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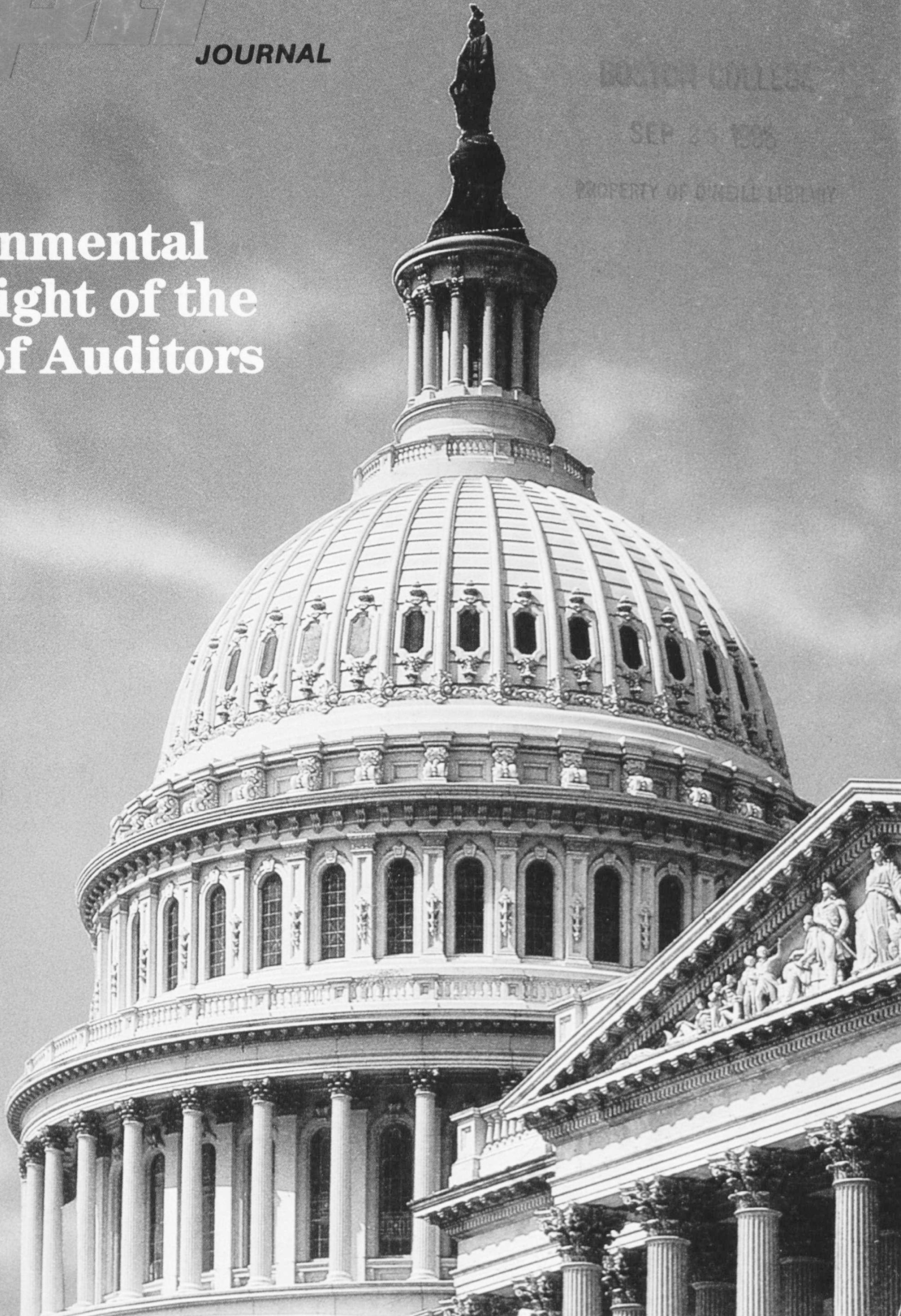

SEC COMMENTARY

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The Liability of Accountants Under the Securities Acts

Within the context of the general trend toward expanding legal liability which permeates our society, the accounting profession has certainly not escaped unscathed. The days when professions were largely autonomous, self-regulated, and immune from significant external legal influences are over; and some legal commentators interpret this change as a threat to the accounting profession. While the profession has strengthened its standards and is considering ever more rigorous educational requirements, the liability explosion and the increasing disciplinary activity of administrative agencies, such as the Securities and Exchange Commission (SEC), have created an environment which necessitates an assessment of the law's treatment of accountants.

