetown ''Whistle Blowing'' Proposal*, 3 Corp. L. Rev. 197 (1980); Samuel H. Gruenbaum, *The SEC's Use of Rule 2(e) to Discipline Accountants and Other Professionals*, 56 Notre Dame Law. 820 (1981); Samuel H. Gruenbaum & Marc I. Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 Loy. L.A. L. Rev. 247 (1980); Stanley A. Kaplan, *Some Ruminations on the Role of Counsel for a Corporation*, 56 Notre Dame L. Rev. 873 (1981); Roberta S. Karmel, *A Delicate Assignment: The Regulation of Accountants by the SEC*, 56 N.Y.U. L. Rev. 959 (1981); Roberta S. Karmel, *Attorneys' Securities Law Liabilities*, 27 Bus. Law. 1153 (1972); John J. Kelleher, *Scourging the Moneylenders from the Temple: The SEC, Rule 2(e) and the Lawyers*, 17 San Diego L. Rev. 501 (1980); Michael R. Klein, *The SEC and the Legal Profession: Material Adverse Developments*, 11 Inst. on Sec. Reg. (PLI) 604 (1979); Reynold Kosek, *Professional Responsibility of Accountants and Lawyers Before the Securities and Exchange Commission*, 72 L. Libr. J. 453 (1979); Steven C. Krane, *The Attorney Unshackled: SEC Rule 2(e) Violates Clients' Sixth Amendment Right to Counsel*, 57 Notre Dame L. Rev. 50 (1981); Werner Kronstein, *The* Carter-Johnson *Case: A Higher Threshold for SEC Actions Against Attorneys*, 9 Sec. Reg. L.J. 293 (1981); Michael R. Lanzarone, *Professional Discipline: Unfairness and Inefficiency in the Administrative Process*, 51 Fordham L. Rev. 818 (1983); Philip H. Levy, *Regulation of the Accounting Profession Through Rule 2(e) of the SEC's Rules of Practice: Valid or Invalid Exercise of Power?*, 46 Brook. L. Rev. 1159 (1980); Frederick D. Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 N.Y.U. L. Rev. 437 (1974); Simon M. Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 Mich. L. Rev. 423 (1978); Lewis D. Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 Colum. L. Rev. 412 (1974); Harold L. Marquis, *An Appraisal of Attorneys' Responsibilities Before Administrative Agencies*, 26 Case W. Res. L. Rev. 285 (1976); Arthur F. Mathews, *SEC Injunctive Proceedings Against Attorneys*, 36 Bus. Law. 1819 (1981); Christine Neylon O'Brien, *SEC Regulation of the Accounting Profession: Rule 2(e)*, 21 Gonz. L. Rev. 675 (1985); L. Ray Patterson, *The Limits of the Lawyer's Discretion and the Law of Legal Ethics:* National Student Marketing *Revisited*, 1979 Duke L.J. 1251; Marvin G. Pickholtz, *SEC Regulation of Professionals*, 4 Rev. Fin. Serv. Reg. 165 (1988); Irving M. Pollack, *The SEC Lawyer: Who is His Client and What are His Responsibilities?*, 49 Geo. Wash. L. Rev. 453 (1981); Martin B. Robins, *Policeman, Conscience or Confidant: Thoughts on the Appropriate Response of a Securities Attorney Who Suspects Client Violations of the Federal Securities Laws*, 15 J. Marshall L. Rev. 373 (1982); Michel Rosenfeld, *The Transformation of the Attorney-Client Privilege: In Search of an Ideological Reconciliation of Individualism, the Adversary System, and the Corporate Client's SEC Disclosure Obligations*, 33 Hastings L.J. 495 (1982); Quinton F. Seamons, *Inside the Labyrinth of the Elusive Standard Under the SEC's Rule 2(e)*, 23 Sec. Reg. L.J. 57 (1995); Morgan Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 Ohio St. L.J. 231 (1973); George J. Siedel, *Rule 2(e) and Corporate Officers*, 39 Bus. Law. 455 (1984); Marshall L. Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 Cal. L. Rev. 1189 (1973); Mindy Jaffe Smolevitz, *The Opinion Shopping Phenomenon: Corporate America's Search for the Perfect Auditor*, 52 Brook. L. Rev. 1077 (1987); Theodore Sonde, *Professional Disciplinary Proceedings*, 30 Bus. Law. 157 (1975); Marc I. Steinberg, *Attorney Liability Under the Securities Laws*, 45 Sw. L.J. 711 (1991); Wallace L. Timmeny, *Responsibilities of Lawyers in Connection with the Sale of Municipal Securities*, 36 Bus. Law. 1799 (1981); Francis M. Wheat, *The Impact of SEC Professional Responsibility Standards*, 34 Bus. Law. 969 (1979); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 Harv. L. Rev. 799 (1992); Harold M. Williams, *Corporate Accountability and the Lawyer's Role*, 34 Bus. Law. 7 (1978); Marie L. Coppolino, Note, *Rule 2(e) and the Auditor: How Should the Securities and Exchange Commission Define its Standard of Professional Conduct?*, 63 Fordham L. Rev. 2227 (1995); Michael J. Crane, Note, *Disciplinary Proceedings Against Accountants: The Need for a More Ascertainable Improper Professional Conduct Standard in the SEC's Rule 2(e)*, 53 Fordham L. Rev. 351 (1984); Robert G. Day, Note, *Administrative Watchdogs or Zealous Advocates? Implications for Legal Ethics in the Face of Expanded Attorney Liability*, 45 Stan. L. Rev. 645, 673 (1993); William Kenneth C. Dippel, Comment, *Attorney Responsibility and* Carter *Under SEC Rule 2(e): The Powers That Be and the Fear of the Flock*, 36 Sw. L.J. 897 (1982); Todd J. Flagel, Note, *Securities Law: SEC Must Clarify Its Position as to the Level of Culpability that Must Be Shown to Constitute a Rule*

during the first 35 years or so of its existence.[18] Things changed in the early 1970's when the Commission embarked on its so-called ''access'' theory of securities law enforcement.[19] As a consequence of its belief that access to capital markets is controlled by a limited number of professionals, the Commission sought to achieve maximum deterrent value from its limited enforcement resources by suing the gatekeepers, rather than simply proceeding against the principal wrongdoers.[20] Accordingly, the Commission brought wave-upon-wave of actions—including many Rule 102(e) administrative proceedings—against securities professionals, accountants and lawyers.[21]

The high water mark of the Commission's ''access'' theory was probably the *National Student Marketing* case.[22] In *National Student Marketing,* the Commission brought an injunctive action that charged two nationally prominent law firms and several of their respective partners with aiding and abetting a securities fraud based on their alleged failure to take proper action when they ''permitted'' their clients to complete a merger that had received shareholder approval based on a proxy statement containing materially misleading financial information.[23] The Commission's complaint alleged that the lawyers had a duty to insist that their clients resolicit proxies based on corrected information, and that, if the clients refused to follow this advice, the lawyers were required to resign and to report the alleged securities violations to the Commission.[24] In practical terms, the Commission sought to make involuntary ''whistle-blowers'' or government agents out of private counsel by ''plac[ing] upon the lawyer a responsibility to investigate his clients'' activities in search for possible violations of law.'' [25]

In discussing *National Student Marketing,* one Commissioner went so far as to state that, at least in the context of a securities transaction, a lawyer's role was ''more akin to that of an auditor,'' i.e., the lawyer would ''have to exercise a measure of independence'' from his client and would have to be ''acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about if not for his professional presence.'' [26] Although the Commission brought *National Student Marketing* as an injunctive action in federal court, it soon changed its emphasis in professional discipline cases and increasingly brought them as administrative proceedings under Rule 102(e).[27]

Although *National Student Marketing* involved charges against law firms and individual lawyers, the Commission did not limit its overreaching to the legal profession—indeed, one contemporaneous commentary referred to accountants as the ''most actively besieged profession'' under Rule 102(e).[28] In *SEC* v. *Arthur Young & Co.,* a case arising from the activities of an oil and gas venture promoter over a seven-year period in the 1960's, the Commission charged a nationally prominent accounting firm and the responsible auditors with committing or aiding and abetting securities fraud.[29] Because the case predated the Supreme Court's decision requiring the Commission to prove scienter in its Rule 10b–5 enforcement cases,[30] the Ninth Circuit assumed that ''negligence, rather than scienter, constitutes the standard by which an accountant's or auditor's

2(e)(1)(ii) Violation By Accountants, 20 Dayton L. Rev. 1083 (1995); Note, *Attorney Discipline by the SEC: 2(e) or not 2(e)?,* 17 New Eng. L. Rev. 1267 (1982); Note, *The Duties and Obligations of the Securities Lawyer: The Beginning of a New Standard for the Legal Profession?,* 1975 Duke L.J. 121; Note, *SEC Disciplinary Proceedings Against Attorneys Under Rule 2(e),* 79 Mich. L. Rev. 1270 (1981); Comment, *SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney,* 1972 Duke L.J. 969.

[18] As to the lawyers, the first Rule 102(e) proceeding was not brought until 1950, and only five cases were brought before 1960. *See Keating,* 47 S.E.C. at 112 (Commissioner Karmel, dissenting). The number of Rule 102(e) cases against accountants during from 1935 to 1970 was also de minimis by comparison to recent years when the Commission has brought (according to statistics supplied by our Office of the Chief Accountant) an average of over 25 cases annually. *See* Marsh, *supra* note 14, 35 Bus. Law. at 987–89. Commentators seem to agree that, for various reasons, it is impossible to obtain accurate historical statistics regarding Rule 102(e) proceedings, particularly for the period before 1975. *See* Emerson, *supra* note 17, 29 Am. Bus. L.J. at 173–83 (comprehensive effort to tabulate number and type of Rule 102(e) proceedings against lawyers through 1989); Marsh, *supra* note 14, 35 Bus. Law. at 988.

[19] *See, e.g.,* Burton, *supra* note 17, 28 Vand. L. Rev. at 19–20; Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC,* 50 Bus. Law. 1293, 1297 (1995); Maxey, *supra* note 12, 22 Del. J. Corp. L. at 549.

[20] Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade,* 7 Yale J. on Reg. 149, 171–74 (1990).

[21] *Id.; see also* Emerson, *supra* note 17, 29 Am. Bus. L.J. at 176 (for attorneys, peak years of Rule 102(e) enforcement activity were 1975 through 1977, when the Commission brought actions against 53 attorneys and three law firms).

[22] *SEC* v. *National Student Marketing Corp.,* [1971–1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360, at 91,913 (D.D.C. 1972) (complaint). Less than two weeks after the filing of the *National Student Marketing* complaint, the Wall Street Journal reported that it had become the ''best-read document since *Gone With the Wind.*'' Green, *Irate Attorneys—A Bid to Hold Lawyers Accountable to Public Stuns, Angers Firms,* Wall St. J., Feb. 15, 1972, at 1, col. 1; *see also* Samuel H. Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibility, Liability to Investors, and* National Student Marketing Corp., 54 Notre Dame Law. 795 (1979).

[23] *National Student Marketing,* [1971–1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360, at 91,913; *see also* Lorne, *supra* note 17, 76 Mich. L. Rev. at 455.

[24] *SEC* v. *National Student Marketing Corp.,* [1971–1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360 at ¶ 48(i).

[25] Milton V. Freeman, *Recent Governmental Attacks on the Private Lawyer as an Infringement of the Constitutional Right to Counsel,* 36 Bus. Law. 1791, 1792 (1981); *see* Cox, *supra* note 17, 34 Case W. Res. L. at 204 (referring to attempts by Commission towards the ''enlistment of attorneys as agents of the government''); Wilkins, *supra* note 17, 105 Harv. L. Rev. at 836 (Commission has appeared to engage in ''overzealous enforcement'' actions against lawyers in order to encourage them to serve as watchdogs over their clients). *Accord* Mathews, *supra* note 17, 36 Bus. Law. at 1829; Marc I. Steinberg, *Attorney Liability for Client Fraud,* 1991 Colum. Bus. L. Rev. 1, 9.

[26] A.A. Sommer, *The Emerging Responsibilities of the Securities Lawyer,* [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,631, 83,686, at 83,689 to 83,690 (Jan. 24, 1974). I have the highest regard for former Commissioner Sommer, but I have long believed that this notion of lawyer as auditor is contrary to traditional canons of professional responsibility. *See* Johnson, *supra* note 8, 1975 Utah L. Rev. at 645–50.

