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# The Distortion and Misuse of Rule 2(e)

Robert A. Downing\* and Richard L. Miller, Jr.\*\*

## I. Introduction

Rule 2(e)<sup>1</sup> of the Securities and Exchange Commission's Rules of Practice is one of the primary means by which the SEC exercises control over accountants and other professionals who practice before the Commission.<sup>2</sup> 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.<sup>3</sup>

This expansion of the regulatory process has come without the benefit or inducement of any recent legislative enactment mandating such an approach and has brought into question not only the means by which the Commission has implemented Rule 2(e) but the fundamental issue of the existence and scope of the Commission's statutory authority to undertake any disciplinary action against accountants and other professionals practicing before it. This article will analyze these and other significant issues raised by the Commission's recent 2(e) proceedings.

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1 17 C.F.R. § 201.2(e) (1978).

2 See generally Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1970).

The Commission's arsenal of enforcement tools includes the explicit authority to seek injunctive relief against securities laws violations (Securities Act § 20 and Exchange Act § 21), (discussed at text accompanying notes 32-35 *infra*); and the foremost enforcement power to refer evidence of securities laws violations to the Justice Department for criminal prosecution (Securities Act § 20(b) and Exchange Act § 21(e)). See Matthews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901 (1971); Morrison, *SEC Criminal References*, 11 REV. SEC. REG. 991 (1978). See also *United States v. Fields*, [current] FED. SEC. L. REP. (CCH) ¶ 96,074 (S.D.N.Y. 1977), *rev'd* [current] FED. SEC. L. REP. (CCH) ¶ 96,552 (2d Cir. 1978).

3 For an excellent discussion regarding the usage of 2(e) proceedings against accountants see Bialkin, *Sanctions Against Accountants*, 8 REV. SEC. REG. 823 (1975), and as a means to discipline attorneys, 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). For a critical view of Securities Exchange Commission (SEC) 2(e) proceedings see Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L. J. 747, 762 (1975); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 62-65 (1975). For a statement of the Commission's view of 2(e) proceedings see Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach*, 28 VAND. L. REV. 19 (1975); Garrett, *New Directions in Professional Responsibility*, 29 BUS. LAW. 7 (1974); Gonson, *Disciplinary Proceedings and Other Remedies Available to the SEC*, 30 BUS. LAW. 191 (1975); Sommer, *Accountants: A Flexible Standard*, 1 LITIGATION 35 (1975); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW.U. L. REV. 1, 20-22 (1973); Sonde, *Professional Responsibility—A New Religion, or the Old Gospel?*, 24 EMORY L. J. 827, 836 (1975). For an accountant's perspective of Rule 2(e) see L. RAPPAPORT, *SEC ACCOUNTING AND PRACTICE*, 18-31 (1972); Jaenicke, *The Effect of Litigation on Independent Auditors*, COMMISSION ON AUDITOR'S RESPONSIBILITIES, RESEARCH STUDY NO. 1, 46-53 (AICPA, 1977).

## II. The Commission's Authority

Rule 2(e)(1) provides that the Commission may deny, temporarily or permanently, the "privilege" of appearing or practicing before it in any way to any person who is found by the Commission, after notice and hearing:

- (i) not to possess the requisite qualifications to represent others;
- (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.<sup>4</sup>

Practice is defined, under Rule 2(g), to include not only transacting business with the Commission but also preparing any statement, opinion or other paper, by an accountant, which is included within any document filed with the Commission.<sup>5</sup>

As it was originally instituted, Rule 2, effective September 13, 1935, dealt exclusively with attorneys and agents who appeared before the Commission in a "representative capacity."<sup>6</sup> As initially framed, the rule established an SEC Bar with special admission procedures and did not purport to reach accountants or other experts who prepared documents or rendered opinions in conjunction with SEC filings.

In March 1938, the Commission issued its decision in *Joseph M. Van Dorn*<sup>7</sup> wherein it held that it possessed the power to regulate and disbar an accountant as a practicing agent even though the conduct giving rise to the proceeding did not involve representation in a Commission proceeding. The Commission stated:

The power of the Commission to prescribe rules of practice and to

<sup>4</sup> 17 G.F.R. § 201.2(e)(1) (1978).

<sup>5</sup> Apart from the above provisions for disciplinary action pursuant to administrative adjudication, Rule 2(e)(2) provides for suspension without a Commission hearing where an accountant's state license to practice has been revoked or suspended or where the accountant has been convicted of a felony or misdemeanor involving moral turpitude. In addition Rule 2(e)(3) provides for temporary suspension without hearing where an accountant has been found by a court in an injunctive proceeding to have violated the federal securities laws. Such suspension becomes permanent in 30 days if not objected to by the accountant. In the event of such objection an accountant is entitled to a hearing at which the accountant may only present mitigating evidence why the penalty of suspension or revocation ought not to be imposed. Moreover, and most significant, this rule applies even if the injunctive proceedings ended in a consent decree by which the accountant did not admit the facts alleged in the complaint. In such a situation the accountant "shall be presumed for all purposes . . . to have been enjoined by reason of the misconduct alleged in the complaint." Rule 2(e)(3)(ii). Thus, under this irrebuttable presumption of guilt, an accountant may only offer evidence on the issue of the sanction to be imposed—a highly questionable deprivation of due process. See note 53 *infra*.

<sup>6</sup> 1 Fed. Reg. 1753 (1936). Although this article is addressed solely to the current application of 2(e) involving accountants, which has been the most actively besieged profession under the rule, it should be noted that the rule also applies by its terms to "attorneys," "engineers," or "other experts." In addition, the Commission has demonstrated a willingness to actively regulate the legal profession. See the 2(e) proceedings against attorneys in *M. J. Melrose*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,578; *Jo M. Ferguson*, 5 SEC Docket 37 (1974); *Emanuel Fields*, 2 SEC Docket 3 (1973); *In Re William R. Carter*, 484 SEC. REG. & L. REP. (BNA) at F-1 (March 14, 1979).

<sup>7</sup> 3 S.E.C. 267 (1938).

admit as attorneys or agents only those applicants who measure up to certain standards is clear. . . . A corollary of the power to make such rules and to erect such standards is the power to suspend or disbar for misconduct.<sup>8</sup>

Shortly thereafter, in June 1938,<sup>9</sup> Rule 2(e)(1) was adopted in substantially similar form to its present-day prescriptions, with the exception that the subsection of the rule covering disciplinary actions of willful violations of the federal securities laws was added in 1971.<sup>10</sup>

From the inception of the rule in 1935 and its amendments, the Commission has grounded its authorization to promulgate Rule 2(e) on the general statutory authority conferred upon the Commission to "make such rules and regulations as may be necessary . . . for the execution of the functions vested in [it] . . . by this title."<sup>11</sup> At no time has the Commission claimed to have express statutory authority to regulate professionals practicing before it. In its public statements the "SEC agrees that it has no explicit authority for promulgating Rule 2(e) but insists that it has implicit authority under its general rulemaking power to do so."<sup>12</sup>

Thus, it is from this meager and vague statutory underpinning that the Commission has commenced its program of significant regulation and intrusion into the day-to-day affairs of the accounting profession—a program which has evoked direct challenge to the Commission's authority. In *Touche Ross & Co. v. SEC*, the plaintiffs, the entire public accounting firm and three of its former partners, sought to enjoin the Commission from conducting the first public 2(e) proceeding.<sup>13</sup>

Touche confronted head-on the Commission's authority to subject accountants to administrative proceedings and sanctions, noting the absence of express authority and the Supreme Court's clear statement that:

The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity [citations omitted]. And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable.<sup>14</sup>

Touche observed that in *Ernst & Ernst v. Hochfelder*<sup>15</sup> the Supreme Court re-

8 *Id.* at 269 n.2.

9 SEC Exchange Act Release No. 1759 (June 27, 1938).

10 SEC Exchange Act Release No. 9164 (May 10, 1971), [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,064.

11 Securities Exchange Act § 23(a); Securities Act § 19(a).

12 *Touche Ross & Co. v. SEC*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,415 at 93,500 (S.D.N.Y. 1978). See SEC Memorandum in Support of Motion to Dismiss in *Touche Ross v. SEC* at 17.

13 *Touche's Complaint* filed on October 12, 1976, set out at [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,742.

14 *Manhattan Co. v. Comm'r*, 297 U.S. 129, 134 (1936). See also *Stark v. Wickard*, 321 U.S. 288, 309 (1944); *Campbell v. Long & Co.*, 281 U.S. 610 (1930); *United States v. Silva*, 272 F. Supp. 46 (S.D. Cal. 1967).

