

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

ACCOUNTANTS: A FLEXIBLE STANDARD

An Address By

A. A. Sommer, Jr., Commissioner
Securities and Exchange Commission

American Bar Association
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Professional Liability
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A. A. Sommer, Jr. *
Commissioner
Securities and Exchange Commission

Early in 1973 a symposium was held at Northwestern University concerning forecasts. Throughout the discussion there was a pervading concern with the liability consequences to issuers and their auditors if the proposals of the Securities and Exchange Commission concerning forecasting were implemented. At the end of the second day of the conference John Hull, the Director General of the Panel on Take-overs and Mergers in Great Britain, expressed his growing amazement at the apparent preoccupation of everyone there with the problem of liability and he suggested that perhaps this had clouded rational consideration of the objective merits of such proposals as those pertaining to forecasting.

It is not surprising that he would experience such surprise. In England, and other countries, the art of litigation against those associated with corporate enterprise has not been as keenly developed as it has in the United States, perhaps in some measure because they have not yet adopted our concepts of the class action. More importantly, in my estimation, they have developed there other means of social control. The overriding influence of the limited number of merchant bankers goes far to thwart objectionable corporate conduct; the spectre of social ostracism is probably stronger; the centralization of financial life in London does much to reinforce the capacity of informal and non-legally sanctioned means, such as the Take-over and Merger panel, to prevent or effectively punish transgressions.

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Without those restraints we in the United States have relied heavily upon litigation, and the threat of litigation, to accomplish effective control of corporate conduct. This may seem a harsher means to many, but few doubt its effectiveness, although perhaps that proposition is not as clear as it was when we reflect on recent corporate misdeeds.

Furthermore, the present upsurge in litigation is in large measure the consequence of the turbulences of our times. Historically we have always tended to accomplish much social change through the courtroom. As de Tocqueville long ago said, "Scarcely any question arises in the United States which does not become, sooner or later, a subject of judicial debate." Thus in a time when consumerism is rampant, when the expectations of society with respect to those upon whom it has historically bestowed prosperity and preferential position in society, it is only expectable that when those expectations are frustrated people will have recourse to courts.

Many things have contributed to this upswelling of corporate litigation: more people own securities, plaintiffs' counsel are more aggressive, the flimsiness of some of the conceptual barriers to the extension of liability is better realized, it is recognized that often legal doctrines with nothing more to recommend them than their antiquity have often prevented those suffering harm from securing retribution from those who did the wrong. Equity Funding, Penn Central, Equity Realty, IOS, National Student Marketing, Four Seasons: everyone of those names is representative of thousands of public investors who trusted and lost. Is it any wonder that those deceived seek out their deceivers?

The Commission has been one of the principal instrumentalities through which these historical movements have been accomplished - - and it should be. While the Commission is an independent agency, its funding depends upon the Congress and the Executive and thus it must, to some extent, as must the Congress and the Executive, be responsive to the needs and wishes of the people - - and the people want redress for the wrongs they have suffered. If there is any doubt of Congress's concern with the level and effectiveness of the Commission's efforts to right wrongs, I suggest a perusal of the record of the Congressional hearings on the Commission's budgets.

Reflecting the the forces I've mentioned, the Commission's enforcement activity has clearly increased in recent years. In 1970 the Commission brought 111 injunctive actions; in fiscal 1974 we estimate we will bring 182. In 1970 it brought 138 administrative proceedings; in fiscal 1974 we estimate we will bring 158. And judging by what we know of the current activities of our Enforcement Division, inevitably some of those are going to involve accountants.

What is the Commission's power with respect to accountants - - and how does it exercise it?

Viewed most broadly, the Commission has a mandate from Congress to protect investors from fraud and deception and insure the integrity of the market place for securities. And Congress has given it tools to accomplish that. One of these is the power to bring actions to enjoin wrongdoers from repeating their conduct.

With this power and this mandate, clearly the Commission must enforce the laws and it must bring to book those involved in their violation, regardless of their position in the community or their professional status. This means that if heretofore respected business men, professionals, government officials are involved in harming investors or attacking the integrity of the market place, they may not be excused because of their eminence.