[27] During the 1970's, federal courts increasingly placed limitations on the Commission's ability to bring suit and obtain injunctive relief. *See, e.g., Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 197–198 (1976) (proof of scienter required in a Rule 10b–5 action); *SEC* v. *Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 98 (2d Cir. 1978) (''current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days''). Convincing evidence exists demonstrating that the Commission increased its use of Rule 102(e) administrative proceedings after *National Student Marketing* as a means to circumvent these judicially-imposed limitations. *See* Downing & Miller, *supra* note 17, 54 Notre Dame Law. at 783–85 (quoting June 1976 memorandum from Commission's General Counsel to Commission's Chairman suggesting that the Commission might appropriately bring Rule 102(e) actions in situations in which a professional's conduct would not satisfy the *Hochfelder* requirement of scienter for Rule 10b–5 actions); *see also, e.g.,* Arthur Best, *supra* note 17, 31 Emory L.J. at 550 (lesser negligence standard ''may explain why SEC chose'' to bring Rule 102(e) action, rather than injunctive action against major accounting firm, and this option ''can be viewed either as an advantage of the administrative process or as a dangerous discretionary weapon that ought not to be available to the agency''); James P. Hemmer, *Resignation of Corporate Counsel: Fulfillment or Abdication of Duty,* 39 Hastings L.J. 641, 650 (1988) (''The unwillingness of the courts to issue injunctions when there is no likelihood of recurring violation * * * is at least one of the principal factors in the SEC's increasing use of rule 2(e) proceedings to govern the discipline of professionals.'').

[28] *See* Downing & Miller, *supra* note 17, 54 Notre Dame Law. at 775 n.6; *see also id.* at 774 (''Recent 2(e) proceedings against accountants demonstrate that the SEC has converted the rule from one designed to serve the limited salutary purpose of exercising disciplinary authority over the incompetent, unethical or dishonest accounting practitioner to a rule which has effectively been utilized to pervasively regulate accounting firms and the profession as a whole.'').

[29] 590 F.2d 785, 786 (9th Cir. 1979).

[30] *Aaron* v. *SEC,* 446 U.S. 680 (1980).

performance must be measured.''[31] Before the district court, the Commission argued that the firm and its auditors performed their work ''with blinders on'' and that they should have done ''more'' to reveal the risks to those who invested in the ventures.[32] On appeal, the Commission apparently argued that the accountants had failed to perform their audit in a manner that would have revealed to ''an ordinary prudent investor, who examined the * * * audits or financial statements, a reasonably accurate reflection of the financial risks * * *.''[33] The Ninth Circuit rejected both formulations of the Commission's argument, noting:

To accept the SEC's position would go far toward making the accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of the securities laws almost always suggest that had it been there earlier with the accountant it would have caught the scent of wrong-doing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on existing securities laws.[34]

To be sure, the Commission's attitude towards the conscription of accountants—and their purported wearing of ''blinders,'' or failures to observe and respond to ''red flags''—persists to this day.[35]

Many legal scholars and members of the securities bar and industry, myself among them, decried the Commission's overreaching in *National Student Marketing, Arthur Young* and similar cases.[36] One commentary described the Commission's efforts, colorfully but accurately, as a '' 'reign of terror' on broker-dealers, accountants and attorneys.''[37] Indeed, for more than twenty-five years, the Commission's attempts to set standards for professional conduct, under Rule 102(e) and otherwise, have caused much dissension on the Commission itself.[38] The roster of distinguished former Commissioners who have expressed serious doubts about the Commission's expansive uses of Rule 102(e) and other attempts to set professional standards includes: Edward H. Fleischman, Roberta S. Karmel, Philip Lochner, Jr., Richard Y. Roberts, and Steven M.H. Wallman.[39]

Much of the criticism of the Commission's efforts in this area has focussed on two factors. First, neither the Commission nor its administrative law judges (''ALJ's'') have a statutory mandate to establish ethical standards nor any special expertise in the area of professional responsibility; second, the threat of disciplinary action might well intimidate and interfere with the exercise of independent professional judgment and, as to lawyers, might deprive clients of their constitutional right to counsel.[40] These fears were far from academic: the *National Student Marketing* case clearly affected the ability and willingness of the securities bar to take zealous positions before the Commission.[41] According to an article co-written by the then-General Counsel of the Commission, the controversy caused by *National Student Marketing* and similar cases became so heated that it affected ''the Commission's ability to carry out its statutory mandates,'' because it lessened the necessary cooperation and trust between the Commission, its staff and the securities bar and industry.[42]

In response to the well-deserved firestorm of criticism caused by *National Student Marketing* and similar cases, the Commission retreated.[43] As to lawyers, the Commission announced that it would commence Rule 102(e) actions only where it could demonstrate scienter and that it would cease bringing ''original'' Rule 102(e) actions (i.e., the Commission would only bring an administrative proceeding against a lawyer if a federal court first determined that the lawyer had violated the federal securities laws).[44] As to accountants, the

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[31] 590 F.2d at 787.

[32] 590 F.2d at 787.

[33] 590 F.2d at 787–88.

[34] 590 F.2d at 788.

[35] In a later case upholding disciplinary sanctions imposed by the Commission on an accountant under Rule 102(e), the Ninth Circuit purported to distinguish *Arthur Young. See Davy* v. *SEC,* 792 F.2d 1418, 1422 (9th Cir. 1986). I confess to being confused by *Davy*—one would think that if the Commission were barred from directly ''conscript[ing] accountants'' under the substantive securities laws, it would also be barred from indirectly ''conscript[ing] accountants'' under Rule 102(e). The real distinction seems to be that *Davy,* unlike *Arthur Young,* involved truly egregious scienter-based misconduct by an accountant. *See* 792 F.2d at 1422 (referring to Commission finding, supported by ''substantial evidence,'' that the accountant ''knowingly participated in the fraud practice by [the issuer] on the investing public''). In any event, *Davy* does not support the Commission's adoption of the Standard, because the Court went to great lengths to limit its holding:

We do not consider whether cases can arise in which the SEC in Rule 2(e) matters exceeds its proper jurisdictional boundaries. The precise reach of the SEC in these situations has not been defined and we leave that task for a future case which implicates that question directly.

Id.; see also id. (''there may be cases where the SEC should not be empowered to determine the standards by which accountants, or attorneys for that matter, are to be judged''; ''[w]e pretermit any discussion of the SEC's power to determine standards for discipline under Rule 2(e) until we have the issue squarely before us'').

[36] *See, e.g.,* Daley & Karmel, *supra* note 17, 24 Emory L.J. 747; Downing & Miller, *supra* note 17, 54 Notre Dame Law. 774; Freeman, *supra* note 25, 36 Bus. Law. 1791; Johnson, *supra* note 8, 1975 Utah L. Rev. 629; Johnson, *supra* note 8, 25 Mercer L. Rev. 637.

[37] Dennis J. Block & Jonathan M. Hoff, *SEC Moves Against Attorneys Under the Remedies Act,* N.Y.L.J., Sept. 23, 1993, at 5 (quoting Harvey L. Pitt & Dixie L. Johnson, *Justice Delayed, Justice Denied: Observations on the SEC's 'Kern' Decision,* N.Y.L.J., July 11, 1991, at 5).

[38] *See, e.g., Keating,* 47 S.E.C. at 109 (Commissioner Karmel, dissenting); Richard E. Brodsky, P.A., CL 54.

[39] *Keating,* 47 S.E.C. at 112 (1979) (Commissioner Karmel, dissenting); *see also Potts,* 1997 WL 690519 (S.E.C.), at *17 (Commissioner Wallman, dissenting); *David J. Checkosky,* 50 S.E.C. 1180, 1198 (1992) (Commissioner Roberts, concurring in part and dissenting in pertinent part); *Allied Stores Corp.,* 1987 SEC LEXIS 4306, at *19 (June 29, 1987) (Commissioner Fleischman, dissenting); Richard Y. Roberts, CL 18.

It appears that the Rule 102(e) skeptics on the Commission have not always been in the minority. *See Potts,* 1997 WL 690519 (S.E.C.), at *12 (Commissioner Johnson, concurring) (noting that the Commission was ''evenly split two-two'' on the issue of whether a single act of mere negligence was sufficient for liability under Rule 102(e)); *see also Checkosky I,* 23 F.3d at 487 (discussing media reports that, at a preliminary stage, three Commissioners had voted to overturn the '' 'harsh sanction' '' imposed by the Administrative Law Judge); *David J. Checkosky,* 50 S.E.C. at 1182 (denying respondents' ''factual assertion that * * * the Commission had [earlier] rendered a final opinion in this case and improperly refused to publish it'').

[40] *See Keating,* 47 S.E.C. at 112–17 & n.31 (1979) (Commissioner Karmel, dissenting); *see also, e.g., Kivitz* v. *SEC,* 475 F.2d 956, 962 (D.C. Cir. 1973) (reversing Commission finding of liability in Rule 102(e) disbarment case; declining to give Commission any deference in matters of alleged professional misconduct); Judah Best, *supra* note 17, 36 Bus. Law. at 1817; Freeman, *supra* note 25, 36 Bus. Law. at 1792–94; Lorne & Callcott, *supra* note 19, 50 Bus. Law. at 1301–03.

[41] *Cf.* Lorne, *supra* note 17, 76 Mich. L. Rev. at 455–56 (recounting post-*National Student Marketing* incident in which a lawyer, unable to compel disclosure, resigned from his law firm and reported the matter to the SEC; after the disclosure was made, a class action lawsuit followed that was settled upon payment of $785,000, $625,000 of which came from the lawyer's former firm, and only $160,000 from the client).

[42] Lorne & Callcott, *supra* note 19, at 1300–01 (referring to actions against lawyers).

[43] Lorne & Callcott, *supra* note 19, at 1303–04; Pitt & Shapiro, *supra* note 20, 7 Yale J. on Reg. at 174; *see also* Freeman, *supra* note 25, 36 Bus. Law. at 1792.

[44] *William R. Carter,* 47 S.E.C. 471, 511–12 (1981); Lorne & Callcott, *supra* note 19, at 1303–04 (referring to a speech given by the Commission's then-General Counsel: Edward Greene, *Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission,* [1981–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,089, at 84,800 (Jan. 13, 1982)). In 1988, the Commission ratified Mr. Greene's speech in a release that stated: ''the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct de novo determinations of professional obligations of attorneys.'' *Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission,* Securities Act Release No. 6783, 53 Fed. Reg. 26,427, 26,431 n.30, 1988 WL

situation was less clear, but, at least for a time, the Commission seemed less aggressive in bringing Rule 102(e) actions against them as well.[45]

In the late 1980's, however, Rule 102(e) actions against accountants became more of a focal point for the Commission.[46] In 1988, the Commission amended Rule 102(e) to create a presumption that disciplinary proceedings would be public rather than private—previously Rule 102(e) proceedings only became public if sanctions were imposed.[47] In addition, as an enforcement adjunct to combat ''financial fraud,'' the Commission stepped up its use of Rule 102(e) to bring charges of ''improper professional conduct'' against the auditors of public companies.[48] It was in this context that the Commission instituted administrative proceedings under Rule 102(e) against two accountants, David J. Checkosky and Norman A. Aldrich.[49]

II. The Checkosky Decisions

Checkosky and Aldrich, partners at one of the nation's preeminent accounting firms, were the engagement partner and audit manager in connection with audits of the Savin Corporation from 1981 to 1984.[50] The Commission brought a Rule 102(e) proceeding against them in 1987, and in 1992 affirmed an ALJ's finding of ''improper professional conduct.'' [51] In its initial 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.[52] These violations were based on a 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'').[53]

Commissioner Roberts concurred in the majority's finding that respondents violated GAAS and misapplied GAAP, but dissented from the finding that these errors amounted to ''improper professional conduct'' under Rule 102(e).[54] In Commissioner Roberts' view, respondents' conduct did not provide a sufficient basis for a finding that they would threaten the Commission's processes.[55]