Statutory Liability of Accountants

The main sources of accountants' federal statutory liability are Secs. 11 and 17(a) of the Securities Act of 1933 and Secs. 10(b) and 18 of the Securities Exchange Act of 1934. Sec. 11 of the 1933 Act imposes a duty of due care on accountants practicing in securities transactions; and Sec. 18 of the 1934 Act provides for a good faith defense to otherwise actionable conduct taken under the 1934 Act, which prohibits false and misleading statements filed pursuant to it. Under Rule 10(b)5 of the 1934 Act, however, mere negligence is not enough to incur liability; intentional misconduct is required.

Rule 2(E) of the SEC's Rules of Practice

Perhaps the most striking development in the federal statutory area having a bearing on accountants is the increased oversight and regulation of the profession by the SEC, under its Rule 2(e) of the Rules of Practice.

The Securities and Exchange Commission (the Commission) is the administrative creature of the Securities Act of 1934. The Act delegates to the Commission the power to "make such rules and regulations as may be necessary or appropriate to implement the provisions of the Act for which it is responsible or for the execution of the functions vested in it by the Act."[1] Pursuant to this general grant of rule-making power, the SEC promulgated reg. 201.2(e) as part of its body of rules governing the procedures, standards, and practice of its proceedings.

Rule 2(e) appears to empower the SEC to create its own bar of professionals who practice before it, all of whom are subject to the professional standards enunciated by the Commission. One who practices before the SEC must "possess the requisite qualifications." He/she must not be "lacking in character or integrity." The negative proscriptions of the rule are somewhat less vague. The SEC professional must not have engaged in willful or "improper" conduct, or have "willfully violated" any federal securities law (or have assisted another in doing so).

The constitutional validity of this type of administrative regulation of the accounting profession is illustrated by the case of *Touche Ross* v. *SEC.*[2] In *Touche Ross*, the plaintiff accounting firm, along with three of its former partners, brought an action seeking to enjoin the SEC from conducting its first public 2(e) proceeding. Touche Ross framed its argument in terms of authority, asserting that the SEC lacked the statutory power to regulate and discipline the accounting profession. The court, however, did not agree:

> We reject appellants' assertion that the Commission acted without authority in promulgating Rule 2(e). Although there is no express statutory provision authorizing the Commission to discipline professionals, Rule 2(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.[3]

The SEC's implementation of the rule has met with much criticism. Some commentators have argued that the SEC lacks the authority to regulate and discipline professionals, echoing the arguments made in *Touche Ross.* Others have intimated that the rule violates due process. This much, at least, can be certain: the rule represents a substantial

[1] 15 U.S.C. Sec. 78w(a) (1) (1976).

[2] 609 F.2d 570 (2d Cir. 1979).

[3] *Id.* AT 574.

inroad upon the professional independence of the accountant who practices before the SEC, and exposes him/her to a risk of substantial liability at the hands of an external regulatory entity. The ramifications for the integrity of the profession are obvious:

> Rule 2(e) is one of the primary means by which the SEC exercises control over accountants who practice before it. But the SEC has converted the rule from one designed to serve the limited salutory purpose of exercising disciplinary authority over the incompetent, unethical, or dishonest practitioner to a rule which has effectively been utilized to pervasively regulate accounting firms and the profession as a whole.[4]

The Foreign Corrupt Practices Act

In 1977, Congress enacted the Foreign Corrupt Practices Act (FCPA), which, in addition to its prohibitions against bribery, imposes bookkeeping responsibilities on publicly held companies. It imposes both civil and criminal liability upon violators of its norms. The part of the Act that poses the most significant problem for accountants is Sec. 13(b)(2), which provides, in pertinent part: "Publicly held companies shall make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of their assets." The section also requires that every publicly held company must devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are executed in accordance with certain standards.