15 425 U.S. 185 (1976).

jected an effort to expand the SEC's Rule 10b-5 beyond the explicit statutory provisions of section 10(b) of the Securities Exchange Act, holding that: "The rule-making power granted to an administrative agency charged with the administration of a Federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'"<sup>16</sup>

Against this backdrop of utter absence of authority to discipline accountants, Touche pointed out that where Congress intended to grant such disciplinary power to agencies, Congress has been explicit,<sup>17</sup> and that Congress has carefully circumscribed the SEC's disciplinary authority by limiting it expressly to censure or suspension of the registration of securities brokers or dealers.<sup>18</sup> The plaintiffs further noted that the legislative history of the 1933 and 1934 Acts indicate that Congress considered and rejected a proposal to place with the then proposed Securities Regulatory Commission the power to license and discipline accountants.<sup>19</sup>

In response to these contentions, the district court held that pursuant to the doctrine of exhaustion of administrative remedies it would not intervene in the SEC's proceeding absent a clear showing "that the agency has acted in flagrant violation of its statutory authority."<sup>20</sup> The court held that under this test the SEC's action was not improper, grounding its ruling on two questionable bases: (1) the "forty-year history of the rule" during which no court found the rule to be without statutory basis;<sup>21</sup> and (2) a line of decisions, beginning with *Goldsmith v. Board of Tax Appeals*,<sup>22</sup> involving the "inherent power" of an adjudicative body to promulgate rules disciplining professionals who practice in proceedings before them.<sup>23</sup>

With respect to the Court's initial ground for decision, it is specious to suggest that unauthorized Commission activity becomes authorized through passage of time and in the absence of judicial dissent. Indeed, the fact that no court has squarely found that the Commission has such authority to act under Rule 2(e), despite opportunities to so hold,<sup>24</sup> suggests an apprehension by the courts

16 *Id.* at 213-14 (quoting *Manhattan Co. v. Comm'r*, 297 U.S. 129, 134 (1936)).

17 *See, e.g.*, 31 U.S.C. § 52(f) (1971), empowering Comptroller General to make rules and regulations concerning practice of attorneys before the GAO, and similar such explicit grants of power to the Treasury (31 U.S.C. § 1026 (1971)), and Commissioner of Patents (35 U.S.C. § 31 (1971)).

18 Securities Exchange Act, § 15(b)(4), 15 U.S.C. § 78o(b)(4) (1978), expressly grants the SEC the power, after notice and hearing, "to censure, place limitations on the activities, functions or operations of [or] suspend . . . or revoke the registration of any broker or dealer. . . ."

19 *Hearings on S. 875 before the Senate Committee on Banking and Currency*, 73rd Cong., 1st Sess. 248 (1933).

20 [Current] FED. SEC. L. REP. (CCH) ¶ 96,415 at 93,500.

21 *Id.* at 93,502.

22 270 U.S. 117 (1926).

23 [Current] FED. SEC. L. REP. (CCH) ¶ 96,415, at 93,501.

24 *See Emanuel Fields v. SEC* 594 F.2d 1075 (D.C. Cir. 1974); *Kivitz v. SEC*, 475 F.2d 956 (D.C. Cir. 1973); *Schwebel v. Orrick*, 251 F.2d 919 (D.C. Cir. 1958). *See also* the letter of comment by the ABA Committee on Federal Regulation of Securities which questions the SEC's 2(e) authority:

While the Commission, of course, has a clear statutory mandate to regulate the securities industry, its statutory authority to regulate the professionals practicing before it is at least doubtful. Rule 2(e) is based solely on the Commission's general rule-making authority; it has never been confirmed by the courts and the existence

that the Commission's 2(e) authority is questionable.

Likewise, the Court's reliance on *Goldsmith* and its progeny is not necessarily compelling or dispositive since that case dealt with the inherent power of the statutory antecedent to the tax court, the Board of Tax Appeals, to promulgate rules of practice governing proceedings before it pursuant to a statute which provided that such proceedings "shall be conducted in accordance with such rules of evidence and procedure as the board may prescribe."<sup>25</sup> There the tax board denied the application for admission of an accountant previously found guilty of improper conduct as examiner of municipal accounts in the Office of Comptroller of the State of New York. The Supreme Court affirmed the tax board's refusal of admission, observing that the tax board was vested with such power by the statute authorizing it to prescribe the procedure pursuant to which it operates.

To the extent that *Goldsmith* holds that an agency vested with rulemaking and investigatory functions has inherent power to regulate professionals appearing in proceedings before it, it is plain that *Goldsmith* should not support the further contention that such inherent power to regulate extends to activities far beyond appearance before the SEC in a representative capacity. Thus, even assuming that the district court's decision in *Touche Ross & Co. v. SEC* can be viewed as dispositive on the issue of the existence of Commission authority to discipline professionals appearing before it, it provides little insight on the scope of that authority.

In affirming the district court's decision, the Second Circuit held that the doctrine of exhaustion of administrative remedies was not applicable in regard to consideration of the Commission's authority to promulgate Rule 2(e).<sup>26</sup> The Second Circuit held that the Commission had 2(e) authority relying not only on the district court's reasoning but also on the following factors: (1) "appellants concede that there is no express statutory *prohibition* against promulgation of the Rule;"<sup>26a</sup> (2) "The Commission, through its Rule 2(e) proceeding, is merely attempting to preserve the integrity of its own procedures, by assuring the fitness of those professionals who represent others before the Commission. *Indeed, the Commission has made it clear that its intention in promulgating Rule 2(e) was not to utilize the rule as an additional weapon in its enforcement arsenal*, but rather to determine whether a person's professional qualifications, including his character and integrity, are such that he is fit to appear and practice before the

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as well as the scope of that authority is unclear. In the absence of any clear mandate the Commission should act in this field with particular restraint and in no event subject attorneys to any adverse consequences without a full opportunity for an evidentiary hearing and argument.

...

Up until now, Rule 2(e) has been used sparingly and Commission decisions under the Rule have been considered only twice by the courts and the ultimate question of the Commission's power to proceed under the Rule remains undecided. . . .

258 SEC. REG. & L. REP. (BNA) at F-1 (June 26, 1974).

25 270 U.S. at 121.

26 Docket No. 78-6095 (2d Cir., May 10, 1979), 5-11. The district court's ruling was limited to the question of the application of the doctrine of exhaustion of administrative remedies and thus "without reaching the substantive question of the validity of Rule 2(e), the court holds that Touche Ross must first exhaust its administrative remedies." FED. SEC. REP. (CCH) ¶ 96,503.

26a Docket No. 78-6095 (2d Cir., May 10, 1979) at 13 (emphasis added).

Commission;"<sup>26b</sup> and (3) "an examination of the policies underlying the securities laws indicates that, contrary to appellants' assertions, the Rule is not inconsistent with the Commission's statutory authority."<sup>26c</sup>

Thus, by amalgamation of these factors the Second Circuit upheld the Commission's power to promulgate 2(e) under its general rulemaking authority, stating:

To summarize: 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 appearing before it, Rule 2(e), promulgated pursuant to its statutory rulemaking authority, 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. *Mourning v. Family Publications Service, Inc.*, *supra*. Moreover, we hold that the Rule does not violate, nor is it inconsistent with, any other provision of the securities laws. We therefore sustain the validity of the Rule as a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general. *Goldsmith v. Board of Tax Appeals*, *supra*.<sup>26d</sup>

The Second Circuit's opinion is at best a "Catch 22" conundrum, and at worst is an endorsement of a variant of the Commission's "effect-oriented approach" to promulgating rules under the securities acts which the Supreme Court explicitly rejected in *Ernst & Ernst v. Hochfelder*.<sup>26e</sup>

The absence of a statute prohibiting the promulgation of 2(e) should hardly

<sup>26b</sup> *Id.* (emphasis added).

<sup>26c</sup> *Id.* at 14. It is submitted that the "policies" argument in support of the SEC's position is not unlike the argument made by the SEC Amicus Brief filed in *Hochfelder* which was rejected by the Supreme Court. (See footnote 26e *infra*.)

<sup>26d</sup> *Id.* at 18.

<sup>26e</sup> See the SEC's Amicus Brief filed in the Supreme Court in *Hochfelder v. Ernst & Ernst*, 10-12, where the Commission argued that section 10(b), and thus Rule 10b-5, prohibited negligent conduct since "[t]here is nothing in this broad language that limits its prohibitions to 'manipulative or deceptive' practices that are done intentionally," and because the effect of such an approach would be consistent with the "congressional purpose in the legislation to provide investors with the broadest possible protection." The Court rejected the SEC's approach, stating:

In its amicus curiae brief, however, the Commission contends that nothing in the language "manipulative or deceptive device or contrivance" limits its operation to knowing or intentional practices. In support of its view, the Commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. See *Affiliated Ute Citizens v. United States*, *supra*, at 151; *Superintendent of Insurance v. Bankers Life & Cas. Co.*, *supra*, at 11-12; *J. I. Case Co. v. Borak*, 377 U.S. 426, 432-33 (1964). See also *SEC v. Capital Gains Res. Bur.*, 375 U.S. 180, 195 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.