In *Checkosky I,* the D.C. Circuit remanded the case because it was unable to discern from the Commission's opinion the basis for its 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.[56] There was no opinion of the Court, and each of the three judges (Judge Silberman, Judge 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.[57] 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.[58] Judge Randolph also extensively discussed a 1981 Commission decision, *William R. Carter,* which he regarded—correctly, in my view—as ''the Commission's most comprehensive discussion of the history, purpose and operation of Rule 2(e),'' that rejected a negligence standard in case involving lawyers.[59] Judge Randolph endorsed the reasoning of *Carter:* ''if a securities lawyer is to exercise his 'best independent judgment * * * he must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of [losing] the ability to practice before the Commission.' '' [60] In Judge Randolph's view, the exercise of independent professional judgment was equally crucial to accountants, and this consideration would preclude the Commission from adopting a negligence standard, even if only applicable to accountants, under Rule 102(e).[61]

Judge Silberman likewise questioned the Commission's ability to adopt a negligence standard. For instance, Judge Silberman explained that:

> 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.[62]

Judge Silberman similarly 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.'' [63] Judge Silberman further indicated that the adoption by the Commission of a negligence standard, given its previous contrary precedent, might be arbitrary and capricious.[64]

On remand, the Commission's majority opinion did not directly address the mental state question posed by the Court.[65] Instead, the majority found that the accountants had behaved recklessly, but at the same time insisted that any deviation from GAAP or GAAS, including purely negligent ones, could violate Rule 102(e), and that the accountants' recklessness was relevant only to the choice of sanctions.[66] I dissented from the Commission's second *Checkosky* opinion because I believed that ''improper professional conduct'' required proof of scienter.[67]

On appeal in *Checkosky II,* the D.C. Circuit again reversed, and scolded the Commission, in scathing terms, for its failure to heed the dictates of *Checkosky I.*[68] The Court found that, the prior remand notwithstanding, the Commission had again failed to offer an adequate explanation of Rule 2(e)(1)(ii), but had ''voic[ed] instead a multiplicity

278442 (F.R.) (July 13, 1988); *see also id.* (referring to Commission practice of generally instituting Rule 102(e) proceedings ''only where the attorney's conduct has already provided the basis for a judicial or administrative order finding a securities law violation in a non-Rule 2(e) proceeding'').

45 Pitt & Shapiro, *supra* note 20, 7 Yale J. on Reg. at 174.

46 Goelzer & Wyderko, *supra* note 11, 85 Nw. U.L. Rev. at 653.

47 Rule 102(e)(7); *see Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission,* Securities Act Release No. 6783, 53 Fed. Reg. 26,427, 1988 WL 278442 (F.R.) (July 13, 1988).

48 Goelzer, *supra* note 17, 52 Brook. L. Rev. at 1061; *see also infra* note 135.

49 *David J. Checkosky,* Order Instituting Private Proceedings, File No. 3–6776 (Nov. 12, 1987).

50 *David J. Checkosky,* 50 S.E.C. 1180, 1180–81 (1992).

51 50 S.E.C. at 1180–81.

52 50 S.E.C. at 1181.

53 50 S.E.C. at 1181.

54 50 S.E.C. at 1198 (Commissioner Roberts, concurring in part and dissenting in part).

55 50 S.E.C. at 1198 & 1212–14.

56 23 F.3rd at 454.

57 Senior District Judge Reynolds dissented from the circuit judges' conclusion that ''improper professional conduct'' under Rule 102(e) required proof of scienter. 23 F.3d at 493–95.

58 *See* 23 F.3d at 466 & 468–69.

59 *See* 23 F.3d at 484; *see also* 23 F.3d at 480–87 (citing *William R. Carter,* 47 S.E.C. 471 (1981)).

60 23 F.3d at 484 (ellipsis and brackets in original; quoting *Carter,* 47 S.E.C. at 504).

61 *See* 23 F.3d at 483–87.

62 23 F.3d at 456.

63 23 F.3d at 459.

64 23 F.3d at 460; *see also* 23 F.3d at 458–59 (referring to *Carter,* 47 S.E.C. 471, and *Kenneth N. Logan,* 10 S.E.C. 982 (1942)).

65 *David J. Checkosky,* 1997 WL 18303 (S.E.C.) (Jan. 21, 1997).

66 1997 WL 18303 (S.E.C.), at *10.

67 1997 WL 18303 (S.E.C.), at *14.

68 *E.g.,* 139 F.3d at 222.

of inconsistent interpretations.'' [69] 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, and instead invoked the exceedingly rare remedy of remanding the case with instructions to dismiss.[70]

In an opinion truly remarkable for the criticism heaped on the Commission, the Court agreed with respondents' contention that the Commission had again ''failed to articulate an intelligible standard for 'improper professional conduct' under Rule 2(e)(1)(ii).'' [71] The Court noted that not only was the Commission's 1997 opinion unclear, but that, ''[i]n something of a tour de force,'' it managed ''to both embrace and reject standards of (1) recklessness, (2) negligence and (3) strict liability—or so a careful (and intrepid) reader could find.'' [72] The Court also enumerated numerous contradictions between the Commission's opinion and its appellate brief and oral argument.[73] In the Court's view, the Commission's failure to adopt an intelligible negligence standard was so lacking that the Commission had violated ''[e]lementary administrative law norms of fair notice and reasoned decisionmaking.'' [74] Referring to one part of the Commission's 1997 opinion, the Court sarcastically observed ''[i]n the space of four short sentences this passage achieves impressive feats of ambiguity.'' [75] The Court continued on, remarking: ''Not only does the opinion on remand provide no clear mental state standard to govern Rule 2(e)(1)(ii), it seems at times almost deliberately obscurantist on the question.''[76]

In a passage of great portent to today's release, the Court stated that the Commission's instrumental good intentions alone will not suffice:

> However legitimate and, indeed, essential the Commission's concern about unreliable financial statements may be, it is no substitute for a clearly delineated standard. Instead, the Commission's statements come close to a self-proclaimed license to charge and prove improper professional conduct whenever it pleases, constrained only by its own discretion (combined, perhaps, with the standards of GAAS and GAAP).[77]

As in *Checkosky I,* the Court questioned the Commission's ability to adopt a negligence standard under Rule 102(e).[78] The Court appeared to reaffirm its previous statements about the limits of the Commission's authority in disciplining 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.'' [79] On this last point, Judge Henderson wrote a two-sentence concurrence to express her disagreement with the majority (Judge Williams, who wrote the opinion, and Chief Judge Edwards).[80]

III. The Commission Lacks the Authority to Promulgate Rule 102(E) or, at the Least, Lacks the Authority To Adopt the Proposed Standard

As a result of this rulemaking process, I have reexamined the Commission's rationale for promulgating Rule 102(e), that is, the rule has a remedial purpose to protect the integrity of the Commission's administrative processes. This reexamination leads me to the conclusion that Rule 102(e) does not have that remedial purpose, rather it is or has become just another weapon in the Commission's enforcement arsenal. Rule 102(e)'s status as an enforcement tool removes the basis relied upon by those few courts that have upheld the Commission's ability even to promulgate Rule 102(e). Furthermore, even assuming the authority to promulgate Rule 102(e) in some form, the Commission may not adopt the negligence standard set forth in today's release.

In addition to rendering a single negligent act, under some circumstances, ''improper professional conduct,'' the other two parts of the Standard create liability for: intentional, knowing or reckless conduct; and a pattern of negligent acts. As the Release correctly notes, most commenters agreed with these parts of the proposal.[81] Assuming the Commission has the authority to promulgate Rule 102(e), I support the intentional or reckless part of the amendment without reservation. As to that part addressing a pattern of negligence, I would generally reach the same result as the majority, but through a different analysis. Assuming adequate authority, the Commission may appropriately bring a charge of ''improper professional conduct'' under Rule 102(e) only if the pattern of negligence supports an inference that the accountant acted recklessly.[82] In any event, because of the natural tendency towards the path of least resistance—towards proving one's case the by the easiest method possible—I think that most of the Rule 102(e) cases brought under the new standard will surely be brought under the single negligent act provision.

A. Rule 102(e) Has Become Another Weapon in the Commission's Enforcement Arsenal

In the Release, the Commission explains its refusal to adopt a scienter standard because ''Rule 102(e) protects the integrity of the Commission's processes; it is not an enforcement remedy or a weapon against fraud.'' [83] The Commission also insists that ''the rule is remedial and not punitive in nature.'' [84] I disagree with the first assertion, and think the second assertion is contrary to controlling law in the D.C. Circuit. Although I have come to the conclusion that Rule 102(e) is overly broad, as a structural matter, I do wish to emphasize my view that the Commission, like any adjudicative body, may legitimately adopt a disciplinary rule designed to redress contemptuous, disruptive or obstructionist behavior by advocates who appear in actual proceedings before us.[85] But Rule 102(e) is not such a permissible rule. I am, of course, aware that several courts have accepted the Commission's professed rationale about the need to protect its administrative

[69] 139 F.3d at 222.

[70] 139 F.3d at 222; *see also id.* at 227.

[71] 139 F.3d at 223.

[72] 139 F.3d at 223.

[73] 139 F.3d at 223–24.

[74] 139 F.3d at 224.

[75] 139 F.3d at 225.

[76] 139 F.3d at 225.

[77] 139 F.3d at 225.

[78] 139 F.3d at 225.

[79] *Id.* (citing *Checkosky I,* 23 F.3d at 459 (Silberman, J.)).

[80] 139 F.3d at 227. Unlike the majority, Judge Henderson apparently believed that the Commission did have the authority to adopt a negligence standard under Rule 102(e). *Id.* (the Commission, like every regulatory body, ''possesses—and must possess—authority to maintain the professional standards of its practitioners'').

[81] *See* Release at 3, 15 & 26.

[82] *Compare Potts,* 1997 WL 690519 (S.E.C.), at *12 & n.1 (Commissioner Johnson, concurring) *with Potts,* 1997 WL 690519 (S.E.C.), at *17 (Commissioner Wallman, dissenting).

[83] Release at 31; *see also id.* at 7–8.

[84] Release at 11 & n.26; *see also id.* at 6 & 23.

[85] Many of the abuses of Rule 102(e) stem from the all-encompassing way in which the Commission has defined ''practice before'' us to include, at least at an earlier time, not only appearances before us and the staff, and filings made with us, but also office work by professionals directly related to the federal securities laws. *See* Robert J. Haft, *Liability of Attorneys and Accountants for Securities Transactions* ¶ 8.01[2], at 8–3 (1997); *see also Richard D. Hodgin,* 49 S.E.C. 8, 10 (1979); *SEC* v. *Ezrine,* Litigation Release No. 6481, 1974 WL 13435 (S.E.C.) (Aug. 15, 1974). In addition, partners of a disqualified professional may not permit the sanctioned person to participate in Commission matters, to participate in profits from their Commission business, or to hold him or her out as entitled to practice before the Commission. Haft, *supra,* at 8–3 to 8–4. Finally, partners and associates of a disqualified firm may not practice before the Commission as long as they remain associated with the firm, even if they joined the firm after the disqualification. *Id.* at 8–4.

processes.[86] In my view, however, today's amendment—combined with the Commission's recently announced crackdown on improper accounting practices, as well as recent judicial developments—provides an ample basis for a critical reexamination of these precedents.