At this writing, little relevant case law concerning accountants' liability under the FCPA has developed. The ensuing analysis endeavors to illuminate the road ahead.

While the FCPA, on face value, places the liability burden upon the public company, the nature of the requirements that the Act imposes upon the public company could result in a growing spectre of accountants' liability under the FCPA. As one commentator noted:

> Because the mandated 'books and records' and 'internal accounting control' provisions of the FCPA involve matters within the technical expertise of accountants, companies subject to the Act are likely to engage and rely upon their accountants to develop and review adequate internal compliance systems. This in no doubt foreshadows charges against accountants when the companies themselves are charged with violating the Act's requirements.[5]

The Act, on face value, provides for no private cause of action against violators. This does not mean that a cause of action may not be implied. At present, the lower federal courts seem to be divided on the question. Should such a private right of action clearly emerge, accountants would likely be subject to civil liability for violations of 13(b)(2).

The SEC is clearly authorized to bring civil injunctive suits for violations of the FCPA. Thus, in suits brought against public companies under Sec. 13(b)(2), liability could be extended to accountants on an aider and abettor theory.

Since the legislative history of the FCPA makes plain that the enactment of the Act does not preclude the Commission from utilizing all of its existing remedies under the securities laws, an accountant found liable under the FCPA also could be subjected to a Rule 2(e) disciplinary proceeding. Such a proceeding would be a component of the Commission's general power to institute administrative proceeding under the Securities Acts.

An interesting aspect of the FCPA is its lack of an express materiality requirement. The absence of such a provision, construed to its extreme, would mean that deviation from the standards of the Act, whether material or de minimus, would constitute a violation. As to this issue, the SEC has taken a middle ground, holding that while the traditional materiality standard is not appropriate in the FCPA context, neither would exacting compliance in unreasonable and burdensome detail be required:

> It bears emphasis that the requirements are qualified by the phrase 'in reasonable detail' rather than the concept of materiality .... The statute does not require perfection but only that books, records, and accounts in reasonable detail accurately and fairly reflect the transactions and dispositions of the asset of the issuer.[6]

Whatever the ultimate impact of this "in reasonable detail" standard may be, clearly the lack of an express materiality requirement "will mandate close scrutiny by accountants of their clients' compliance with the provisions of the FCPA."[7]

Attorneys and accountants also are aware that numerous state statutes exist that govern accountants. Since substantial variation may exist from state to state, these professionals must examine each state's statutes for its particular requirements.

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[4] R. Dowling and R. Miller, Jr., "The Distortion and the Misuse of Rule 2(E)," *Notre Dame L. Rev.* 774 (1979).

[5] S. Gruenbaum and M. Steinberg, "Accountant's Liability: Statutory, Criminal and Common Law," 13 *Loy. L. Rev.* 248, 288 (1980).

[6] Securities Exchange Act Release No. 34-15570, *Fed. Sec. L. Rep.* (CCH) 81.959, 81.398 (Feb. 15, 1979).

[7] Gruenbaum and Steinberg, Note 7 *Supra* at 290.

Criminal Liability of Accountants

"No potential legal hazard has so surprised and alarmed the public accounting profession as the spectre of criminal liability." So wrote accounting scholars Paul Hooper and John Page in 1984.[8] The exposure of accountants to the risk of criminal penalties is expanding.

In general, most criminal liability actions against accountants were brought under the federal securities laws, most notably under Sec. 24 of the 1933 Act and Sec. 32(a) of the 1934 Act. The Federal Mail Fraud Statute also is a principal source of criminal liability for auditors. Lately, the accounting profession is concerned with suits brought under the Racketeer Influenced and Corrupt Organizations Act (RICO).