Remarkably the accountant's liability qua accountant is dealt with explicitly only in one part of the statutes we administer (and then only because he falls in the category of "expert"): that is in Section 11 of the 1933 Act, and that section provides only a private remedy for its violation and makes no provision for Commission enforcement of accountants' derelictions under it.

The principal source of Commission enforcement activity against accountants - - and many people for that matter - - is that amazing, vital, pervasive creature of administrative expediency, Rule 10b-5, adopted under the broad power given the Commission under Section 10(b) of the 1934 Act. This rule makes it unlawful to engage in fraudulent, deceptive, or misleading practices in connection with the purchase or sale of securities. The language is

maddeningly broad, and the courts have chosen repeatedly to extend its applicability to the farthest the words will allow. The Commission is also given a similar power under Section 17(a) of the 1933 Act which makes unlawful the same conduct Rule 10b-5 does, only it is limited to sales of securities. Violations of those provisions may also constitute criminal conduct; the Commission, of course, does not bring criminal actions, but instead refers cases which appear to have criminal implications to the Justice Department for processing.

In addition to the powers the Commission has under Section 17(a) and Rule 10b-5, it also has the power to, and has, adopted rules of practice governing those who practice before it and the manner in which the practice is done. Rule 2(e) of those rules applies peculiarly to professionals. It provides that the Commission may deny permanently or temporarily the privilege of appearing and practicing before it to persons (1) found not to possess the requisite qualifications to represent others, (2) lacking in character or integrity or who have engaged in unethical or improper professional conduct, or (3) who have willfully violated, or aided and abetted the violation of, any provision of the federal securities laws.

Rule 2(e) actions have almost invariably been private proceedings, with the public knowing nothing of the existence of the proceeding or its course until a final determination. Most so-called 2(e)'s travel a lengthy and tortuous course, replete with long delays, intricate procedural finesses, and much frustration. In most cases they end in settlement. The Commission recently asked for comment on a proposal that instead of 2(e)'s being private unless the Commission specifically determines otherwise, the reverse would be true: a proceeding would be public unless the determination was to make it private. This proposal is eliciting extensive and, frankly, sometimes harsh comment. I would emphasize that, in the vernacular of this gathering, the jury is very much still out on that issue and no one should conclude from the publication of the proposed change that the Commission has made up its mind and is now going through a ritual before announcing an already reached conclusion.

2(e)'s exact no direct penalty from the respondents. The most the Commission can do is bar a practitioner from appearing before the Commission. This stricture is construed broadly,

and in the case of an accountant, would deny him not only the right to participate with a client in conferring with Commission personnel, but would make unacceptable in any Commission filings statements covered by his opinion.

The very limited nature of the remedies available under Rule 2(e) has posed difficult problems for the Commission, particularly when dealing with national and international accounting firms. Very often the conduct which has led the firm into a 2(e) proceeding involved a minute fraction of the personnel of the firm; one office out of dozens, three or four people out of thousands. And yet often the shortcomings which have occasioned the proceeding were really rooted in poor supervision which extended high in the organization, insufficient controls mandated or enforced, inadequate training for the complex assignments given. Hence in many instances the Commission has felt compelled to name national firms in such proceedings.

I would emphasize that the conduct which may give rise to a Rule 2(e) proceeding is not necessarily of the same sort as would justify an injunctive or criminal proceeding. As indicated, absence of professional qualifications or ethical insufficiency may be enough. This circumstance makes it difficult to fashion appropriate remedies that do more than simply substitute faces in our conference rooms and new names on filed financial statements.

Indications of an approach preferred by the Commission can be seen in two recent proceedings which were settled by consent. In both cases, an important part of the settlement was an agreement by the firms to adopt improved control procedures and to permit, after the procedures had been in effect for a year, an inspection of their practices by a peer review team made up of professional accountants under the auspices of the AICPA to determine whether the agreed upon procedures were being adequately followed. In each case, the review team will report its findings to the Commission.

In addition, the firms had various constraints placed on their ability to take on new SEC business while procedures were being established and implemented. In one case, a 30-day suspension period was established during which no new SEC clients would be accepted by the firm. In the other, one of the firm's offices was prohibited from accepting new SEC clients for a

year and the firm as a whole was prohibited from accepting any new SEC business in a specified industry area until the firm's revised audit guides and programs in that area were adopted and tested to the satisfaction of the Commission's Chief Accountant.