In *Touche Ross,* which was decided in 1979, the Commission successfully argued to the Second Circuit that Rule 102(e) was necessary to protect the integrity of its administrative processes.[87] The Commission has consistently relied on the same rationale since then, which is repeated in today's release.[88] Before the press of litigation arose, however, the Commission could be more candid. In a speech published in 1974 discussing ''spectacular recent failures'' such as the collapse of National Student Market Corporation, then-Chairman Ray Garrett made the following statement:

> We are not entirely happy with the means at our disposal to cause higher standards of professional conduct for investor protection. It is true that we can legislate rules governing the contents of financial statements filed with the Commission, but that won't insure a careful audit, and it certainly won't improve standards of professional conduct by lawyers. *Our tools in this context,* aside from informal comment and criticism, *are enforcement weapons—suspension or disbarment from practicing before the Commission, under Rule 2(e) of our Rules of Practice,* and an action for an injunction on the ground that the accountant or lawyer has participated in or aided and abetted a violation of the securities laws, including Rule 10b–5.[89]

Former Chairman Garrett's remarks support the assertion of one commenter, a former Commission enforcement attorney who played a leading role in prosecuting *Carter* and other Rule 102(e) cases during the 1970's, that protection of the Commission's processes is merely a ''convenient legal fiction'' or ''shibboleth [the Commission] used to win the *Touche Ross*[] case twenty years ago.'' [90] This commenter also points out that, as a practical matter, the Commission's staff approaches Rule 102(e) proceedings in the same manner as other enforcement cases, such that charges under Rule 102(e) are just another enforcement alternative.[91] This practical approach will often suit the convenience of potential respondents who may well prefer an administrative settlement of Rule 102(e) charges to other enforcement alternatives (e.g., a federal court injunctive action, in which the Commission would likely seek monetary penalties).[92]

The Commission's use of Rule 102(e) has not changed since 1974—it remains an ''enforcement weapon.'' Under usual procedures, the Commission's Division of Enforcement investigates cases, and, in the case of a financial fraud involving a public company, will routinely scrutinize the conduct of the responsible accountants.[93] If the Division of Enforcement determines that the accountant's conduct is substandard, the Division of Enforcement will consult with the Commission's Office of the Chief Accountant, and then make an enforcement recommendation to the Commission.[94] If the Commission authorizes the case as an administrative proceeding under Rule 102(e), the Division of Enforcement prosecutes it in the name of the Office of the Chief Accountant.[95] As should be apparent from these procedures, notwithstanding surface appearances, Rule 102(e) is much more than a mere disciplinary rule.[96] If Rule 102(e) were just a disciplinary rule, one would expect that the Commission's use of it would parallel other administrative agencies' use of their respective disciplinary rules—surely the Commission's processes need no greater protection than those of, for instance, the Federal Trade Commission or the Nuclear Regulatory Commission. But the opposite is true. Reflecting the enforcement nature of Rule 102(e), one academic has calculated that, over a 50-year period, the Commission has disbarred or suspended more lawyers than ''nearly all other federal agencies combined.'' [97] Were accountants included in this tabulation, I am sure the numbers would demonstrate an even greater disparity.

These arguments that the Commission lacks the authority even to promulgate Rule 102(e) are not new. In fact, Commissioner Karmel, in a series of dissents starting almost 20 years ago, made many of the same points I make today.[98] For instance, Commissioner Karmel began her best-known dissent as follows:

> This is another Rule 2(e) disciplinary proceeding which arises from the Commission's efforts to protect investors by articulating and enforcing professional responsibility standards for attorneys. The Commission's authority to promulgate Rule 2(e) is tenuous at best. Since the Commission's program is in aid of its prosecutorial function, rather than its rule making or adjudicatory functions, I view it as an invalid exercise of power * * *.[99]

[86] *See Sheldon* v. *SEC,* 45 F.3d 1515, 1518 (11th Cir. 1995); *Davy,* 792 F.2d at 1421; *Touche Ross,* 609 F.2d at 582.

[87] 609 F.2d at 579.

[88] Release at 7–8.

[89] Ray Garrett, Jr., *New Directions in Professional Responsibility,* 29 Bus. Law. 7, 11 (1974) (emphasis added); *see also id.* at 9 (referring to stockholders of National Student Marketing losing ''in excess of $400 million in 3 months''). In *Touche Ross,* the Second Circuit purported to find support for the proposition that the Commission did not use Rule 102(e) as ''an additional weapon in the its enforcement arsenal'' in a Commission release that predated Chairman Garrett's remarks. *See* 609 F.2d at 579 (citing Securities Act Release No. 5088 at 1, 1970 SEC LEXIS 645 (Sept. 24, 1970)). This release, however, supports the *Touche Ross* citation, if at all, only in the most general sense.

[90] Richard E. Brodsky, P.A., CL 54, at 1 n.2 & 4. Mr. Brodsky candidly admits that he has ''represented numerous accounting firms in SEC investigations'' since leaving the Commission in 1981. *Id.* at 1 n.2.

[91] Richard E. Brodsky, P.A., CL at 6.

[92] *Id.; see also* Judah Best, *supra* note 17, 36 Bus. Law. at 1815 (from perspective of defense counsel, Rule 102(e) ''is a great settlement device''—''a means of avoiding the necessity of an injunction if you can bargain successfully for it'').

[93] *See* Ferrara, *supra* note 17, 36 Bus. Law. at 1807–09.

[94] *Id.;* Coppolino, Note, *supra* note 17, 63 Fordham L. Rev. at 2232.

[95] *Id.: see SEC Announces Organizational Changes as to Accountants, Consumer Affairs,* 1193 Daily Exec. Rep. (BNA) No. 236, at d–3 (Dec. 10, 1993). For lawyers, our Office of the General Counsel takes the place of the Division of Enforcement in recommending and prosecuting Rule 102(e) cases. *Id.*

[96] Many commenters have observed that the Commission's aggressive use of Rule 102(e) goes well beyond other agencies' use of comparable disciplinary rules (with the possible exception of the Office of Thrift Supervision, which intentionally modelled its disciplinary rule on Rule 102(e)). *See, e.g.,* ABA, CL 81 at 3–4; *see also* Ted Schneyer, *A Tale of Four Systems: Reflections on How Law Influences the ''Ethical Infrastructure'' of Law Firms,* 39 S. Tex. L. Rev. 245, 263 (1998) (''Over the years, the Securities and Exchange Commission (SEC) and, more recently, the Office of Thrift Supervision (OTS) have asserted far-reaching authority to directly regulate lawyers who practice in their fields, much as judges regulate trial lawyers.''); Ted Schneyer, *Professional Discipline for Law Firms?,* 77 Cornell L. Rev. 1, 43–44 (1991) (under Rule 102(e), SEC has been the ''most aggressive agency'' in disciplining lawyers). In addition, the Commission's use of Rule 102(e) goes well beyond standards used to enforce the disciplinary rules of most courts. *See* ABA CL 81, at 3–4; AICPA, CL 84 at 12.

[97] Emerson, *supra* note 17, 29 Am. Bus. L.J. at 178.

[98] *Keating,* 47 S.E.C. at 111 (Commissioner Karmel, dissenting); *see also, e.g., Darrel L. Nielsen,* 49 S.E.C. 50, 51 (1980) (Commissioner Karmel, dissenting); *Bernard J. Coven,* 49 S.E.C. 46, 47 (1979) (Commissioner Karmel, dissenting); *Hodgin,* 49 S.E.C. at 11 (Commissioner Karmel, dissenting).

[99] *Keating,* 47 S.E.C. at 109; *see also id.* at 111 (expressing disapproval of use of Rule 2(e) as ''a general enforcement tool to discipline attorneys''). Though Commission Karmel questioned most strongly the Commission's authority to regulate the conduct of attorneys, she questioned the Commission's authority to regulate the conduct of accountants as well. *See id.* at 111 & 115 n.31; *see also Nielsen,* 49 S.E.C. at 52–54 (Commissioner Karmel, dissenting).

The force of Commissioner Karmel's arguments have increased, rather than diminished with time.[100]

Starting with the Second Circuit's decision in *Touche Ross,*[101] the few courts to consider these arguments have rejected them, but I think there is ample cause for reconsideration. As the Release repeatedly recognizes, the legitimacy of Rule 102(e) depends on it having a remedial purpose.[102] A recent decision by the D.C. Circuit, *Johnson* v. *SEC,*[103] however, and the Commission's response to it, place the characterization of Rule 102(e) as ''remedial'' in great doubt. In *Johnson,* the D.C. Circuit rejected the Commission's argument that sanctions imposed on a branch manager at a registered broker-dealer, a censure and a six-month suspension, were ''remedial''; rather the Court determined that these sanctions fell within the definition of ''penalty'' for purposes of the statute of limitations.[104] Precisely these same sanctions, censure and suspension, are among the sanctions frequently imposed by the Commission in Rule 102(e) cases. Under the reasoning of *Johnson*, the punitive nature of Rule 102(e)'s sanctions could well give rise to questions about the Commission's ability to promulgate it. The D.C. Circuit decided *Johnson* after *Checkosky I*, but before *Checkosky II.*[105] In *Checkosky II,* the D.C. Circuit determined that the Commission had failed to comply with the directions in *Checkosky I* that it clearly enunciate its standard for Rule 102(e), and thus had no need to determine whether, as a result of *Johnson,* the Commission still had the authority to promulgate Rule 102(e).

Subsequent action by the Commission indicate its own recognition that this argument may be well-founded. In *Angelo P. Danna, CPA,* two accountants filed a motion to dismiss a Rule 102(e) proceeding as one seeking a penalty and thus time-barred under *Johnson.*[106] The Division of Enforcement failed to object, and the Commission dismissed the proceeding.[107] Likewise, in *George Craig Stayner, CPA,* the Commission dismissed a Rule 102(e) case against an accountant who had raised the *Johnson* issue, this time over the objection of the Office of the Chief Accountant.[108] In several analogous disciplinary cases not involving Rule 102(e), the Commission has ordered dismissals, without objections from the staff, in response to similar arguments relying on *Johnson*.[109] Given the time and resources the Commission devoted to *Danna* and *Stayner*, one would have thought the Commission would have declined to dismiss these cases if it had any confidence in its chances on the ''punitive''/''remedial'' question in the D.C. Circuit.

In my view, the purpose of Rule 102(e) is not to protect the Commission's administrative processes, but rather to enforce compliance with the federal securities laws. In addition, under controlling law in the D.C. Circuit, Rule 102(e) is punitive, not remedial. As a result, the Commission lacks the authority even to promulgate Rule 102(e).

B. The Commission Lacks the Authority To Adopt a Negligence Standard

Even assuming the Commission could validly promulgate Rule 102(e), it lacks the authority to adopt a negligence standard. In my view, this conclusion is compelled by the D.C. Circuit's decisions in *Checkosky I* and *Checkosky II.*[110] Others at the Commission question my interpretation of both *Checkosky* cases, but I note that this same urge to construe an adverse decision as narrowly as possible (sometimes even more narrowly than possible) is precisely what so enraged the D.C. Circuit in *Checkosky II.*[111]

I must confess that I remain somewhat mystified by the begrudging attitude towards *Checkosky* that is prevalent at the Commission. After two of the worst defeats in the Commission's 60-plus year history, we should not adopt merely the absolute minimum necessary to pass muster in the D.C. Circuit. Rather, we should strive toward caution and conservatism, and give ourselves an ample margin for error. The Standard is not cautious; it is not conservative. Instead, the Commission has again reverted to a ''push the envelope'' strategy, and thrown down the gauntlet to the D.C. Circuit.

Editorializing aside, I believe that the Commission lacks the authority to adopt a negligence standard under Rule 102(e). No appellate court has approved the Commission's adoption of a negligence standard, and I fully concur with the ABA's statement that ''the prognosis for appellate court affirmance of * * * a [negligence-based] standard is very poor.'' [112] Of course, the Release denies that what the Commission has adopted is a ''simple'' or ''mere'' negligence standard.[113] But the Proposing Release contained similar

[100] The academic commentary largely supports the view that Rule 102(e) is ''just part of the SEC's disciplinary enforcement arsenal.'' Emerson, *supra* note 17, 29 Am. Bus. L.J. at 167; *see generally supra* note 17.

[101] 609 F.2d 570. In one of the many ironies surrounding Rule 102(e), the opinion in *Touche Ross* was written by Judge Timbers. Before Judge Timbers' distinguished service as a federal judge, he served with distinction as the Commission's General Counsel in the mid-1950's. At that time, the General Counsel had supervisory responsibility for overseeing all the Commission's Rule 102(e) cases.

[102] Release at 7, 11 & n.26, 19 & 31.

[103] 87 F.3d 484 (D.C. Cir. 1996). At the time *Johnson* was decided, I disagreed with its reasoning, and supported the Commission's unsuccessful efforts to seek Supreme Court review. Regardless of my earlier disagreement with *Johnson* and my support of continuing efforts to raise this issue in other circuits, *Johnson* represents controlling law in the D.C. Circuit and will almost certainly be a factor the next time the D.C. Circuit reviews Rule 102(e).

[104] 87 F.3d at 485–87 (construing 28 U.S.C. 2462).