425 U. S. at 197-98.

be the passkey for justifying such a rule without explicit authorization. Similarly, the Commission's intent in promulgating the rule is scarcely relevant to Congress' intent which has been explicit in granting disciplinary and enforcement power to the Commission.<sup>26f</sup> Moreover, the court of appeals' acceptance of the argument that 2(e) is not "an additional weapon in [the SEC's] enforcement arsenal" ignores the realities of the Commission's present-day use of, and statements regarding, the rule.<sup>26g</sup>

By upholding the validity of Rule 2(e) on the basis that it is "'reasonably related' to the purposes of the securities laws,"<sup>27</sup> the Second Circuit has distorted the governing standard which allows an agency to exercise rulemaking authority which "constitutes a 'legitimate, reasonable and direct adjunct to the Commission's *explicit statutory power*.'" <sup>27a</sup> The only explicit statutory power upon which the Commission has grounded 2(e) is its general rulemaking authority which by its terms merely grants the Commission power to promulgate rules "as may be necessary or appropriate to implement the *provisions of this title* for which [it is] responsible or for the execution of the functions *vested in [it] by this title*."<sup>27b</sup> Thus, the Commission's rulemaking power extends no further than the express statutory provisions of the securities acts which, as the Second Circuit concedes, "contain no express statutory provision authorizing the Commission to discipline professionals appearing before it."<sup>27c</sup>

Equally erroneous is the Second Circuit's justification of authority on the basis that 2(e) "represents an attempt by the Commission to protect the integrity of its own processes" and "as such the Rule is 'reasonably related' to the purposes of the securities laws." That the rule is reasonably related to, or in furtherance of the purposes of the securities acts, should not of itself be the litmus test for under such an "effect-oriented approach," there would seldom, if ever, be a situation where the Commission, either with or without explicit power, promulgates a rule which is *contrary* to, or *inconsistent* with, the purposes of the securities acts or the integrity of its processes. Such an approach would be tantamount to granting the Commission the power to make laws, not merely rules.<sup>27d</sup>

26f *Supra* text at notes 17-19; *infra* text at notes 32-34.

26g *Infra* text at notes 39-47 and 56-63. The Court of Appeal's acceptance, per the opinion of Judge Timbers, of the Commission's argument cannot be attributed to any unfamiliarity with the Commission's use of Rule 2(e) on the part of Judge Timbers, a former SEC General Counsel.

27 Docket No. 78-6095 (2d Cir., May 10, 1979), at 18.

27a *Id.* at 14 (emphasis added); *Trans Alaska Pipeline Rates Cases*, 436 U.S. 631, 655 (1978); *Mouring v. Family Publications Services, Inc.*, 411 U.S. 356 (1973).

27b *Supra*, note 11 (emphasis added).

27c Docket No. 78-6095 (2d Cir., May 10, 1979), at 18.

27d *See SEC v. Arthur Young & Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,006 (9th Cir. 1979), where the Ninth Circuit in an enforcement action refused to hold that the Commission had power over auditors where such authority was lacking, holding:

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 securities laws almost always suggests that had it been there earlier *with the accountant* it would have caught the scent of wrongdoing 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.



Apart from the Second Circuit's feeble attempt to find explicit authority, the court expressly disclaims any opinion regarding the scope of that authority,<sup>27e</sup> or the due process standards which must attend such proceedings,<sup>27f</sup> holding that these are questions which may be raised only after Touche has exhausted its administrative remedies.

Accordingly, the decisions in *Touche Ross & Co. v. SEC* cannot be viewed as strong or persuasive affirmations of authority for expansive application of Rule 2(e), but instead should be viewed as mandating that the Commission act with restraint. Rule 2(e) proceedings in recent years reflect that both the Commission's means and objectives in implementing Rule 2(e) have been anything but restrained.<sup>27g</sup>

27e The court stated: "Accordingly, we wish to make it clear that Touche Ross must exhaust their administrative remedies by submitting to the Rule 2(e) proceeding before we will consider any challenges which they may assert with respect to any disciplinary action that the Commission may determine is appropriate under the circumstances." Docket No. 78-6095 (2d Cir., May 10, 1979), at 6.

The Court also raised for the SEC's consideration the question of whether the SEC's Rule 2(e) authority may be extended to discipline an entire public accounting firm for the acts of a few of its members, stating:

Touche Ross chose to remain loyal to its retired partners and to challenge Rule 2(e) in a broadside attack on the right of the Commission to discipline *anyone*. Our opinion today rejects this sally. Nothing in the complaint, or the district court proceedings, or the briefs and oral argument before us purports to raise the question of the extent to which the Commission has the power, in a disciplinary action, to hold Touche Ross and its 525 partners vicariously liable to the extent of permanent revocation of the rights to practice for the acts of its erstwhile partners. It may be argued, for example, that the Commission may not proceed against Touche Ross on a theory of *respondent superior* without first establishing that Congress has delegated such authority and that the Commission has, through a rulemaking proceeding, set standards for such an adjudication, including a definition of "willful conduct" by organizations. . . . We express no view on this question, but it is one that the Commission might want to consider. In any event, since it is far from clear that the Commission will in fact determine to discipline Touche Ross, and since the question was *not* raised before the Commission or this court, the resolution of such issues should await the conclusion of the administrative process.

*Id.* at 21.

27f The court held that "appellants must exhaust their administrative remedies before they attempt to obtain judicial review of their other claims, including their claim that the Commission is acting with bias and will not afford them a fair hearing in accordance with due process." *Id.* at 19.

27g Apart from *Touche Ross & Co. v. SEC*, a SEC administrative law judge has addressed the issue of the Commission's 2(e) authority in *In Re William R. Carter*, SEC Administrative Proceeding File No. 3-5464, which involved two attorneys. In an Initial Decision rendered March 7, 1979, the administrative law judge held that the Commission had jurisdiction to discipline attorneys under Rule 2(e) and rejected the attorneys' claim that the prohibitions of Rule 2(e) are unconstitutionally vague. 494 SEC. REG. & L. REP. (BNA) at F-14 (March 14, 1979). See note 81 *infra*.

It is more than possible that the Second Circuit's and administrative law judge's conviction that there exists 2(e) authority may not be shared by all courts or all members of the Commission. See *SEC v. Arthur Young*, discussed in note 27d *supra*.

In a recent speech SEC Commissioner Roberta Karmel, in criticizing the Commission for failing to observe the limits of the agency's power, stated:

In practice, however, I believe the Commission has been paying insufficient attention to the jurisdictional limitations of an administrative agency. In particular, I have dissented from the Commission's use of Section 21(A) of the Securities Exchange Act of 1934 to publicize the termination of enforcement investigations. I believe that such publicity is being used as a sanction and that the Commission only has the jurisdiction to impose sanctions by way of the disciplinary proceedings specifically set forth in the securities laws. I have similar doubts about the Commission's authority to imply proceedings against professionals under Rule 2(e) of the Commission's Rules of Practice.

Karmel, *Jurisdictional Concerns in Securities Law Enforcement*, February 23, 1979. Com-

### III. Implementation of Rule 2(e)

The more expansive the Commission's application of Rule 2(e) the more pernicious becomes the deprivation of due process which results in such proceedings where the SEC is not only the investigator but the prosecutor and judge as well.<sup>27h</sup> Moreover, the "rudimentary requirements of fair play"<sup>28</sup> which must attend any administrative adjudication are called into question when it becomes clear that the SEC is utilizing a Rule 2(e) proceeding to accomplish indirectly that which it is expressly prohibited from doing directly under the explicit provisions of the federal securities laws.

Unlike the statutory requirements for compliance with section 10(b) and Rule 10b-5 of the 1934 Act,<sup>29</sup> and the body of judicial precedents which have fleshed out those requirements, there are few, if any, requirements or standards which provide an accountant with sufficient notice of what constitutes "requisite qualifications to represent others"<sup>30</sup> or what the SEC might deem "improper professional conduct"<sup>31</sup> in a given situation.

Indeed, the one aspect of Rule 2(e) which provides some measure of normative conduct, namely, the prohibition on willful violation of the securities laws,<sup>32</sup> has been seldom used in 2(e) proceedings. The reason for the minimal use of this provision of 2(e) may be due to the fact that it is contrary to the express statutory provisions of the 1933 and 1934 Acts which grant the federal courts the exclusive power to try actions brought by the SEC for alleged violations of the securities laws by an accountant. Specifically, section 21(e) of the Securities Exchange Act of 1934 provides that if it appears to the Commission that "any person is engaged or about to engage" in any violations of that Act, "it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices,"<sup>33</sup> and section 27 of the Exchange Act directs

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missioner Karmel's frank admission that charges brought against professionals for "improper or unethical" actions "should be heard 'under the aegis of the federal courts,' not by the commission itself," is both refreshing and incisive. See SEC's Tough Case: New Commissioner With Abrasive Style, Wall Street Journal, May 18, 1979, at 1, 14.