We believe this approach is promising. It provides some assurance through review of control procedures that the possibility of recurrence of such problems will be significantly reduced, with benefits both to the public and to the firm and in the meantime it provides for limitations on practice growth in affected areas until there are assurances that such growth will not impair quality. The Commission is in the process of cooperating with the AICPA to develop a procedure under which the latter would establish a subsisting ongoing capacity to make such inspections both as part of their own program for improved profession-wide quality control and in cases where such inspections become part of a settlement or order in a 2(e) or injunctive proceeding.

I would pause to emphasize the value of this approach. It is not intended to be punitive or retributive; rather it is intended to provide the stimulus for the firm to review, with the assistance of disinterested professionals, the adequacy of controls and supervision so that the possibility of a recurrence of violations, with perhaps even graver financial and other consequences, is minimized. It has been charged that it is the ultimate design of the Commission to create situations which would result in all the "Big Eight" being under such review procedures. Nothing could be further from the truth. There is no such plan or intent. As proceedings develop we will deal with them one at a time, without plan or design to subject the profession to the thumb of the Commission. And it has been charged that this procedure jeopardizes the records of the clients of the firm reviewed and places the firm at a competitive disadvantage vis-a-vis the firms from whence come those who do the review. In the case of at least seven of the eight of the "Big Eight" and most of the second tier firms these are phantom concerns, since they have agreed to assist in the implementation of the program, which, I might add, the Board of Directors of the AICPA has approved on an experimental basis. Again, be

assured that measures will be used to prevent the untoward results foreseen by the critics of this approach.

In the final analysis, the Rule 2(e) proceeding is not the Commission weapon most dreaded by the accounting profession; rather it is the injunctive proceeding and, even more so, the criminal reference.

The injunctive proceeding often occurs in a total context which includes civil litigation seeking huge damages from the accounting firm. In some cases the Commission action follows - - sometimes by quite a period of time - - the commencement of private litigation, in others it precedes.

The most difficult problem the Commission confronts whenever it considers a recommendation for the commencement of an injunctive proceeding by the staff is: what is the standard of conduct to which we think accountants should be held? Is it negligence? Is it recklessness, indifference to economic reality? Must there be an element of knowledge or "should have known"ness? What is the measure of, to use that fine old misused word, scienter?

The first thing I would say with regard to this is this: the Commission does not consider the auditors the guarantors of the integrity, solvency, honesty, or conduct of their clients. Auditors can be duped just like investors or anyone else and we have refused to authorize actions when it appeared they were the victims of their clients, rather than actionable abettors of their misconduct.

Likewise we do not bring actions because we disagree with the judgments of the auditors - - unless, of course, that judgment is so bad that it leads to inferences of a state of mind inconsistent with the integrity demanded of those who practice the accounting profession. We recognize that auditors can differ in their judgments with regard to the propriety of the application of an accounting principle, or the selection of the accounting principle to apply. But on the other hand, the existence of some authority to support a position, while persuasive, is not conclusive with regard to the Commission's determination to authorize an action; much more is involved in a Commission proceeding.

It seems to me that engaging in extensive discussions of whether the standard of care for accountants is negligence, or recklessness, or willfulness, or knowledge, or should have known-ness is a bit of a waste of time. I doubt very much whether a jury properly instructed engages in that kind of discourse in trying to determine the liability of an accountant in a private action and I doubt if the Commission should in concluding whether to bring an action.

I think the old mechanistic application of traditional common law concepts is eroding in the Rule 10b-5 context. In his seminal article, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scierter, Mr. Bruce Mann of San Francisco said:

“Instead of perpetuating the practice of discussing scierter and negligence as absolutes which are capable of being objectively applied, more is gained by recognizing that there is a sliding scale which determines what constitutes sufficiently diligent conduct to avoid 10b-5 liability, and that 10b-5 liability is determinable only within the context of the vagaries of the specific facts presented.”

In specifying applications of this mode of analysis in decided cases, Mr. Mann referred to Drake v. Thor Power Tool Co. (282 F. Supp. 94 [N.D. Ill. 1967]) which stated that since the defendant, a national accounting firm, purported to be independent certified public accountants, it “has assumed a peculiar relationship with the public.”