Both Secs. 24 (33 Act) and 32 (34 Act) make willful violations of any provision, rule, or regulation of the respective acts a crime. However, unlike Sec. 24, Sec. 32 uses the word "knowingly" in conjunction with "willfully." Whether the two words are to be construed as synonymous is the subject of debate. However, regardless of whether these two terms are interpreted independently or together, it appears well settled that in a prosecution under either section, a specific intent on the part of the defendant to violate the law need not be shown. In a prosecution under the "willfully knowing" standard of Sec. 32(a), an evil purpose on the part of the defendant must usually be established.[9]

Case law under the criminal provisions of the federal securities laws reveals a tendency toward increasing criminal liability for accountants. In *United States* v. *Benjamin*,[10] the United States Court of Appeals for the Second Circuit held that an accountant cannot "shut his eyes" in the presence of fraud. *Benjamin* involved a prosecution against a certified public accountant who, after preparing pro forma statements relating to his client's financial status, falsely reported that certain assets existed, when no procedures for verification or examination had been used. Responding to the argument that the evidence adduced at trial was insufficient to establish the defendant's criminal state of mind, Judge Friendly held that:

> The government may meet its burden by proving that a defendant closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant . . . Congress . . . could have intended that men holding themselves out as members of . . . ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen, or have represented a knowledge they knew they did not possess.[11]

The issue of the extent to which accountants can rely on generally accepted practices of their profession as a defense to criminal charges was addressed in *United States* v. *Simon*.[12] In *Simon*, accountants were prosecuted for including in their client's financial statements a footnote which concealed looting of the corporation by its president. Eight accounting experts testified at trial that the footnote was not inconsistent with Generally Accepted Accounting Principles (GAAP) or Generally Accepted Auditing Standards (GAAS). The trial judge denied the defendants' request for a jury instruction that would have made proof of compliance with GAAP a valid defense, holding that compliance with such standards is persuasive but not necessarily conclusive evidence of good faith.

The Second Circuit Court of Appeals affirmed, with Judge Friendly once again writing for the court:

> Generally accepted accounting principles instruct an accountant what to do in the usual cases where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has

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[8] "The Legal Environment of Public Accounting," Liv *The CPA Journal* No. 6, 36 at 38 (1984).

[9] *United States* v. *Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976).

[10] 328 F.2d 854 (2d Cir. 1963) *cert. denied*, 377 U.S. 953 (1964).

[11] *Id.* at 863.

[12] 425 F.2d 796 (2d Cir. 1969) *cert. denied*, 397 U.S. 1006 (1970).

> reason to believe that this basic assumption is false, an entirely different situation confronts him. Then . . . he must extend his procedures to determine whether or not such suspicions are justified.[13]

Thus, after *Simon*, compliance with GAAP and GAAS is a defense only in those cases where the auditor has no reason to believe that the affairs of the corporation are not properly in order.

Conclusion

As the accounting profession comes to grips with the storm clouds of legal liability gathering above its head, it will suffer from the financial burdens imposed by swelling monetary damage awards and from the rising cost of professional insurance. Because accountants may be held liable to third parties on the theory that the third party's reliance was reasonably foreseeable, despite the absence of the traditional contractual privity requirements, they will have to raise their audit fees.

Professional uncertainty has been engendered by the possibility of administrative censure or loss of license to practice before the SEC. Thus, the American Institute of Certified Public Accountants and state CPA societies must guide their members through the current legal thicket and lobby for legislative changes to clarify and improve the accountants' and auditors' legal positions, both at common law and pursuant to statute.

These professional organizations must ensure that accountants who comply with the CPA Code of Ethics, GAAP, GAAS, and relevant statutes and regulations are protected from unwarranted legal liability and disciplinary action based upon the hindsights of the courts and administrative agencies. Just as doctors and lawyers have developed defensive modes of practicing their professions, so too must accountants. Advocates for the accounting profession also should consider spearheading a fresh challenge to the broad discipline of practitioners by the SEC pursuant to its Rule 2(e), a rule which might be overthrown or favorably restricted in a carefully selected judicial contest. Ω

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[13] *Id.* at 806–07.