27h For a recent example of deprivation of due process caused by an Environmental Protection Agency staff attorney's simultaneous actions as an "investigator," "prosecutor," "witness" and "judge," see *United States v. Velsicol Chemical Corp., et al.*, No. 77 CR 1073 (N.D. Ill., April 20, 1979), where the district judge dismissed an indictment which was procured by a "totality of grand jury abuse by government attorneys" (*id.* at 53), holding:

The indictment was returned by a grand jury that had an attorney before it, presenting the government's case while laboring under conflicts of interest. It heard a government attorney who alternated his role as a prosecutor with that of an important witness, and then remained in the presence of the grand jury. This attorney was a person who was not authorized to be in the grand jury room; his presence there voids the indictment in this case, even without a showing of prejudice. . . . Moreover, and firming the balance toward dismissal of this indictment, the evidence shows a totality of grand jury abuse by government attorneys, circumstances of prosecutor conduct that undermined the grand jury, destroyed its independence, and deprived defendants of their Fifth Amendment rights. . . .

*Id.* at 54.

28 *Withrow v. Larkin*, 421 U.S. 35 (1975); *Greene v. McElroy*, 360 U.S. 474, 508 (1959); *Morgan v. United States*, 304 U.S. 1, 14 (1938); *Mack v. Florida State Board of Dentistry*, 296 F. Supp. 1259 (S.D. Fla. 1969).

29 15 U.S.C. § 78j(b) (1971); 17 C.F.R. § 240.10b-5 (1978).

30 17 C.F.R. § 201.2(e)(1)(i) (1978).

31 17 C.F.R. § 201.2(e)(1)(ii) (1978).

32 17 C.F.R. § 201.2(e)(1)(iii) (1978).

33 15 U.S.C. § 78u(e) (1971).

that: "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all . . . actions at Law brought to enforce any liability or duty created by this title. . . ." <sup>34</sup> Thus, the securities acts clearly contemplate that the SEC shall bring any claim for securities laws violations in federal court and not before itself. <sup>35</sup>

Beyond the foregoing infirmities of due process under Rule 2(e), the possibility exists under the standards of the rule and the Commission's application thereof, that a Rule 2(e) proceeding may be adjudicated without regard to any standard of culpability or without regard to proof of fault on the part of the accounting practitioner. The Commission has long held that it need not prove scienter in a 2(e) proceeding. In *The Matter of Haskins & Sells*, <sup>36</sup> it held:

We accept respondents' assertion that they acted in good faith and accordingly do not find any willfulness in the sense referred to by them. However, in a disciplinary action under Rule II(e) we are not required to make such a finding. We are of the opinion that respondents' accounting work in connection with the Thomascolor registration statement was so deficient in the respects set forth above, as a result of their failure to give this professional undertaking the degree of care and inquiry it demanded under the circumstances, that disciplinary action is required. <sup>37</sup>

Moreover, following the Supreme Court's decision in *Ernst & Ernst v. Hochfelder* the Commission's General Counsel clearly stated that which had become the Commission's apparent practice in 2(e) proceedings—simple negligence would serve as an appropriate basis to a finding of violation of 2(e). The Commission's General Counsel observed in a memorandum <sup>38</sup> to the Chairman of the SEC which analyzed *Hochfelder* that the Supreme Court's decision strongly implied that the Commission would need to prove scienter in future injunctive actions brought under Rule 10b-5, and that as a result, "it may be appropriate for the Commission to place greater reliance upon Rule 2(e) in the future as a means of preventing a recurrence of unethical or improper conduct." <sup>39</sup> In a subsequent memorandum to the Chairman, the General Counsel stated:

There may be cases where, as a consequence of *Hochfelder*, negligent conduct by an accountant or attorney which injured investors may not constitute a violation of Section 10(b) and Rule 10b-5, nor otherwise violate the securities laws, yet represent a substantial threat to the public interest if such conduct were to continue in the future. If this conduct would amount to a significant deviation from professional standards, a proceeding under Rule 2(e) to test the individual's fitness to continue to be permitted to practice before the Commission might be appropriate. <sup>40</sup>

34 15 U.S.C. § 78aa (1971).

35 See also Securities Act §§ 20(b) and 22(a). The only exception to this scheme of exclusive jurisdiction is the express authority granted to the Commission to conduct disciplinary proceedings against broker-dealers. See note 18 *supra*.

36 Accounting Series Release No. 73 (1952), 5 FED. SEC. L. REP. (CCH) ¶ 72,088.

37 *Id.* at 62,197.

38 Memorandum to Chairman Hills, June 8, 1976, Staff Study, Senate Subcommittee on Reports, Accounting and Management, Appendix I (1976).

39 *Id.* at 1472 n.2.

40 SEC Office Memorandum, August 27, 1976, Staff Study, Senate Subcommittee on Reports, Accounting and Management, Appendix I, at 1508 (1976).

It appears clear therefore that the Commission views 2(e) as a means whereby it may accomplish indirectly that which *Hochfelder* has arguably foreclosed it from doing directly.<sup>41</sup> The Commission's public 2(e) proceeding against Touche Ross & Co. stands as testimony to this fact.

There, instead of joining Touche in an injunctive action, which was brought against certain other defendants related to the audit client,<sup>42</sup> the Commission chose to commence a 2(e) proceeding and thereby avoid the risk that it would be held to the scienter standard of culpability. Nowhere in the order instituting the 2(e) proceeding does the Commission allege that Touche Ross had any intent to deceive or defraud in connection with the audits it performed.<sup>43</sup> Moreover, by announcing publicly the commencement of the 2(e) proceeding the Commission did not deprive itself of the benefit, from a settlement standpoint, which usually attends an injunctive action resulting from the publicity adverse to the professional.<sup>44</sup>

In addition to avoiding the scienter requirement, a 2(e) proceeding also avoids the further judicial requirement that an injunction should not be entered and sanctions granted where there has been no showing by the Commission of the likelihood of any further violations or wrongdoing by the accounting firm.<sup>45</sup> Under Rule 2(e) the Commission has not encumbered itself

41 For decisions holding that the SEC must prove scienter in an enforcement action under Rule 10b-5 see *SEC v. Southwest Coal & Energy Co.*, 439 F. Supp. 820, 825 (W.D. La. 1977); *SEC v. Am. Realty Trust*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1240-41 (S.D.N.Y. 1976), *aff'd*, 565 F.2d 8 (2d Cir. 1977). *But see SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 709-10 (D.D.C. 1978), where the court sets forth those authorities which hold that scienter is not a necessary element of proof in an enforcement action.

42 *SEC v. Giant Stores Corp.*, Civ. No. 76-164 (D.D.C. 1976).

43 *In Re Touche Ross & Co.*, Administrative Proceeding File No. 3-5075, Order of September 2, 1976.

In certain 2(e) proceedings it is questionable whether the Commission's contentions that an accountant was negligent would pass muster under judicial standards of due diligence and reasonable care. Indeed, in many 2(e) proceedings the Commission merely states that an accountant has engaged in "improper professional conduct" by virtue of some Commission-determined departure from generally accepted auditing standards, and without elaboration or specific analysis or findings which clearly indicate that such departure was due to negligence or some level of conduct amounting to fault. *See, e.g.*, *Ernst & Ernst, Accounting Series Release No. 248* (1978), 5 FED. SEC. L. REP. (CCH) ¶ 72,270; *Haskins & Sells, Accounting Series Release No. 241* (1978), 5 FED. SEC. L. REP. (CCH) ¶ 72,263. To be sure, the failure of an accountant to comply with generally accepted auditing standards, even under the Commission's view of those standards, is not necessarily tantamount to a lack of due diligence on the part of the professional. *See CODE OF PROFESSIONAL ETHICS, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, Rule 202, 2 PROFESSIONAL STANDARDS* (CCH) § 202.

44 That this benefit is considerable has not gone unnoticed by one Chairman of the SEC who observed that "if the proceeding is disposed of at the very time that it is begun, there normally will be only one round of adverse publicity. Otherwise, there may be two — or more. Lawyers should think about such things." Address by Garrett, *A Look at the SEC's Administrative Practice* (August 25, 1974) (address to Southwestern Legal Foundation).

*See also* the dissenting statement of Commissioner Roberta Karmel to the Commission's practice of publicizing investigative reports where she states that "publication by the Commission under Section 21(a) of a negotiated statement by a person under investigation setting forth admissions and undertakings constitutes, in effect, a sanction," and observes:

I subscribe to the objective of making available and disclosing information in a simple and effective way as long as it does not ignore the harm that can be inflicted upon an individual by publication directed by a governmental agency.