[105] Because *Johnson* came after *Checkosky I,* I regard the statements of Judges Silberman and Randolph supporting the Commission's ability to promulgate Rule 102(e) as less than authoritative. *See* 23 F.3d at 455 (Silberman, J.) & 472 (Randolph, J.). Because there was no opinion of the Court in *Checkosky I,* the D.C. Circuit probably need not invoke *en banc* procedures in its next review of Rule 102(e) to determine whether to follow the Second Circuit's decision in *Touche Ross.* Any panel of the D.C. Circuit would have the power to decide to follow or not to follow *Touche Ross.*

[106] Exchange Act Release No. 38499, 1997 WL 197555 (S.E.C.) (April 14, 1997). These respondents had earlier sought to enjoin the Commission in federal court from commencing the Rule 102(e) proceedings; in an unpublished decision (relied on in the Release at 18 & 29), the district court held that the Commission's Rule 102(e) authority is not limited to instances of intentional misconduct or bad faith. *See Danna* v. *SEC,* 1994 WL 315877 (N.D. Cal. Feb. 8, 1994).

[107] 1997 WL 197555 (S.E.C.).

[108] Exchange Act Release No. 39994, 1998 SEC LEXIS 956 (May 14, 1998).

[109] *See, e.g., Paul C. Kettler,* Exchange Act Release No. 40011, 1998 SEC LEXIS 986 (May 20, 1998); *Richard M. Kulak,* Exchange Act Release No. 38657, 1997 SEC LEXIS 1113 (May 20, 1997).

[110] *See supra* Section II.

[111] A respected securities scholar, Dean Joel Seligman of the University of Arizona College of Law, submitted a comment letter opining that, although ''there is some uncertainty'' because of the *Checkosky* decisions, the Commission has the authority under the federal securities laws to adopt a negligence standard for Rule 102(e). *See* CL 53 at 2. Dean Seligman qualified his endorsement in other important ways—even he expressed concerns about the clarity of the June proposal. *See* CL 53 at 3. Dean Seligman's opinion is contrary to the clear weight of academic commentary. *See, e.g.,* Downing & Miller, *supra* note 17, 54 Notre Dame Law. at 775–81; Maxey, *supra* note 12, 22 Del. J. Corp. L. at 563–64; Flagel, Note, *supra* note 17, 20 Dayton L. Rev. at 1095–98; *see also supra* note 17. In addition, most other commenters share my view that the *Checkosky* opinions appear to preclude the Commission from adopting a negligence standard. *See* ABA, CL 81 at 3; Robert K. Elliott, Partner, KPMG Peat Marwick LLP (''KPMG Peat Marwick''), CL 82 at 2–3; AICPA, CL 84 at 4–5 & 10–15; *see also, e.g.,* Don Hummel, Administrative Director, Department of Commerce and Insurance, Tennessee State Board of Accountancy, CL 12; Richard Y. Roberts, CL 18.

[112] ABA, CL 81 at 3. *Cf. Checkosky I,* 23 F.3d at 456 (Silberman, J.) (courts of appeals have not ''squarely addressed'' question of Commission's authority to adopt a negligence standard under Rule 102(e)). Although the Eleventh Circuit's subsequent opinion in *Sheldon*, 45 F.3d at 1518, discussed generally the Commission's authority to promulgate Rule 102(e), it did not address the negligence question.

[113] Release at 30.

unconvincing attempts to narrow what seemingly was an all-encompassing standard.[114] Interested parties submitted over 150 comment letters, more than half (by my estimate) expressing skepticism or worse as to whether the standard in the Proposing Release truly limited the Commission's discretion to bring Rule 102(e) cases for simple negligence. Though insisting that it has the authority to adopt a ''simple'' or ''mere'' negligence standard, the Commission now purports to adopt a higher standard.[115] I think that the Standard will not limit the Commission's discretion to bring cases for simple negligence. Moreover, as I discuss in the next section, the revisions to the Proposing Release's standard only add to the lack of clarity surrounding this issue.

As an initial matter, it is important to recognize that today's release actually *expands* the Commission's Rule 102(e) jurisdiction beyond that encompassed by the Proposing Release. The single negligent act provision in the Proposing Release contained a requirement that the act be tied to ''making a document prepared pursuant to the federal securities laws materially misleading.'' [116] The single negligent act provision in the Standard omits this requirement, thereby increasing substantially the potential reach of Rule 102(e).[117]

The Standard does contain two elements which form the basis for the Commission's claim that it adopts ''an intermediate standard, higher than ordinary negligence but lower than the traditional definition of [Rule 10b–5] recklessness.'' [118] These elements are that the alleged misconduct: (1) Must be ''highly unreasonable,'' not merely ''unreasonable,'' as in the Proposing Release; and (2) must occur under ''circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.'' [119] On close examination, these elements present only illusory limits on the Commission's discretion to bring charges of ''improper professional conduct'' based on a single act of negligence.

Unlike ''highly unreasonable conduct,'' the Proposing Release discussed the concept of ''heightened scrutiny,'' and, accordingly, interested parties had the opportunity to explain its drawbacks. The AICPA objected to any attempt by the Commission to

> use Rule 102(e) proceedings to determine in the first instance the circumstances under which particular items of financial statements require ''heightened scrutiny.'' In our view, auditors should determine which items require increased scrutiny according to existing professional guidance, not because they fear the Commission will, in hindsight, so conclude. Determinations announced retrospectively by an Administrative Law Judge or the Commission would make Rule 102(e) a vehicle for improper back-door regulation through the adjudicatory announcement of standards.[120]

I fully endorse these views.

Furthermore, I think the Commission's use of ''heightened scrutiny'' is merely a form of materiality that will have no practical effect on limiting the Commission's ability to bring cases for simple negligence. One would think that the Commission would have limited interest in bringing Rule 102(e) cases for alleged misconduct that involved only immaterial matters, but the Release tells us otherwise.[121] The Release asserts that the Commission need not show either actual harm or materiality under Rule 102(e) because:

> An auditor who fails to audit properly under GAAS—whether recklessly or highly unreasonably—should not be shielded because the audited financial statements fortuitously turn out to be accurate or not materially misleading.[122]

I am troubled by this statement. The ''heightened scrutiny'' element is based in considerations of materiality, yet the Release disclaims any need for the Commission to prove materiality. This is but one of the many contradictions and ambiguities raised by the Standard. As in *Checkosky,* the Commission refuses to recognize any meaningful limitations on its discretion to bring cases under Rule 102(e).

Likewise, the other added requirement—that the Commission prove that the single negligent act was ''highly unreasonable,'' rather than simply ''unreasonable''—also fails to place any significant limitations on the Commission's discretion under Rule 102(e). In my view, this distinction amounts to no more than legal hair-splitting. It seems that ''highly unreasonable conduct'' was chosen precisely for its lack of content: it is an empty vessel that gives virtually no guidance to the accounting profession or reviewing courts and into which the Commission can pour whatever content it deems fit, contrary to the dictates of *Checkosky.*[123]

One person's ''unreasonable'' act might well be another person's ''highly unreasonable'' act. Since the Commission has a well-deserved reputation for aggressiveness in its interpretation of Rule 102(e), it seems likely that what it considers ''highly unreasonable'' may not appear to others even to be ''unreasonable'' at all.[124] I cannot imagine a single case that the Commission would have wanted to bring under the standard in the Proposing Release that it could not also bring under the Standard. The revisions from the standard in the Proposing Release amount to mere window dressing, having more to do with assisting the Commission's litigation posture than with giving proper deference to the good faith judgment calls of accountants.

In attempting to justify the standard, the Commission treads on thin ice. The Release asserts that: ''The Commission believes that a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive.'' [125] This is the very same Commission argument two judges of the D.C. Circuit rejected in *Checkosky I.* Judge Randolph recognized that the Commission had made this same argument in *Hochfelder* as support for not requiring scienter under Rule 10b–5, and the Supreme Court had there rejected '' 'this effect-oriented approach' '' as one that would logically result in absolute liability whenever investors suffered harm.[126] Similarly, Judge Silberman also questioned this argument, observing that the Commission's no-fault

> language, tellingly, suggests that the Commission's reasons for considering an auditor's negligence to be 'improper professional conduct' ha[ve] more to do with protecting the public than the Commission's administrative processes.[127]

[114] Proposing Release, 1998 WL 311988 (S.E.C.), at *4.

[115] Release at 30.

[116] Proposing Release, 1998 WL 311988 (S.E.C.), at *3.

[117] *See supra* note 85 and accompanying text.

[118] Release at 18.

[119] Release at 14.

[120] AICPA, CL 84 at 14 (footnotes omitted).

[121] Release at 24–25.

[122] Release at 25.

[123] *See Checkosky I,* 23 F.3d at 462 (Silberman, J.); *see also Checkosky II,* 139 F.3d at 224–25.

[124] *See Kivitz* v. *SEC,* 475 F.2d at 962 (D.C. Circuit reversed Commission's finding of liability in Rule 102(e) disbarment case for lack of substantial evidence; declining to give Commission any deference on issues of alleged professional misconduct); *see also, e.g., Checkosky I,* 23 F.3d at 482 n.17 (Randolph, J.) (expressing ''serious doubt'' whether the evidence supported the Commission's recklessness finding; noting contradiction between Commission's opinion and Commission's position at oral argument).

[125] Release at 17; *see also id.* at 10 & 11.

[126] 23 F.3d at 483 (quoting *Hochfelder,* 425 U.S. at 198).

[127] 23 F.3d at 459 & n.7. Although toned down, the Release still contains multiple references to investor protection as a valid rationale for Rule 102(e) proceedings which seem questionable in

Continued

Notwithstanding the harsh scolding received in *Checkosky II,* the Commission seems bound and determined to repeat its past mistakes.

The Standard exceeds the Commission's authority in several ways. It improperly gives the Commission de facto substantive regulatory authority over the accounting profession, and it arrogates to the Commission authority to enforce the securities laws that is reserved to the federal courts. Accountants, like attorneys, are members of ''ancient professions,'' regulated according to rigorous ethical rules enforced by professional societies and 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 the 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.

The comment letters overwhelmingly echo these thoughts.[128] One commenter asserted that the Commission is improperly expanding its authority over matters properly left to the states and the AICPA:

> The Commission's sole legitimate goal with respect to Rule 102(e), absent any express statutory authority to punish professionals for misconduct, is to regulate the conduct of practice before it, not to serve as the ''first line of defense'' against violations of professionals standards more generally.[129]

Another commenter remarked that adoption of a negligence standard would ''constitute an illegitimate expansion of the Commission's regulatory powers.'' [130]

Today's release claims that: ''The Commission does not seek to use Rule 102(e)(1)(ii) to establish new standards for the accounting profession.'' [131] I disagree. The Commission is being too modest in protesting that it does not set substantive ethical standards.[132] In the past—pre-*Checkosky I,* of course, the Commission boasted about its instrumental uses of Rule 102(e) litigation to set ethical standards for both lawyers and accountants. In *Carter,* the Commission reversed sanctions an ALJ had imposed on two lawyers because of the recognition that the Commission itself had not ''firmly and unambiguously established'' the relevant ''ethical and professional responsibilities.'' [133] The length of the Commission's 43-page opinion in *Carter* largely resulted from the Commission's attempts to articulate the relevant Rule 102(e) standards in exhaustive detail.[134]

The Commission has also used Rule 102(e), at the very least, to explain the application of professional standards for accountants, as reflected in a 1991 article co-written by a former Commission General Counsel and the then-Assistant General Counsel who supervised litigation of all Rule 2(e) cases, which stated as fact that:

> the Commission frequently uses Rule 2(e) proceedings as a forum for explaining its views concerning the professional standards applicable to accountants. Indeed, *the Commission's guidance to accountants on particular facets of the audit function is often more extensive than that issued by the profession's standard-setting bodies.[135]*

These observations also seem to describe accurately the likely effects of the Commission's present rulemaking. Many commenters pointed out that the standard in the Proposing Release went well beyond those promulgated by most state accountancy boards.[136] Even assuming that the revisions reflected in the Standard have substance, which I doubt, most state standards contain a ''good faith'' element that the Release expressly rejects.[137] Therefore, the amendment has the potential to cause a fundamental change in the way accountants approach their duties. As occurred during the *National Student Marketing* and *Arthur Young* era, I think accountants may well be forcibly conscripted into following the staff's views because of well-grounded fears that otherwise they may face Rule 102(e) sanctions.[138]

IV. The Proposed Standard Is Unclear

One of the few things regarding Rule 102(e) on which my colleagues and I agree is that, as a result of the *Checkosky* opinions, the Commission has the obligation to set forth clear standards.[139] In my view, the most important part of the Standard—that rendering an accountant's single act of negligence actionable under Rule 102(e)—fails to comply with the directions of the D.C. Circuit in *Checkosky*. I think today's release introduces new flaws that were not contained in the Proposing Release. In June, I severely criticized the earlier standard on the jurisdictional and policy grounds, but I did not claim that it was unclear.[140] On the contrary, as I interpreted it, the Commission sought to adopt a simple negligence standard. The Proposing Release went to some pains to deny that the standard it contained amounted to mere negligence, but I was not convinced. In fact, the ambiguity and lack of clarity in the Proposing Release largely resulted from the Commission's unpersuasive attempts to explain why the earlier standard did not amount to simple negligence.

light of Judge Silberman's observation. *See* Release at 9 (''Investors have come to rely on the accuracy of the financial statements of public companies when making investment decisions.''); *see also id.* at 5, 9–10 & 22.