These thoughts have been echoed by the Ninth Circuit in White v. Abrams (CCH [Current] Fed. Reg. of Sec. Rep. para. 94,457) which stated:

“The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standards with traditional fault concepts which tend to cloud rather than clarify. . .”

Again in specifying this concept, the court said:

“Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that the plaintiff completely relies upon him for information to which he has

ready access, but to which the plaintiff has no access, the law imposes a duty upon the defendant to use extreme care to assure that all material information is accurate and disclosed.”

The Court went on:

“Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defendant’s duty under Rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant’s access to the information as compared to the plaintiff’s access, the benefit that the defendant derives from the relationship, the defendant’s awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant’s activity in instituting the securities transaction in question.”

White v. Abrams did not involve accountants, hence the court’s specifications of the relevant inquiries are not directly pertinent in assessing the conduct of accountants. However, the approach, the departure from the conventional inquiries concerning negligence, scienter, and the like is, I think, an appropriate one in this context. Instead of trying to measure conduct by the ambiguous standards customarily employed, I think one must look to the nature of the duty properly imposed upon the auditor, the extent to which his work is expectably relied upon, the indications of departure from accepted norms of the profession, the suggestions of submission to pressures from clients, the extent of his awareness of the picture the financial statements present to one relying upon them, the seriousness of consequences if care is not exercised.

Of course, this is troubling to us as lawyers. As lawyers we like clear guides to use in advising clients. But I would submit that the factual circumstances surrounding corporate conduct today are too complex, too varied, too multi-faceted to rely upon the old mode of analysis and hence I think the Commission should assess the desirability of ordering enforcement action on the basis of its total conception of the auditor’s role in the particular situation. This must include an examination of the entire pattern of conduct. What warning flags were flying? What evidences met the eye which might dictate further inquiry? What was the relationship of

the auditor to the client? To what extent did the selection of accounting principles and their application by management magnify earnings?

Auditors are paid -- and handsomely -- for their services of auditing and reporting. It is now too clear to demand much exegesis that their responsibility is to the public and not only to management or the bankers of a company; indeed, as long ago as 1912 a distinguished investment banker argued to a meeting of accountants that the investing public was as much the client of accountants as existing shareholders and owners. Thus their duty is clear; it is to perform their auditing and reporting functions in a manner that is protective of that client, the investing public.

Thus I would suggest that some conception of their duty may be perceived by thinking in terms of what that client wants and needs. Bearing in mind that that public investor is going to rely upon financial statements enjoying the authority of the accountant, do the financial statements present a picture that he could reasonably rely upon to choose to invest in this company rather than another? Has sufficient care been exercised within reasonable parameters to be able to give that assurance?

Put very simply, when the Commission discerns that the auditor has not been alert to his duty, that he has gone through an exercise by rote, that he has not been true to the duty of fair presentation, then in my estimation the Commission should properly authorize an action to enjoin the accountant from a repetition of those faults.

The most recent instance in which the Commission confronted the issue of auditor responsibility was the action arising out of the collapse of Penn Central. In that case the Commission charged that certain transactions had been recorded, and implicitly approved, by the auditor by its certificate, in an improper manner which inflated income. More important, the Commission charged that the statements opined upon did not make a fair presentation of the financial position and the operating results of the company. These charges say that there was a failure in informing the investor that he was not receiving the kind of picture he needed to make

an informed investment decision and that the auditors simply did not exercise the degree of care commensurate with their duty to those they knew would rely upon their work product in deciding whether to buy, hold or sell Penn Central Stock.

Auditors, of course, recoil from the notion that they should be held responsible for compliance of financial statements with a standard that is essentially more ethical than legal. However, it seems to me, and this thought is echoed by more than one leader of the accounting profession, that it is that judgment of the auditor that the investor needs more than his judgment concerning mechanical compliance with GAAP. Frequently accountants complain that the effort to winnow down the acceptable accounting principles to one for each set of facts denies them the opportunity for professional judgment. Surely no greater opportunity for truly professional judgment is presented than the opportunity to make this judgment of fairness. Without discoursing at undue length, I believe that in time this responsibility will rest easily upon auditors and they will rise to the challenge in making this critical determination.