*Sec. Exch. Act Release No. 15664* (March 21, 1979, [Current] FED. SEC. L. REP. (CCH) ¶ 82,015. *See note 27g supra.*

45 *See SEC v. Geotek*, 426 F. Supp. 715, *aff'd sub nom. SEC v. Arthur Young & Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 (9th Cir. 1979); *SEC v. National Student Mar-*

with such a requirement in determining whether sanctions are appropriate.<sup>46</sup> Moreover, since the Commission's sanctions under 2(e) are severe—temporary or permanent suspension from practice before the Commission—it effectively has at its command a range of sanctions, to be secured through settlements, which may be more far-reaching than the ancillary relief afforded by the courts in injunctive proceedings.<sup>47</sup>

Apart from these substantive infirmities in the means by which 2(e) is implemented there are also certain procedural aspects of 2(e) proceedings which underscore the unfairness of its present usage as a vehicle to discipline and regulate the accounting profession. Unlike a judicial proceeding, discovery in a 2(e) proceeding is not a matter of right but is subject to the discretionary approval of the administrative law judge, and in no event is the permissible scope of discovery as broad as that allowed under the Federal Rules of Civil Procedure.<sup>48</sup>

The rules of evidence employed in 2(e) proceedings are less rigorous than the governing rules of evidence in judicial proceedings.<sup>49</sup> As a result inherently unreliable hearsay and conjectural evidence are likely to be admitted and utilized as a basis for decision-making.<sup>50</sup> Related to the quality of the evidence is the fact that although the SEC's staff has the burden of proof in a 2(e) proceeding, it is a burden which in the Commission's view may be satisfied by a mere preponderance of the evidence<sup>51</sup> and not by clear and convincing evidence, which

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keting Corp., 457 F. Supp. 682 (D.D.C. 1978); SEC v. Koracorp Indus., Inc. [Current] FED. SEC. L. REP. (CCH) ¶ 95,756 (N.D. Cal. 1976), *aff'd*, 575 F.2d 692, 701 (9th Cir. 1978), *cert. denied*, 99 S. Ct. 348 (1978).

46 In many 2(e) proceedings the Commission applies sanctions applicable to the nationwide practice of an accounting firm despite the Commission's acknowledgement that the alleged audit transgressions relate to a small percentage of the total number of audit engagements properly performed. See, e.g., Peat, Marwick, Mitchell & Co., Accounting Series Release No. 173 (1975), 5 FED. SEC. L. REP. (CCH) ¶ 72,195 at 62,455; Seidman & Seidman, Accounting Series Release No. 196 (1976), 5 FED. SEC. L. REP. (CCH) ¶ 72,218 at 62,542.

See note 81 *infra*, for a discussion of the recent 2(e) order in *In Re William R. Carter*, where despite the absence of evidence to infer that the attorneys disciplined there were likely to engage in future misconduct (indeed, the evidence indicated that they were eminently qualified SEC practitioners with no previous "blemishes" on their records), the administrative law judge ordered that they should be suspended from all SEC practice for periods of one year and nine months, respectively, 494 SEC. REG. & L. REP. (BNA) at F-1, F-15 (March 14, 1979).

47 See SEC v. Savoy Indus., 587 F.2d 1149, 1169 (D.C. Cir. 1978) where the court stated that:

The principal purpose of this type of injunction is, of course, to deter future violations, and not to punish the violator. *Hecht Co. v. Bowles*, 321 U.S. 321, 329 (1944). Furthermore, an injunction against violation of the reporting provisions does not ipso facto involve a deprivation of livelihood, and, as a practical matter, would not be nearly as extensive an impairment to Zimmerman as a revocation would be to a broker-dealer.

48 Compare SEC Rule of Practice 15, 17 C.F.R. 201.15 (1978), with FED. R. CIV. P. 26(b), 28 U.S.C. § 26(b) (1970). See also *In Re Ernst & Ernst*, Accounting Series Release No. 248 (1978), 5 FED. SEC. L. REP. ¶ 72,270 (CCH), at 62,731-732; *The Report of the Commission's Advisory Committee on Enforcement Policies and Practices*, June 1972, 158 SEC. REG. & L. REP. (BNA) 11 (June 28, 1972).

49 See SEC Rule of Practice 14, 17 C.F.R. 201.14 (1978).

50 See *Kivitz v. SEC*, 475 F.2d 956 (D.C. Cir. 1973), where the court reversed a 2(e) disciplinary order against an attorney which was grounded on rank hearsay and speculative evidence. See also *In Re William R. Carter*, 484 SEC. REG. & L. REP. (BNA) at F-1, F-14 (March 14, 1979), and note 81 *infra*.

51 See, e.g., *Joseph H. Van Dorn*, 3 S.E.C. 267, 272 (1938). See the SEC disciplinary proceeding in *Boston Co. Inst. Investors, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 81,705 at 80,818 n.6 (1978) where the Commission specifically refused to apply the clear and con-

is the governing standard in judicial proceedings where the "heavy sanction" of "deprivation of livelihood" may be imposed.<sup>52</sup>

Thus, a 2(e) proceeding is devoid of more than just an independent jurist attired in a black robe. As the foregoing indicates, many of the fundamental attributes of due process which attend judicial proceedings under the securities acts are totally lacking. In many types of administrative proceedings this would be objectionable. In this type of proceeding, which is tantamount to a "quasi-criminal proceeding" with the deleterious consequences of impugning the accountant's professional reputation and depriving him of his livelihood, the absence of fundamental concepts of fair play and due process is highly questionable.<sup>53</sup>

#### IV. Rule 2(e) Objectives

Beyond the Commission's facile and often-repeated statement that the objective of 2(e) proceedings is "to protect the public and the integrity of the Commission's own processes from incompetent, unethical or dishonest attorneys, accountants and other professionals and experts,"<sup>54</sup> there exist questions as to what are the specific objectives of the SEC and its staff in administering 2(e), and the effect of those objectives on the accounting profession as a whole.

At the outset of the Commission's increased enforcement activity under 2(e), the Commission and its staff denied that:

[I]t is the ultimate design of the Commission to create situations which would result in all the "Big Eight" being under . . . review procedures [monitored by the Commission]. Nothing could be further from the truth. There is no such plan or intent. As proceedings develop we will deal with them one a a time, without plan or design to subject the profession to the thumb of the Commission.<sup>55</sup>

Subsequent statements and actions by the Commission cast doubt on the notion that the present-day objective of the Commission is not to subjugate the accounting profession to the Commission's day-to-day control. In a memorandum to the SEC's Chairman,<sup>56</sup> the Commission's General Counsel observed:

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vincing standard which the District of Columbia Circuit held was applicable in such proceedings. See note 52 *infra*.

52 See SEC v. Savoy Indus., 587 F.2d 1149, 1168 (D.C. Cir. 1978); Collins Sec. Corp. v. SEC, 562 F.2d 820, 824 (D.C. Cir. 1977); SEC v. National Student Marketing Corp., 457 F. Supp. 682, 701 n.43 (D.D.C. 1978).

53 See In Re Ruffalo, 390 U.S. 544, 550-51 (1968) ("Disbarment, designed to protect the public is a punishment or penalty imposed on the lawyer. . . . He is accordingly entitled to procedural due process. . . . These are adversary proceedings of a quasi-criminal nature."); Charlton v. FTC, 543 F.2d 903, 906 (D.C. Cir. 1976) ("And contrary to the Commission's concept, disciplinary proceedings 'are adversary proceedings of a quasi-criminal nature. . . . [footnotes omitted]").

54 SEC Memorandum in Support of Motion to Dismiss in Touche Ross v. SEC, at 5-6.

55 Gonson, *Disciplinary Proceedings and Other Remedies Available to the SEC*, 30 Bus. Law. 191, 197 (1975); Sommer, *Accountants: A Flexible Standard*, 1 LITIGATION 35, 37 (1975).

56 Memorandum to Chairman Williams, June 10, 1977, SEC Report to Congress on the Accounting Profession and the Commission's Oversight Role, Exhibit W (July 1978) [hereinafter cited as Williams Memorandum].

Admiral Rickover suggests that the Commission, periodically, should supervise audits of the performance of public accounting firms. Under its existing authority, and particularly Rule 2(e) of its Rules of Practice, the Commission has, where it finds substandard, unprofessional or questionable auditing practices, commenced and concluded disciplinary proceedings requiring the firm, at its expense, to undergo an independent quality control review. This approach has been employed in Commission disciplinary proceedings, involving some of the largest accounting firms, with the consent of the firms named as respondents in those proceedings. Variations of this procedure have also been used in settlements involving smaller accounting firms. Although some accounting firms apparently might argue otherwise, we believe the Commission's authority in this regard to be soundly based. The Commission has the authority to preclude accounting firms from practicing before it at all, and, accordingly, has the authority to condition an accounting firm's ability to practice before the Commission upon a thorough review of the firm's practices and procedures, and an undertaking by the firm to correct any deficiencies highlighted by such a review.

While the Commission's authority would, in our view, permit the Commission itself to conduct this review of an accounting firm's performance and quality controls as Admiral Rickover has suggested, such an approach would be costly, time-consuming, and likely a less effective allocation of the Commission's limited resources in light of the results achieved in the cases discussed above, where the profession has undertaken to review its own performance, subject to Commission oversight. In these cases, of course, a condition of the settlement has been that the review performed be satisfactory to the Commission.