[128] *E.g.,* Peter D. Rothman, Volt Information Sciences, Inc., CL 28; John Sommerer, CPA, CL 46; Richard Dillon, CL 86; Robert A. Boyd, CPA, CL 126; Robert J. Sonnelitter, Jr., Director, Accounting and Auditing, Reminick, Aarons & Co., LLP, CL 128; Frank H. Brod, CPA, CL 137; Bull and Associates, Austin, Texas, CL 143; Kyle E. Carrick, CPA, Senior Financial Analyst, International Accounting, The SABRE Group (''SABRE''), CL 144.

[129] Wayne A. Kolins, National Director of Accounting and Auditing, BDO Seidman, LLP (''BDO Seidman''), CL 80 at 3; *see* AICPA, CL 84 at 5.

[130] Steven A. Templeton, Templeton & Company, P.A., CPAs, CL 24.

[131] Release at 13; *see also id.* at 21.

[132] *See, e.g.,* Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will,* 66 S. Cal. L. Rev. 1075, 1087 n.50 (1993) (''The SEC has used rule 2(e) proceedings to announce standards of conduct applicable to the legal profession.'').

[133] 47 S.E.C. at 508 (''We also recognize that the Commission has never articulated or endorsed [the relevant] standards.'').

[134] 47 S.E.C. at 508 (''[T]he Commission is hereby giving notice of its interpretation of 'unethical or improper professional conduct' as that term is used in Rule 2(e)(1)(ii).'').

[135] Goelzer & Wyderko, *supra* note 11, 85 Nw. U. L. Rev. at 666 (emphasis added). To the same effect, this article also asserted:

> Rule 2(e) affords the Commission a vehicle to engage, to a limited degree, in professional standard-setting. Through its opinions and orders in these proceedings, the Commission articulates what it deems to be improper or unprofessional conduct in particular factual situations. For example, because of the concentration during the last decade of the Commission's enforcement program on ''financial fraud,'' the use of Rule 2(e) against auditors of public companies has increased. This, in turn, has created an important body of Commission case law on auditor's responsibilities * * *.

Id. at 653.

[136] *See* AICPA, CL 84, at 25–26; *see generally, e.g.,* Paul Seitz (attached to comment letter of Dennis Paul Spackman, CPA, CL 15); John Sommerer, CPA, CL 46; Robert Sonnelitter, CL 128: Frank H. Brod, CPA, CL 137.

[137] *Id.;* Release at 32–33.

[138] *See, e.g.,* Downing & Miller, *supra* note 17, 54 Notre Dame Law. at 786 (suggesting that objective for Rule 102(e) might be to ''subjugate the accounting profession to the Commission's day-to-day control''); Francis M. Wheat, *SEC* v. *Bar—''Fear'' is the Name of the Game,* N.Y*L.J., Aug. 16, 1978, at 1, col. 2.

[139] *See* Release at 2.

[140] Proposing Release, 1998 WL 311988 (S.E.C.), at *9 (Commissioner Johnson, dissenting).

Now, in response to a tidal wave of comment letters complaining about the Commission's lack of authority to adopt a negligence standard, the Commission purports to adopt ''an intermediate standard, higher than ordinary negligence but lower than the traditional definition of [Rule 10b–5] recklessness.'' [141] Even if this description were accurate—and I do not agree that it is—it only serves to emphasize the lack of clarity in the Standard.

At first blush, one might think that the Standard is based in recklessness. After all, the term ''highly unreasonable'' is part of traditional definitions of ''recklessness.''[142] However, the Release correctly insists that the Standard is not a recklessness standard.[143] If, as the Release claims, the Standard is an intermediate standard, the next logical choice would be ''gross negligence.'' Again, however, the Release is at some pains to disclaim that its standard amounts to gross negligence. In a footnote, the Release explains that ''[t]he Commission is not adopting a 'gross negligence' standard because courts have not interpreted the term uniformly.'' [144] I disagree. I think that the majority view tends to equate ''gross negligence'' with ''recklessness,'' as stated by the leading American torts authority, Prosser and Keeton:

> ''reckless'' conduct tends to take on the aspect of highly unreasonable conduct, involving an extreme departure from the standards of ordinary care, in a situation where a high degree of danger is apparent. *As a result there is often no clear distinction at all between such conduct [i.e., ''recklessness''] and ''gross'' negligence, and the two have tended to merge and take on the same meaning,* of an aggravated form of negligence * * *. It is at least clear, however, that such aggravated negligence must be more than any mere mistake * * *, and more than mere thoughtlessness or inadvertence, or simple inattention, * * * or even of an intentional omission to perform a statutory duty.[145]

In any event, ''gross negligence'' itself is a highly unclear term that Prosser and Keeton, among others, disfavor.[146] Thus, the Commission has rejected as unclear a ''gross negligence'' standard in favor of a standard that is even more unclear (and unlike ''gross negligence'' and ''recklessness'' has no currency among courts, lawyers or accountants).

One thing is clear, however, and that is the Commission intends its new Rule 102(e) standard to reach conduct that would not amount to ''recklessness'' or ''gross negligence'' under the Prosser and Keeton definition.[147] If the Commission's standard is not ''recklessness'' or ''gross negligence,'' as those terms have been traditionally defined, well then what is it? The logical answer would seem to be simple negligence, but the Release expressly disclaims that alternative as well.[148] As stated in the preceding section, however, it seems that the Standard will amount to simple negligence, though the Release does contain disguised hints of an intent to apply a strict liability standard in some areas as well.[149]

The Release's equivocal, simultaneous embrace and rejection of recklessness, gross negligence, negligence and strict liability seem familiar, with good reason. The Commission employed exactly the same strategy in *Checkosky*—the Release represents yet another ''tour de force'' by the Commission.[150] Again, the Commission has the best of intentions in its efforts to improve accounting standards, but, as the D.C. Circuit has told us, good intentions alone cannot make up for deficiencies in ''[e]lementary administrative law norms of fair notice and reasoned decisionmaking.'' [151]

With the Standard, the Commission attempts to have it both ways. Because the *Checkosky* decisions raised questions about its authority, the Commission purports to adopt something more than the simple negligence standard contained in the Proposing Release (which the Proposing Release denied was a simple negligence standard). In attempting to finesse the issue of its authority, however, the Commission has sacrificed clarity. With due recognition to the dedication, hard work and long hours put in by the Commission's staff, the Standard and the Release are convoluted and incomprehensible—they have been written by committee and point in varying and conflicting directions. The Standard does not meet the requirements of due process and will not give accountants adequate guidance as to what the Commission may allege, in hindsight, to have been ''improper professional conduct.''

V. The Proposed Standard Is Not in the Public Interest

As explained above, the Commission lacks the legal authority to adopt the Standard and the standard is itself unclear, contrary to what was demanded of the Commission in the *Checkosky* opinions. Even apart from these fatal flaws, strong public policy considerations also call for rejection of the Standard: (a) The Standard is arbitrary and capricious in failing to explain why accountants should be singled out for discriminatory treatment; (b) the Standard will interfere with the ability and willingness of accountants to exercise independent professional judgment; (c) the costs of the Standard will exceed its benefits; and (d) the Standard will unfairly disadvantage small accounting firms. s

A. The Standard Is Arbitrary and Capricious in Singling Out Accountants for Discriminatory Treatment

By my rough count, about half of the comment letters specifically complained that the standard in the Proposing Release discriminated against accountants.[152] The basis for this assertion is simple and compelling—the Commission applies a scienter standard in Rule 102(e) proceedings against lawyers, and the standard in the Proposing Release would have allowed the Commission, without adequate justification, to impose sanctions on accountants for much less egregious conduct.[153] Several commenters also correctly pointed out that the standard in the Proposing Release would allow

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[141] Release at 18.

[142] *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); W. Page Keeton et al., *Prosser and Keeton on The Law of Torts* 214 (5th ed. 1984).

[143] Release at 18–19 & n.42. The Standard omits the second part of traditional formulations of recklessness that requires ''an extreme departure of ordinary care.'' *See Sundstrand,* 553 F.2d at 1045; Keeton, *supra* note 142, at 214. One comment letter proposed the addition of an ''extreme departure'' element. *See* J. Michael Cook, Chairman and Chief Executive Officer, and Philip R. Rotner, General Counsel, Deloitte and Touche LLP, CL 77 at 5–6.

[144] Release at 22 n.49.

[145] Keeton, *supra* note 142, at 214 (footnotes citing cases omitted).

[146] Keeton, *supra* note 142, at 211 (quoting common law judge for proposition that '''gross' negligence is merely the same thing as ordinary negligence, 'with the addition * * * of a vituperative epithet''').

[147] *e.g.,* Release at 18–26.

[148] Release at 30.

[149] *See* Release at 13 n.31, 14 n.32 & 23.

[150] *Checkosky* II, 139 F.3d at 223.

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

[152] *See* PricewaterhouseCoopers LLP, CL 116; *see also, e.g.,* Peter D. Rothman, Volt Information Sciences, Inc., CL 28; Eric Tanquist, CL 32; Daniel S. Kuerner, CPA, CL 33; James I. Linkous, CPA, CL 34; Raymond F. Marin, Hixson, Marin, Powell & De Sanctis, P.A., CPAs, CL 45; AICPA, CL 84; Nancy L. Ryder, CL 85; Dominick A. Bellino, CPA, CL 87; Michael D. Castleberry, CPA, CL 90; Wayne Scroggins, CL 89; Public Company Practice Committee, Colorado Society of CPAs, CL 99; Myron J. Banwart, CPA, CL 125.

[153] *E.g.,* AICPA, CL 84 at 19 (citing *Carter,* 47 S.E.C. at 511); *see also* KPMG Peat Marwick, CL 82 at 2 & 6–8.

the Commission to bar accountants from SEC practice for much less serious misdeeds than required to bar members of corporate management (who almost without exception have the greatest culpability for financial frauds in which accountants have secondary liability) from serving as officers and directors of public companies.[154] The Standard fails to remedy these disparities.

This point is not obscure. To the contrary, Judge Randolph made it a centerpiece of his demonstration that the Commission had acted arbitrarily and capriciously in *Checkosky I.*[155] Relying on *Carter,* ''the Commission's most comprehensive discussion of the history, purpose and operation of Rule 2(e),'' Judge Randolph held that the Commission was required to apply a scienter standard in all Rule 102(e) proceedings and that the Commission had therefore erred in failing to apply a scienter standard in *Checkosky.*[156]

Accountants and lawyers do have different duties and obligations. As a general matter, lawyers must zealously advocate the interests of their private clients, while accountants have an overriding duty to the investing public. As a consequence of accountants' public obligations—the ''P'' in CPA—they have a statutory duty, under certain circumstances, to report a client's past fraudulent activities.[157] As was Judge Randolph, I am aware of these differences, but fail to understand why they should make a difference for purposes of Rule 102(e).[158] As several commenters perceptively pointed out, Rule 102(e) proceedings for ''improper professional conduct'' are necessarily based on the failure to follow applicable professional standards.[159] Because applicable standards already incorporate and distinguish between the differing duties and obligations of various professions, there is no logical basis for the Commission to apply different mental state requirements under Rule 102(e).[160]

In any event, regardless of whether the Commission *could* justify applying different mental state requirements to lawyers and accountants—and I do not totally foreclose this possibility—it has not made even an attempt to do so.[161] Other than to state the obvious, i.e., ''this release does not address the conduct of lawyers,'' the Release fails to discuss why the Commission should apply a less forgiving standard to accountants than to lawyers and others who also play an equally crucial role in the ''financial reporting process.''[162] Indeed, the Release fails even to cite, much less to discuss *Carter.*

In *Checkosky I*—on this very issue of the Commission's differential treatment of accountants and lawyers under Rule 102(e)—Judge Randolph noted that ''[o]ne of the abiding principles of administrative law is that when agencies refuse to treat like cases alike, they act arbitrarily, in violation of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A).'' [163] Judge Randolph elaborated that should factual differences ''lead to variations in the interpretation and application of [an agency's] rules,'' the agency then becomes obligated to provide a ''reasoned explanation'' of why the differences should matter.[164] Although Judge Silberman choose to rely primarily on the lack of clarity in the Commission's first *Checkosky* opinion, he too noted that the Commission had failed to give an adequate explanation for its differential treatment of lawyers and accountants under Rule 102(e).[165] The Commission now repeats the same arbitrary and capricious error it committed in *Checkosky.*[166]

B. The Standard Will Interfere With Accountants' Exercise of Their Independent Professional Judgment

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.''[167] 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 compels restraint. Accountants, like other securities professionals subject to Rule 102(e), must make difficult judgment calls, navigating through complex statutory and regulatory requirements.[168] 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

[154] *See* AICPA, CL 84 at 20 (referring to showing Commission must make to obtain an officer and director bar under Section 20(e) of the Securities Act or Section 21(d)(2) of the Exchange Act); Arthur Andersen, CL 98 at 8–9 & n.21. In addition, the standard in the Proposing Release and the Standard disadvantage accountants as compared with similarly situated broker-dealers, for whom the Commission has direct statutory authority to discipline. *See* Arthur Andersen, CL 98 at 9 & n.22 (citing Section 15(b)(6) of the Exchange Act).