As a consequence of the litigious mood of the day, and not simply as a consequence of Commission actions accounting firms have charged in suits claiming many millions of dollars; if full relief were granted in all the pending cases the structure of the accounting profession would be profoundly altered. This is unlikely to happen since in most instances the cases will be settled for amounts within tolerable limits and those litigated will not likely result in judgments payable by the accountants beyond their reasonable financial capacities.

Nonetheless, none of us can be indifferent to the potential of this litigation. While auditors are paid good fees for their services, still there is no record of any major accounting firm profiting beyond those fees because of the wrongdoing of a client; they do not wax rich on the proceeds of fraud. Hence it seems to me reasonable that we should concern ourselves with the possibility of limiting the exposure of auditors to unbearable liability.

One approach to that is contained in the proposed Federal Securities Code which is being formulated by Professor Louis Loss and his advisors, with the approval and involvement of the American Law Institute. In that Code the liability of a party which did not knowingly participate

in the wrongful conduct would be limited to the greater of \$100,000 or 1% of gross income during its previous fiscal year, to a maximum of \$1,000,000, for each misrepresentation or omission, regardless of the number of times it was repeated in multiple filings or documents. Judging by the income of the one firm which has disclosed such income information, the exposure to liability for large firms would be substantial enough to be an effective deterrent, but the spectre of liability extending into the hundreds of millions because of one error would be obliterated.

It seems to me that there is a price accountants should pay for this limitation of exposure and that is a heightened awareness of their responsibility, a greater willingness to involve themselves in expanded responsibility for the integrity of their clients' whole financial reporting process. This means involvement in interim statements (though not the auditing of them), responsibility for the entire reporting process, and generally much deeper concern for the manner and means by which issuers keep the investing public informed concerning its financial affairs.

The Commission is often criticized for its proceedings (and Commissioners for their speeches) because they allegedly cast a cloud of suspicion over the entire profession. It is asserted that when a firm is named, confidence in it and the profession is undermined to the alleged detriment of the entire business community. Further, it is asserted that our proceedings result in the expansion of the activities of auditors, with resulting increased costs for firms which employ them.

Unfortunately, any enforcement proceeding is going to cast a shadow over the one involved in it. When the Anti-Trust Division charges disregard of the nation's anti-trust laws, there is a stigma which attaches to defendants. When charges are made that environmental requirements are violated there is a cost in terms of public prestige. I submit it is not possible to enforce the laws of the country in secrecy -- and the Commission is mandated by Congress to enforce the securities laws. It is not possible, and it is not effective, to silently admonish wrongdoers to do better the next time. And it certainly is not right or just or fair to accord one group of wrongdoers the benefit of a quiet resolution of complaints while subjecting others --

their clients -- to the full curse of public charges. Would it have been fair to tell Bar Chris and its officers that they had done wrong, and quietly admonish their auditors in private?

Unquestionably Commission enforcement actions have resulted in greater care on the part of auditors which clients have paid for. But I submit this is one of the costs of being publicly held, or having the use of the public's money in carrying on corporate enterprise. The losses in one debacle far exceed the total costs of the audits of most of a goodly portion of the 500 largest corporations in the country. Increased diligence, better disclosure, and greater financial integrity are benefits that justify the additional cost of full compliance with the federal securities laws.

I would suggest that every accounting firm in the United States that audits the financial statements of publicly held companies has as a consequence of Commission enforcement proceedings reviewed their practices and procedures, their controls, their standards, their supervision and their overall competence -- and frankly, our experience today indicates that this has resulted in considerable upgrading of performance. The extent to which investors are given benefits heretofore denied them is not capable of exact measurement; however, it would be naïve to deny it has been substantial.

The Commission has no vendetta against the accounting profession; it does not seek to harass them into total dependence upon federal bureaucracy. It does, however, wish it to rise to the challenge that is posed by its critical role in the entire investment process. Today as never since the early 30's the financial markets in our country are going through a crisis of confidence. Essential to the restoration of that confidence is belief on the part of investors that they are being given the truth, the whole truth, and nothing but the truth, about the affairs of the corporations in which they invest. The accounting profession has the opportunity to contribute mightily to that restoration of confidence.