Finally, Admiral Rickover suggested that, in the event an accounting firm does not meet minimum standards of professional performance and independence, the Commission should suspend the firm or revoke its license to audit publicly-held companies. This of course, is the function of Rule 2(e) of the Commission's Rules of Practice.<sup>57</sup>

The strongest evidence of the Commission's intention is the compiled record of the Commission's significant and "inordinate intrusion of government into professional activity."<sup>58</sup> With few exceptions, virtually all the large public accounting firms practicing before the Commission have been the subject of recent 2(e) proceedings and have succumbed to some form of sanctions with continuing Commission oversight, including:

- (a) the undertaking of peer reviews and quality control inspections which are subject to Commission approval and oversight;<sup>59</sup>
- (b) imposition of continuing education requirements;<sup>60</sup>
- (c) prohibitions on a partner participating in a firm's activities in a partnership capacity;<sup>61</sup>

57 *Id.* at 989-91 (footnotes omitted).

58 Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 63-64 (1975).

59 *See, e.g.*, Laventhol, Krekstein, Horwath & Horwath, Accounting Series Release No. 144 (1973), 5 FED. SEC. L. REP. (CCH) ¶ 72,166; S. D. Leidesdorf & Co., Accounting Series Release No. 209 (1977), 5 FED. SEC. L. REP. (CCH) ¶ 72,231; Price Waterhouse & Co., Accounting Series Release No. 238 (1978), 5 FED. SEC. L. REP. (CCH) ¶ 72,238; *In Re Haskins & Sells*, Accounting Series Release No. 241 (1978) FED. SEC. L. REP. (CCH) ¶ 72,263.

60 *In Re Benjamin Botwinick & Co.*, Accounting Series Release No. 168 (1975), 5 FED. SEC. L. REP. (CCH) ¶ 72,190.

61 *Id.*

(d) prohibitions on undertaking new business; notification of prospective clients of the SEC's findings;<sup>62</sup>

(e) restrictions on a firm's merger activities; and inducements for a firm to merge with a larger firm.<sup>63</sup>

Although the above sanctions may be viewed as untoward by only those to whom the sanction applies,<sup>64</sup> the one sanction which appears most nettlesome to the accounting profession as a whole is the SEC's involvement in these proceedings in the *ad hoc* promulgation and implementation of what it views as generally accepted auditing standards.

That the Commission's regulatory effort in such situations is intrusive is clearly undeniable.<sup>65</sup> More important, however, is whether the Commission's *ad hoc* promulgation of generally accepted auditing standards is either authorized by statute or desirable.

Unlike the Commission's explicit statutory power to promulgate accounting principles generally acceptable in SEC practice,<sup>66</sup> the Commission's power to promulgate auditing standards generally acceptable to SEC practice is notably absent from the securities acts.<sup>67</sup> Despite the absence of express authority, the Commission finds such authority not only in the recesses of its antifraud authority and authority to define independence, but also as a part of its authority under Rule 2(e),<sup>68</sup> which is itself highly suspect. Thus, the Commission's General Counsel has stated that:

In addition to its antifraud and definitional powers, Rule 2(e), as noted above, provides a ready vehicle for Commission articulation of standards of auditing practice not just as a means of treating specific instances of unprofessional or improper conduct, but also as a means, through the publication of its dispositions of such Rule 2(e) proceedings, of offering guidance to all auditors for their future audits.<sup>69</sup>

Apart from the Commission's authority to promulgate auditing standards there remains the question of the desirability of the Commission's enactment of such standards. The means by which the Commission "promulgates" auditing standards is, by the Commission's own concession, on an "*ad hoc*" basis through

62 In *Re Touche Ross & Co.*, Accounting Series Release No. 153 (1974), 5 FED. SEC. L. REP. (CCH) ¶ 72,175; In *Re Loux Gose & Co.*, Accounting Series Release No. 160 (1974), 5 FED. SEC. L. REP. (CCH) ¶ 72,182.

63 Laventhol, Krekstein, Horwath & Horwath, at note 59 *supra*; Wertheimer, Fine, Berger & Co., Accounting Series Release No. 167 (1974), 5 FED. SEC. L. REP. (CCH) ¶ 72,189.

64 The peer review of Peat Marwick, the cost of which was borne by Peat, "assertedly cost over \$1 million, and required in excess of 14,000 man hours." See Williams Memorandum, note 56 *supra*, at 990 n.18.

65 For example, as a result of its proceedings against Peat and Touche, the Commission has injected itself into the process of drafting accounting firm audit manuals for those firms. Likewise, pursuant to the order entered in the proceeding against Laventhol, that firm was required to secure Commission and court approval to change audit procedures reflected in the firm's manual. See Bialkin, *Sanctions Against Accountants*, 8 REV. SEC. REG. 823, 829 (1975).

66 Securities Act § 19(a); Securities Exchange Act §§ 3(b), 12(b)(1), 13(b) and 23(a).

67 For the classic discussion on the SEC's authority to promulgate auditing standards, see Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201, 225 (1975).

68 Memorandum to Chairman Williams, note 56 *supra*, at 997 n.33.

69 *Id.* at n.33.



the medium of a 2(e) proceeding.<sup>70</sup> Thus the procedures which would normally attend the enactment of a Commission rule or regulation (or the enactment of an auditing standard by the AICPA),<sup>71</sup> including notice and publication of the proposal and a period for comment, are absent.<sup>72</sup> Accordingly, the expression of such "guidance to all auditors for future audits," comes at the expense of the professional reputation of some auditor who should have known what the standards for "future audits" would be.<sup>73</sup>

Moreover, by making such proclamations of generally accepted auditing standards without the benefit of the views of those who actually are engaged in the day-to-day practice of auditing, the risk is created that a patently unrealistic standard will be the guiding light for avoidance of disciplinary activity under Rule 2(e). The danger of such an approach is amply demonstrated by the Commission's explication of an auditing standard in its 2(e) proceeding in the *Matter of Peat, Marwick, Mitchell & Co.*,<sup>74</sup> involving that firm's examination of National Student Marketing Corporation. There the Commission suggests the ex-

<sup>70</sup> *Id.* at 998.

<sup>71</sup> The American Institute of Certified Public Accountants is the only national accounting association whose membership is limited to certified public accountants. Because of its efforts to promote and maintain professional standards of practice, the AICPA has come to be accepted as the authoritative source of auditing standards and procedures. *See, e.g., SEC v. Arthur Young & Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,766, n.2 (9th Cir. 1979); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976); *United States v. Natelli*, 527 F.2d 311, 320, 324 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976).

<sup>72</sup> *See* Administrative Procedures Act, 5 U.S.C. § 553 (1966); *Pickus v. U.S. Board of Parole*, 507 F.2d 1107, 1112-14 (D.C. Cir. 1974); *Lewis-Mota v. Secretary of Labor*, 469 F.2d 478, 481-82 (2d Cir. 1972); *Texaco v. Federal Power Comm'n*, 412 F.2d 740, 744 (3rd Cir. 1969).

<sup>73</sup> That this approach is "overly crude" has been conceded by no less an authority than an SEC Chairman who stated:

I have observed in the past that I think our enforcement weapons may be overly crude, or at least not well tuned to achieve our objective. The use of Rule 2(e) has theoretical attraction. In some cases it has clearly seemed like the appropriate remedy with respect to lawyers whose sins have extended to misrepresentations if not outright lies in their dealings with the Commission itself. But I doubt whether it can ever serve as an appropriate vehicle for enunciating professional guidelines.

Garrett, *New Directions in Professional Responsibility*, 29 Bus. Law. 7, 12-13 (1974). Similarly, see the petition to amend Rule 2(e) recently filed with the SEC by the Institute for Public Interest Representation (May 25, 1978), which proposes that a whistle-blowing obligation be imposed on attorneys through an amendment to existing Rule 2(e), which the Institute states (p. 9):

While this rule is certainly worded broadly enough to reach the attorney who fails to disclose his client's misrepresentations, there appear to be no cases in which an attorney was disciplined for that reason. Moreover, the breadth of the rule is also its primary drawback. It does not list any criteria by which the Commission is to determine whether an attorney lacks the "requisite qualifications" or "character or integrity" necessary to practice before the Commission. Nor does it define "unethical or improper conduct." In short, the rule does not clearly inform the securities bar what standards of conduct the Commission deems most important — one of which, we submit, should be the requirement to reveal a client's fraud if perpetrated during the course of the representation. Inasmuch as requirements of due process require that any attorney to be disbarred or suspended for violation of a disciplinary rule have advance notice that his particular course of conduct is improper, *cf., In re Rufalo*, 390 U.S. 544 (1968), the Commission may feel itself constrained to pursue only the most flagrant abuses of ethical obligations through the general provisions of Rule 2(e) [footnote omitted].

*See also* the Report of SEC Advisory Committee on Corporate Disclosure (November 1977) which recommends that the SEC discontinue its comparable practice of promulgating disclosure rules through enforcement proceedings rather than rulemaking (at 328-29).

<sup>74</sup> Accounting Series Release No. 173 (1975), 5 Fed. Sec. L. Rep. (CCH) ¶ 72,195.

istence of a "whistle blowing" obligation<sup>75</sup> in certain circumstances—an obligation which is not grounded on any ethical requirement,<sup>76</sup> accounting principle, auditing standard or judicial decision,<sup>77</sup> and which was not subjected to the benefits of scrutiny by auditing practitioners and others, who might have addressed the extent to which that standard would have a chilling effect on auditor-client communications and could impair the entire audit process.