[155] 23 F.3d at 483–87.

[156] *Id.*

[157] *See Checkosky I,* 23 F.3d at 485–86; *see also* Exchange Act 10A(b)(3), 15 U.S.C. 78j–1(b)(3) (requiring auditors to report illegalities to board of directors, and resign and notify the Commission if the board fails to notify the Commission).

[158] 23 F.3d at 486–87.

[159] BDO Seidman, CL 80 at 5–6 & n.6; AICPA, CL 84 at 22–23.

[160] *Id.*

[161] The Commission has limited indirect statutory authority to regulate the conduct of accountants that it lacks for lawyers. *See* ABA, CL 81 at 11 & n.6 (citing Items 25 and 26 of Schedule A to the Securities Act, and Section 10A and Section 12(b)(1)(J) and (K) of the Exchange Act); *see also* Securities Act Section 19(a), 15 U.S.C. 77s(a) (Commission has authority, among other things, to define accounting terms and to prescribe accounting methods used in preparation of financial forms filed with the Commission).

[162] Release at 25–26.

[163] 23 F.3d at 483 (citations omitted).

[164] 23 F.3d at 483–84.

[165] 23 F.3d at 458–59. The third judge in *Checkosky I,* District Judge Reynolds accepted the Commission's arguments that *Carter* did not apply to the ''improper professional conduct'' provision of Rule 102(e) and that, in any event, the Commission had a rational reason for not following *Carter* based on the ''overriding duty'' of accountants/auditors to the investing public. 23 F.3d at 494–95.

[166] Lest I be thought obtuse, I will point out my awareness that this omission is entirely deliberate. Based on discussion at the Commission's open meetings on June 12, 1998 and September 23, 1998, some at the Commission intend to ramp up our Rule 102(e) enforcement program as to lawyers, a prospect I view with alarm. Because, as always, the Commission wishes to leave its future options open regarding Rule 102(e), the Release intentionally glosses over this point.

[167] *Keating,* 47 S.E.C at 120 (Chairman Williams, concurring).

[168] One commenter offered an eloquent statement of this core issue:

[GAAP and GAAS] are not like cookbook recipes, where reading words and following directions results in a uniform outcome. Resolution of many auditing and accounting issues requires judgment. Even where there is written guidance, there is often ambiguity. The accountant must attempt to synthesize practice and different pronouncements that may speak ambiguously or indirectly to the issue and that may have changed over time. What the proposed amendment labels as a ''violation of professional standards'' is apt to be, in practice, a difference of opinion between the Commission's staff and the respondent accountant over how a particular pronouncement or pronouncements should be applied.

PricewaterhouseCoopers LLP, CL 116 at 6.

cases, careless—mistakes without fear of [losing] the ability to practice before'' us.[169] 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.'' [170]

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 auditor about difficult accounting issues may be just as desirable as encouraging management to consult candidly with outside lawyers, and for similar reasons.[171]

The steadfast belief that the Commission must respect the good faith judgments made by accountants and other professionals formed the basis of my dissent from the Commission's second *Checkosky* opinion.[172] The outpouring of comment letters highlighting the importance of this issue has confirmed and validated my prior view.[173] Even some of those few commenters to support the June proposal also recognized the importance of respecting an accountant's exercise of independent professional judgment.[174]

Because the fear of Commission discipline will intimidate accountants and prevent them from exercising their best independent professional judgment, accountants will likely refuse to opine on difficult issues or bend over backwards to conform their views to those of the Commission's staff.[175] As a result, financial statements will become overly conservative in derogation of the fundamental accounting principal of neutrality. One commenter, a professor of accounting, stated that he could not support the addition to Rule 102(e) of the single negligent act provision for this very reason:

I believe that it is important that the SEC foster neutrality in financial statements. That is, * * * Rule 102(e) should not foster conduct that results in either overstatement or understatement of amounts in financial statement presentations and disclosures. The rule should therefore foster choosing accounting policies, recording transactions and events, and making accounting estimates toward a neutral framework. The terminology in the proposed Rule 102(e)(1)(iv)(B)(1), especially in the light of the discussion in the Release and the framework for litigation currently existing, does not foster such neutrality. Accountants * * * will increasingly be driven to what some have referred to as ''conservative accounting'' which can harm the capital market system.[176]

The AICPA similarly remarked that the standard in the Proposing Release ''would chill the provision of the highest quality audit and accounting services'' and that ''exposure of auditors to sanctions based on a single negligent mistake would introduce an overly conservative bias into the financial reporting process.'' [177]

Other commenters strongly concurred that the standard in the Proposing Release would have a detrimental effect on an accountant's neutrality that is contrary to the public interest.[178] One commenter acknowledged that the public does have a legitimate interest in the integrity of the Commission's processes, but ''the public also benefits from an environment in which accountants are free to exercise their independent judgment without fear that a particular judgment might be viewed, in hindsight, as subject to sanction by the SEC.'' [179] Another commenter correctly remarked that ''the proposed rule 102(e) amendment would have a chilling effect on the justifiable exercise of professional judgment * * * contrary to the intent of the Court in *Checkosky* v. *SEC.*'' [180]

In my view, the Standard is no less flawed than that set forth in the Proposing Release—it still fails to give adequate protection to an accountant's independent professional judgment. The Release's discussion of this issue amounts to no more than a conclusory tautology.[181] At the same time the Release professes the Commission's deep respect for an accountant's need to exercise independent professional judgment—and that this factor has caused the Commission to adopt a standard that is purportedly more deferential than that in the Proposing Release—the Release emphasizes at least four times, in various phrasings, that ''the Commission possesses

[169] 47 S.E.C. at 504.

[170] *Id.*

[171] *Checkosky I,* 23 F.3d at 485.

[172] David J. Checkosky, 1997 WL 18303 (S.E.C.), at *14.

[173] *See, e.g.,* Richard Y. Roberts, CL 18 at 4; Barbara Hutson Gonzales, CPA, McElroy, Quirk & Burch, CL 25; Mike Molinaro, CL 26; Daniel S. Kuerner, CPA, CL 33; J. Eric Bjornholt, CPA, Senior Tax Manager, Microchip Technology Incorporated, CL 43; Howard McElroy, CL 44; Raymond F. Marin, Hixson, Marin, Powell & De Sanctis, P.A., CPAs, CL 45; John Sommerer, CPA, CL 46; Edward L. Rand, Jr., Vice President and Treasurer, Atlantic American Corp., CL 47; Ronald H. Beck, Vice President and Chief Financial Officer, Columbus Energy Corp., CL 49; Dan Ramey, CPA, Manager—KEI Operations Accounting (''KEI''), CL 60; BDO Seidman, CL 80 at 4 & 8–9; KPMG Peat Marwick, CL 82 at 2 & 11–12; Public Company Practice Committee, Colorado Society of CPAs, CL 99 at 1–2; Edwards Leap & Sauer, CPA's, CL 102; Larry D. Cyrus, CPA, Finance Manager, Ericsson, Inc., CL 106; Dennis K. Wilson, Vice President, Finance, and Chief Financial Officer, Beckman Coulter, Inc., CL 113; Jim Brausen, CPA, CL 132; Frank H. Brod, CPA, CL 137; David D. Gathman, CL 141; SABRE, CL 144.

[174] *See, e.g.,* Peter C. Chapman, Teachers Insurance and Annuity Association of America (''TIAA'') and the College Retirement Equities Fund (''CREF''), CL 8 at 4 (''We recognize that an overly broad interpretation of 'improper professional conduct' could create an environment of uncertainty in the accounting profession. This could impair the investment process by restricting the flow of information.'').

[175] Arthur Andersen, CL 98, at 5–7.

[176] Ray G. Stephens, KPMG Peat Marwick Professor, Kent State University, [currently serving as Senior Academic Fellow, Office of the Auditor of the State of Ohio], CL 42 at 4–5. Other accounting academics also expressed strong disagreement with the negligence standard in the Proposing Release. *See* Stella Fearnley and Richard Brandt, University of Portsmouth, United Kingdom, CL 161 at 2.

[177] AICPA, CL 84 at 30–31.

[178] SABRE, CL 144 (''The investing public benefits from an environment in which accountants are free to exercise their best independent judgment without fear that a particular judgment might be viewed as subject to sanction by the SEC.''); *see also, e.g.,* Raymond F. Marin, CL 45 (proposal ''would actually diminish the vital role of accountants as guardians of the financial reporting system''); Edward L. Rand, CL 47 (proposal ''would allow the SEC, with the benefit of hindsight, to disagree with [accountants'] judgments and thereby subject them to sanctions''; ''[s]uch a system is certainly not in the best interest of the investing public''); KEI, CL 60 (proposal ''completely out of line with the philosophy of accountants being able to make business-related decisions and exercise independent judgment in accounting treatment''; proposal will cause accountants to be overly conservative); KPMG Peat Marwick, CL 82 at 2 (''the proposed negligence standard conflicts with the public interest in fostering the exercise of independent accounting judgment, free from fear that any individual judgment could be second-guessed—with the benefit of 20/20 hindsight—by the Commission as part of a Rule 102(e) proceeding''); Dennis K. Wilson, CL 113 (''every time one of our professionals is asked to make a judgment regarding an issue, the fear of subsequently being deemed to have acted inappropriately will be present, which may keep that person from adequately considering all available options and may unduly impact the ultimate decision made''); David D. Gathman, CL 141 (proposed rule ''will serve to weaken [accountants'] role as guardians of the integrity of the financial reporting system''.

[179] Raymond F. Marin, CL 45. Accord Barbara Hutson Gonzales, CL 25; J. Eric Bjornholt, CL 43.

[180] John Sommerer, CPA, CL 46.

[181] Release at 18–23.

authority, wholly independent of Rule 102(e), to address and deter * * * negligent conduct.'' [182] Likewise, in a reprise of the Commission's losing argument in *Checkosky II,*[183] the Release expressly states that an accountant's subjective good faith will have no bearing on a finding of liability under the negligence-based provisions of the new standard.[184] I find these passages positively Orwellian: the Commission seems to be saying that if our staff disagrees with an accounting judgment call, even if we do not sue you under Rule 102(e), we will find a way to sue you for some other violation.[185] Either way, the chilling effect on accountants' professional judgment caused by the Commission's return to the discredited *in terrorem* tactics of the *National Student Marketing* era surely remains the same.[186]

[182] Release at 20; *see id.* at 12 & n.29 (a ''single judgment error'' may not subject ''the person committing such an error to discipline under Rule 102(e),'' but that person ''would be exposed to the sanctions available under * * * other provisions''); *see also id.* at 21 & n.47 (''an isolated error in judgment,'' even if not actionable under Rule 102(e), ''could have legal consequences''). *Accord id.* at 23 (noting ''the availability of [Commission] remedies other than Rule 102(e) to address ordinary negligence'').