Indeed, the Commission's enunciation of this "auditing standard" totally disregards the likelihood that application of such a standard would not only result in an auditor being deprived of information by clients who would be reticent to discuss questionable matters with a professional advisor compelled to disclose such information to the SEC,<sup>78</sup> but also creates the potential for the

<sup>75</sup> *Id.* at 62,450-51.

<sup>76</sup> Under the AICPA's Code of Professional Ethics, Rule 301, an accountant "shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client." 2 PROFESSIONAL STANDARDS (CCH) ET § 301.

<sup>77</sup> Indeed, contrary to the SEC's position, there is support in the case law for the general proposition that an auditor's disclosure obligation terminates upon withdrawal and disassociation as auditor. *See* *Wessel v. Buhler*, 437 F.2d 279, 282 (9th Cir. 1971); *Katz v. Realty Equities Corp.*, 406 F. Supp. 802 (S.D.N.Y. 1976); *In Re Republic National Life Ins. Co.*, 387 F. Supp. 902 (S.D.N.Y. 1975); *Gold v. DLC, Inc.*, 399 F. Supp. 1123 (S.D.N.Y. 1975); *Seeburg-Commonwealth United Litigation*, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,802 (S.D.N.Y. 1972); *Fisher v. Kletz*, 226 F. Supp. 180, 195 (S.D.N.Y. 1967). *See also*, *Isbell, An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-blowing*, 35 OHIO ST. L. J. 261 (1974).

<sup>78</sup> It cannot be gainsaid that to the extent that a client cannot be assured that confidences reposed with a professional advisor will be safeguarded, the client will be less inclined to share all its confidences with the professional advisor.

*See, e.g.*, the AICPA's Petition to the Internal Revenue Service, May 12, 1977, wherein the AICPA opposed IRS efforts to obtain access to workpapers prepared for use by auditors in analyzing the adequacy of contingent tax liabilities. In support of its Petition the AICPA stated:

Successful demands by IRS for access to tax accrual working papers will cause a breakdown in the vital free and candid exchange between client and auditor and would seriously impair the ability of auditors to perform their principal role, the expression of opinions on the fairness of clients' financial statements. [see page 6 of the petition]

... The public interest demands that the freedom of communication between auditor and client remain unimpaired — not for the benefit of the company or its auditors, but for the benefit of those in the economy who must have accurate and dependable information. It is absolutely essential that the auditor must have complete and full access to the client's financial transactions if he is to express an opinion on a client's financial statements. Obviously this will include complete information with respect to the provision for income taxes. If the IRS were granted free and unfettered access to the working papers, the client's willingness to deal with the auditor completely and frankly would be seriously and irreparably undermined. This breakdown in communications inevitably would result in a substantial number of CPAs opinions being qualified as to scope, a result unacceptable to the SEC and clearly contrary to the public interest. [see pages 13-14 of the petition]

The American Bar Association has expressed a similar concern regarding the inhibiting effect on attorney-client communications resulting from "compelled" disclosure:

This vital confidentiality of consultation and advice [between lawyer and client] would be destroyed or seriously impaired if it is accepted as a general principle that lawyers must inform the SEC or others regarding confidential information received by lawyers from their clients even though such action would not be permitted or required by the CPR. Any such compelled disclosure would seriously and adversely affect the ability of lawyers as advocates to represent and defend their clients' interests.

In light of the foregoing considerations, it must be recognized that a lawyer cannot, consistently with his essential role as legal adviser, be regarded as a source of information concerning possible wrongdoing by clients. Accordingly, any principle of law which, except as permitted or required by the CPR, permits or obliges a lawyer to disclose to the SEC otherwise confidential information, should be established only

greater harm that clients might take active steps at intentionally concealing information from the auditor which might relate to possible sensitive and questionable matters.

Apart from creating a potentially unhealthy situation between the client and auditor, the SEC's auditing standard unnecessarily places the onus for whistle blowing on the auditor when in effect the auditing profession's existing standards place such a burden on the client. If the client declines to make disclosures necessary to prevent its financial statements from being materially misleading, and refuses to accept a qualified or disclaimed audit report, the auditor is then compelled to withdraw from the engagement.<sup>79</sup> In such circumstances withdrawal by an auditor is tantamount to whistle blowing, and results from the client's decision not to disclose.<sup>80</sup> Such a system, as created and applied by

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by statute after full and careful consideration of the public interests involved, and should be resisted unless clearly mandated by law.

ABA Section of Corporation, Banking and Business Law, *Report to House of Delegates*, 31 Bus. LAW. 544 (1975).

See also the *en banc* decision in *Diversified Indus., Inc., v. Meredith*, 572 F.2d 596 (8th Cir. 1978) where the court of appeals extended the attorney-client privilege to prevent the disclosure of information relating to a "corrupt practices" investigation conducted by independent legal counsel. In preventing discovery on the basis of attorney-client privilege, the court observed that to allow disclosure "may result in discouraging communications to lawyers made in a good faith effort to promote compliance with the complex laws governing corporate activity" and that

the application of the attorney-client privilege to this matter and others like it will encourage corporations to seek out and correct wrong-doing in their own house and to do so with attorneys who are obligated by the Code of Professional Responsibility to conduct the inquiry in an independent and ethical manner.

...

To hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to investigate and advise them in order to protect stockholders, potential stockholders and customers.

*Id.* at 609-11.

79 See STATEMENT ON AUDITING STANDARDS No. 2, *Reports on Audited Financial Statements* (AICPA 1974); STATEMENT ON AUDITING STANDARDS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities* (AICPA 1977); STATEMENT ON AUDITING STANDARDS No. 17, *Illegal Acts by Clients* (AICPA 1977); CODE OF PROFESSIONAL ETHICS, *Rules of Conduct 202 and 203* (AICPA 1973).

80 Securities Exchange Act Form 8-K, Item 4 requires all registrants who must file reports with the Commission pursuant to Section 13 or 15(d) of the Securities Exchange Act to disclose to the SEC a change in the registrant's certifying accountant. Among the disclosures that must be made on resignation or termination of the certifying accountant are:

(b) State whether in connection with the audits of the two most recent fiscal years and any subsequent interim period preceding such resignation, dismissal or engagement there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his report to the subject matter of the disagreement(s); also, describe each such disagreement. The disagreements required to be reported in response to the preceding sentence include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this rule are those which occur at the decision-making level; i.e., between personnel of the registrant responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report.

(c) State whether the principal accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainty, audit scope, or accounting principles; also describe the nature of each such adverse opinion, disclaimer of opinion, or qualification.

(d) The registrant shall request the former accountant to furnish the registrant with a letter addressed to the Commission stating whether he agrees with the statements made by the registrant in response to this item and, if not, stating the respects

auditing practitioners, has as its virtues the preservation of client confidentiality and the free flow of client-auditor communication vital to the audit process, while assuring that an isolated instance of material management fraud known to the disengaging auditor will not go unnoticed by the SEC or any successor auditor.<sup>81</sup>

in which he does not agree. The registrant shall file a copy of the former accountant's letter as an exhibit with all copies of the Form 8-K required to be filed pursuant to General Instructions E.

(e) State whether the decision to change accountants was recommended or approved by:

1) any audit or similar committee of the Board of Directors, if the issuer has such a committee; or

2) the Board of Directors, if the issuer has no such committee.

3 FED. SEC. L. REP. (CCH) ¶ 31,003. This elaborate system of disclosure which attends the termination or resignation of a registrant's auditor will assure the Commission and investing public that all necessary financial statement disclosures have either been made in the financials themselves or will be made or at least alluded to in the Form 8-K and thus will become a point of scrutiny by the Commission and users of financial information.

In addition, STATEMENT ON AUDITING STANDARDS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA 1975), requires that before an auditor undertakes an engagement where a prior auditor has resigned or been terminated, the "successor auditor":

should make specific and reasonable inquiries of the predecessor regarding matters that the successor believes will assist him in determining whether to accept the engagement. His inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; and on the predecessor's understanding as to the reasons for the change of auditors.

This professional standard further diminishes the possibility that a material inadequacy in financial statement disclosure will escape the attention of the SEC or users of financial statements.

81 Unlike accountants, there is no 8-K requirement mandating disclosure of the circumstances surrounding termination or resignation of outside legal counsel. Thus, in a factually egregious case such as *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978), the proponents of a "whistle-blowing" obligation gain credibility for their arguments. See Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibility and Liability to Investors, and National Student Marketing Corp.*, 54 NOTRE DAME LAW. 1795 (1979). It is indeed the unusual case where legal counsel will not resign rather than countenance or facilitate a transaction which is predicated on information that is materially misleading and known to be such. See, e.g., *In Re Peat, Marwick, Mitchell & Co.*, Accounting Series Release No. 173 (1975), 5 FED. SEC. L. REP. (CCH) ¶ 72,195, where the Commission noted that National Student Marketing's predecessor legal counsel and independent auditor had both resigned prior to the merger transaction subsequently at issue, and that these resignations "came as a result of a series of events which led [the auditors] and [the lawyers] to question the reliability of information which they received from NSMC's management." *Id.* at 62,443.