[183] 139 F.3d at 224 (referring to Commission argument that Rule 102(e) does not require proof of any particular mental state, but that mental state was ''relevant only to the choice of sanction'').

[184] Release at 33 (While the negligence aspects of the new standard ''do[] not require subjective inquiry into the accountant's intent * * * [, t]he Commission may, however, consider the accountant's good faith when determining what sanction would be appropriate.'').

[185] How times have changed. Barely three years ago, the Commission's then-General Counsel disclaimed any resort to administrative cease and desist proceedings as a means to circumvent the Commission's prudential limitations on bringing ''original'' Rule 102(e) proceedings against lawyers. *See* Lorne & Callcott, *supra* note 19, 50 Bus. Law. at 1316–17; *see also supra* note 44.

[186] *See* Mary C. Daly, *Resolving Ethical Conflicts in Multijurisdictional Practice—Is Model Rule 8.5 the Answer, an Answer, or No Answer at All?,* 36 S. Tex. L. Rev. 717, 781 n.261 (1995) (''The SEC has been particularly adept at using its licensing scheme as an *in terrorem* weapon to 'encourage' lawyers to police their clients to prevent securities law violations.''). Many commentators have accused the Commission of improperly using Rule 102(e) to second-guess a professional's judgment. *See, e.g.,* Kenneth J. Bialkin & Chase A. Caro, *Issuer Fraud and Financial Reporting,* 692 PLI/Corp 299, 343 & 350 (PLI Corp. Law & Practice Course Handbook Series No. B46927, 1990) (Commission has ''used Rule 2(e) to second-guess the accountant's professional judgment,'' citing cases; ''in many instances [GAAS] call upon the accountant to exercise professional judgment, yet the SEC is using its disciplinary proceedings to second-guess that judgment,'' citing cases; ''[t]he SEC has, in many cases, instituted disciplinary proceedings in situations where the accountant's treatment of a given issue has a reasonable basis in accounting literature''); Downing & Miller, *supra* note 17, 54 Notre Dame Law. at 789–90; Crane, Note, *supra* note 17, 53 Fordham L. Rev. at 355.

C. The Costs of The Standard Will Exceed Its Benefits

The Release asserts ''the Commission continues to believe that the amendment will impose no costs.'' [187] I find this statement highly questionable, to say the least. The whole point of the Commission's adoption of a new Rule 102(e) standard for accountants and its recently announced crackdown on purportedly improper accounting practices is to require more care and greater scrutiny on the part of accountants. But increased care and scrutiny are not cost-free items. Clearly, accountants will have to devote greater time and effort to performing audits. I suspect that accountants will pass these costs along to their audit clients, as well they should. While one could argue that increased care and scrutiny might produce net benefits, one cannot reasonably argue, in my view, that they have no associated costs.

Moreover, I disagree that the new standard will produce net benefits. Rather, I concur with the numerous commenters who offered compelling arguments why the standard contained in the Proposing Release will not result in significant benefits.[188] I do not think that the revisions made to the standard in the Proposing Release redress these problems, and, accordingly, these comments have equal applicability to the Standard. For instance, one commenter asserted that, under the standard in the Proposing Release:

> audit and tax fees from a continuing audit would substantially increase. The steps and costs to take a company public would escalate. The difficulty of conducting day to day business affairs should the amendment become effective could be staggering.[189]

Another commenter stated that the proposed amendment might well ''shift the focus to more 'CYA' type behavior rather than making sure that the information is accurate.'' [190] A third commenter persuasively argued that:

> If an auditor has to be looking over his shoulder, for fear of losing his livelihood, his work will be bogged down in trying to get the absolute answer. Labor costs will soar on audits and the public ultimately will not be served.[191]

The ABA comment letter observed that the standard in the Proposing Release could well deprive the public of competent auditors, and that, since ''the number of accounting firms providing audit services to public companies has declined sharply in the past 20 years,'' this decline, combined with the consolidation occurring in the accounting profession, might have the effect of increasing audit fees.[192] I do not think the Release adequately refutes these comment letters.[193]

In my view, the costs of today's proposal will substantially outweigh its benefits. I have long had an interest in promoting small business, and I think the proposal will, in all likelihood, drastically increase the audit costs for start-up and small public companies. These costs will amount to an unwarranted drag on capital formation.

[187] Release at 41.

[188] *E.g.,* ABA, CL 81 at 7; AICPA, CL 84 at 30–31; Arthur Andersen, CL 98 at 6.

[189] SABRE, CL 144.

[190] Jay Shah, CL 95.

[191] RFoggnwl@aol.com, CL 65.

D. The New Standard Will Unfairly Disadvantage Small Firms

Several commenters wrote that the standard contained in the Proposing Release would unfairly eliminate or lessen the ability of small firms or sole practitioners to audit public companies.[194] I think these comments have merit, and that, in this regard, the Release shares the same flaws as the Proposing Release. In my view, smaller CPA firms can and do play a vital role in auditing public companies, particularly smaller public companies.

One commenter noted that raising the level of ''professional risk'' might preclude ''many smaller CPA firms from participating in [audits of public companies]'' and that ''at least for [small business] registrants, * * * smaller CPA firms can often provide better and more affordable service.'' [195] Another commenter similarly remarked that the proposed amendment would ''further restrict the participation in SEC practice to the few 'good ol' boys' who currently dominate in that area.'' [196] The ABA comment letter expressed concern that sanctions imposed under the new standard might be applied in a disproportionate manner and have a disproportionate effect on smaller firms.[197]

[192] ABA, CL 81 at 7; *see also* BDO Seidman, CL 80 at 9 (June proposal threatens to '' 'flush[ ] the baby down the drain with the bathwater' '').

[193] Release at 37–41.

[194] *See, e.g.,* Edmond B. (Ted) Gregory, CPA/ABV, CBA, Linton, Shafer & Company, P.A., CPAs, CL 22; John G. Ratliff, CL 27; John Sommerer, CPA, CL 46.

[195] John G. Ratliff, CL 27.

[196] John Sommerer, CL 46.

[197] ABA, CL 81 at 12; *see Touche Ross,* 609 F.2d at 582 n.21 (noting but not deciding unfairness of holding national accounting firm with more than 500 partners vicariously liable under Rule 102(e) for alleged misconduct of two retired partners); *see also* Coppolino, Note, *supra* note 17, 63 Fordham L. Rev. at 2248 (Under Rule 102(e), ''[t]he Commission appears to impose lighter sentences on Big Six firms as compared to solo practitioners and small- or medium-sized firms.''). *Cf. Blinder, Robinson & Co. v. SEC,* 837 F.2d 1099, 1112 (D.C. Cir. 1988) (expressing ''concern'' that SEC may impose more

These last comments seem indirectly validated by the Release, which notes both that most of the accounting and auditing practiced before the Commission is ''conducted by the 'Big Five' firms'' and that ''three of the largest five accounting firms * * * suggested that the Commission could appropriately adopt'' the Standard.[198] It seems that these large firms have a different perspective as to the likely effects of the Standard on their respective businesses than do their smaller competitors.

VI. The Commission Has Failed To Comply With the Administrative Procedure Act

I am more interested in the substance of today's amendment than with the procedures used to adopt it. It appears, however, that the Commission may not have fully complied with the requirements of the Administrative Procedure Act (APA) in adopting the amendment.[199] In particular, I have concerns that the Commission may have failed to give adequate notice that: (a) the Standard would apply to conduct occurring before its effective date; and (b) as to the subpart (B)(1) of the proposed amendment, the standard of ''highly unreasonable conduct'' might be adopted.

Under the APA, an agency fulfills its obligation to give adequate notice if it '' 'provide[s] sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully.' '' [200] The general test for whether an agency has to provide new notice and resolicit comment on a revised proposal before adopting it, as is the case with the proposed amendment to Rule 102(e), is ''whether the final rule promulgated by the agency is a 'logical outgrowth' of the proposed rule.'' [201] The Release states that the new standard will be used in ''all cases considered after the amendment's effective date, * * * regardless of when the conduct in question occurred.'' [202] Any potential application of the new standard to conduct occurring before its effective date was not mentioned and is not a ''logical outgrowth'' of anything contained in the Proposing Release.

As to the ''highly unreasonable conduct'' part of Rule 102(e)(1)(vi)(B)(1), the situation is less clear. The Proposing Release did mention that the Commission was considering possible standards, including that of recklessness, other than that proposed.[203] The ''highly unreasonable'' standard adopted, however, was not specifically mentioned anywhere in the Proposing Release. The Release even admits that ''new terminology—the 'highly unreasonable' standard'' is included in the new rule.[204] Because this ''new terminology'' was not included in the Proposing Release the Commission deprived interested parties of the opportunity to comment meaningfully on the new standard of liability under Rule 102(e).

Moreover, regardless of whether the Commission has achieved technical compliance with the APA, I strongly believe that the Commission would have been better served if it reproposed the Standard for notice and comment, thereby allowing interested parties the opportunity to provide us with their insights on its advantages and disadvantages. It is not clear what, if anything, the Commission has gained through its rush to adopt the Standard.

VII. The Commission Intends To Expand Its Authority Under Rule 102(E) Even Further

Although predicting the future is necessarily an inexact science, ominous signs already exist regarding the Commission's intentions to expand its authority under Rule 102(e). As previously noted, within days of the adoption of the new Rule 102(e) standard on September 23, 1998, the Commission announced a major new initiative to address improper accounting practices.[205] For the sake of all accountants with an SEC practice, I hope that the Commission's recently announced crackdown does not represent a return to the days of *National Student Marketing and Arthur Young,* and a new '' 'reign of terror.' '' [206] But that remains to be seen. In my view, the accounting profession has already sustained irreparable harm from the Commission's adoption of the new standard on September 23, 1998. In particular, I believe that the new amendment will have a chilling effect on the independent professional judgment of all accountants who practice before the Commission.[207]

As also noted above, the amendment creates an imbalance between the treatment of lawyers and accountants under Rule 102(e).[208] Although I do not foreclose the possibility that a valid rationale may exist to justify this disparity, the Release offers none.[209] The reason for this omission was made clear by the discussion at our open meetings on June 12, 1988, and September 23, 1998—some at the Commission intend to ramp up our Rule 102(e) enforcement program as to lawyers. While I still have some hopes that the institutional lessons learned from the *National Student Marketing* debacle might ultimately prevail, it seems clear that some at the Commission would like to apply the new Rule 102(e) standard to lawyers, as well as accountants.

To accomplish this goal, presumably the Commission would have to overrule *William R. Carter.*[210] Again, I hope these events do not come to pass, but I fear that, absent judicial intervention, they will happen.

* * * * *

Unfortunately, although acting in good faith, it seems that the Commission is bound and determined to repeat its past mistakes. For the good of all professionals who practice before us, as well as the Commission itself, investors and issuers, I hope that these matters receive definitive clarification sooner rather than later.

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disproportionately heavy sanctions on ''small, newer [brokerage] firms than it does on old-line, or at least more established houses'').

[198] Release at 21 & 34.

[199] 5 U.S.C. 553(b) & (c).

[200] *American Water Works Ass'n v. EPA,* 40 F.3d 1266, 1274 (D.C. Cir. 1994) (quoting *Florida Power & Light Co. v. United States,* 846 F.2d 765, 771 (D.C. Cir. 1988)).

[201] *Id.; see also Omnipoint Corp. v. FCC,* 78 F.3d 620, 631 (D.C. Cir. 1996).

[202] Release at 6.

[203] *See* Proposing Release, 1998 WL 311988 (S.E.C.), at *5.

[204] Release at 22 n.49.

[205] *See supra* note 6 and accompanying text.

[206] Block & Hoff, *supra* note 37, N.Y.L.J., Sept. 23, 1993, at 5.

[207] *Cf.* Judah Best, *supra* note 17, 36 Bus. Law. at 1817 (noting Rule 102(e)'s ''chilling effect upon counsel,'' and referring to Rule 102(e) as ''a vehicle for abuse'').

[208] *See supra* Section V.A.

[209] *See Keating, Muething & Klekamp,* 47 S.E.C. 95, 110–11 (1979) (Commissioner Karmel, dissenting) (as result of the Congressional grant of power to define accounting terms and to require that financial statements be certified by an independent public accountant, ''[i]t therefore can be argued'' that the Commission may have authority to discipline accountants that it lacks for lawyers).

[210] 47 S.E.C. 471.