See also *In Re William R. Carter*, SEC Administrative Proceeding File No. 3-5464 (Initial Decision March 7, 1979) where the administrative law judge held that the two attorneys who were the subject of that disciplinary proceeding "willfully aided and abetted" their client's violations of Rule 10b-5 and section 13(a) of the Exchange Act. There the attorneys did not resign from their engagement as outside counsel to the client, National Telephone Company, despite repeated refusals by National's chief executive officer (and controlling shareholder) to make certain disclosures of information which the attorneys recommended as necessary under the federal securities laws. 494 SEC. REG. & L. REP. (BNA) F-5—F-10. The administrative law judge observed that:

respondents' defense is that they repeatedly told Hart to comply with the applicable securities laws and regulations, and the fact that he continually ignored such advice is not their fault. Despite the urging of other attorneys and Bank representatives they took no steps to see that proper disclosure of the company's financial affairs was made to anyone, including shareholders, investors, the SEC or even National's board of directors.

*Id.* at F-10. The administrative law judge held that on the basis of the ethical standards of the law profession, as well as the custom and practice of the securities bar (which custom and practice the law judge derives from articles and speeches published by SEC officials and members of academe), the attorneys had also violated Rule 2(e), stating:

It is concluded that respondents failed to carry out their professional responsibility

## V. Conclusion

The Commission's questionable use, and abuse, of Rule 2(e) gives rise to serious considerations of the due process afforded the professional who is the subject of such a proceeding, and the larger question of the proper role of the SEC in disciplining and regulating professionals.

If the Commission continues to misuse Rule 2(e) and usurp power it does not really have,<sup>82</sup> and assuming courts countenance such continued activity, then at a minimum the Commission would do well to shore up those aspects of its 2(e) proceedings which are vulnerable to challenge on due process grounds, not the least of which is its failure to require that a professional be subjected to the severe penalty of suspension or disbarment only on a showing of scienter or some higher standard of culpability.<sup>83</sup> Moreover, proof of such culpability should be by clear and convincing evidence, and based on existing principles and standards and not those which grow out of the proceeding and are given *ex post facto* application. In no event should sanctions be administered absent a clear finding

ties with respect to appropriate disclosures to all concerned, including stockholders, directors and the investing public, of the material facts described herein, and thus knowingly engaged in unethical and improper professional conduct, as charged in the Order.

*Id.* at F-13. If the administrative law judge's decision stands unblemished by further Commission review, it potentially could lead to great harm due to its intimation that in all circumstances—and not merely those before the administrative law judge—legal counsel not only must resign in the face of a dispute with his client, but also must disclose such dispute to the SEC.

For an account of the lawyer's reaction to this decision see the Wall Street Journal, March 13, 1979, at 4, col. 4. See also the SEC's investigative report relating to the activities of National Telephone's outside directors. Securities Exchange Act Release No. 14380 (January 16, 1978), [Current] FED. SEC. L. REP. (CCH) ¶ 81,410.

82 Section 1502(a)(5) of the proposed American Law Institute's Federal Securities Code explicitly provides the Commission with authority to discipline professionals practicing before it. ALI FEDERAL SECURITIES CODE, *Reporters Revision of Text of Ten. Draft Nos. 1-3*, p. 182 (October 1, 1974). In its initial draft, the ALI Code contained no explicit provision for disciplining accountants, the Reporter's comment stating that: "It seems just as well to leave implicit the Commission's authority to discipline accountants who practice before it — and this applies equally to lawyers — as in Rule of Practice 2(e)." T.D. No. 3, p. 26 (April 1, 1970) (emphasis in original).

To the extent that Congress addresses the ALI's efforts at codification of the federal securities code, it can be expected that the SEC's authority to discipline professionals will be an issue which will be fully addressed. See the announcement of the ABA Subcommittee on SEC Practice and Enforcement Matters regarding that subcommittee's proposed review of SEC adjudicative and disciplinary proceedings. 484 SEC. REG. & L. REP. (BNA) A-17 (January 3, 1979), including the Commission's powers to discipline professionals.

83 See *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 n.6 (2d Cir. 1976) where Judge Friendly stated:

The Court left open "the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10(b)-5." 425 U.S. at 194 n.12. The Court said nothing about whether scienter is a necessary element in disciplinary actions under § 15. These actions share with damage suits the quality of visiting serious consequences on past conduct, even though they also have a remedial effect. They thus differ from injunctive proceedings, the objective of which is solely to prevent threatened future harm, although unlawful conduct is necessary — if not always sufficient — to demonstrate the reality of this threat. We therefore assume, *arguendo*, without deciding, that the *Hochfelder* culpability standard applies in disciplinary proceedings. Cf. Jaffe, *Judicial Control of Administrative Action* 267-68 (1965) ("Revocation, indeed, seems often to be used as a sanction not so much to control the respondent as to warn others, and thus it has a significant 'penal' component, even though the courts may choose to mask its character by calling it a 'civil' remedy") (footnote omitted).

See also *In re Ruffalo*, 390 U.S. 554, 555-56 (1968); *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978); *In re Fisher*, 179 F.2d 361, 369 (7th Cir. 1950).

that the professional is likely to engage in future wrongdoing.

In addition, the Commission should refrain from advancing in 2(e) proceedings new or "exotic" theories of accounting principles or auditing standards which are better and more fairly addressed through the hearing and rulemaking processes of the accounting profession.<sup>84</sup> The imposition of such safeguards in 2(e) enforcement proceedings goes no further than that which is expected and required in injunctive enforcement proceedings, where the stakes in winning or losing are no greater.

Moreover, the SEC's continued misuse of Rule 2(e) should not be necessary under any view of need, including the Commission's, if the results of the accounting profession's current efforts at self-regulation prove successful. The self-policing efforts of the professional accounting organizations such as the AICPA and state societies of CPAs are under way at an accelerated pace<sup>85</sup> and in many instances have been and will be supplemented by increased regulatory activities of the state boards of accountancy which license CPAs.<sup>86</sup> This pervasive scheme of regulation, if actively implemented, should totally preempt the need for SEC involvement in disciplinary matters and thereby foreclose Commission intrusion into the daily activities of the accounting profession.

In the absence of future restraint by the SEC and increased regulatory efforts by the profession it can be expected that the present-day misuse of Rule 2(e) will not subside.<sup>87</sup>

84 See the Report of the Special Committee of the AICPA to Study the Structure of the Auditing Standards Executive Committee, JOURNAL OF ACCOUNTANCY, October 1978, at 131-38.

85 See SEC Report to Congress on the Accounting Profession and the Commission's Oversight Role, at 8-9, 46 (July 1978).

86 See, e.g., recently enacted professional disciplinary legislation in the State of Iowa which, among other things, places an affirmative whistle-blowing obligation on all accounting practitioners to report to the state Board of Accountancy known acts of misconduct committed by fellow practitioners. Failure to report is itself a statutory violation subjecting the practitioner to suspension or termination of license. Senate File 312, § 9(2) 1978. See generally 7 IOWA CODE ANN. §§ 116.3, 116.21(4) (1978-79 Supp.).

87 The call for change in the Commission's use of Rule 2(e) is not new for in 1973 this law review recorded the following recommendation made by a former SEC Commissioner:

The Commission is entitled to expect that professionals who practice before it, such as lawyers, accountants, engineers and geologists, should maintain high standards of ethics and professional conduct. To this end, the Commission has recently instituted court proceedings in which it has named lawyers and accountants as defendants. This author has urged the need for study of such litigation and a definition of the role of attorneys in representing public companies, and otherwise practicing before the Commission. *Rules of professional conduct should not be developed through case-by-case litigation*, but rather through reasoned discussion in the public interest. Lawyers have long maintained rules of professional responsibility and the courts have enforced compliance with such standards since lawyers are officers of the courts. Other professions are capable of doing likewise. *The Commission's unilaterally seeking to establish its ideas or concepts of professional responsibility, or those of its staff, through litigation rather than bilaterally with the various professions does not merit commendation, but requires change.* As with its failure to change its procedural rules to invest its administrative trial procedures with a needed tone of fairness, the Commission as an institution likewise has not moved expeditiously in the public interest to formulate standards of professional conduct. It would be well if the Commission would modify its posture from "headhunter" to regulator, in the sense that it looks for compliance with established standards.

McCauley, *The Securities Laws — After 40 Years: A Need for Rethinking*, 48 NOTRE DAME LAW. 1092, 1106-07 (1973) (emphasis added). Unfortunately, the Commission's continued abuse of Rule 2(e) in the period subsequent to Mr. McCauley's recommendation bears witness to the authors' reservation.