Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants

Dixie L. Johnson
John H. Sturc
Kenneth B. Winer
Jayne W. Barnard
William & Mary Law School, jwbar@wm.edu
Evan J. Falchuk

See next page for additional authors
Authors
Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants

*By the Task Force on Rule 102(e) Proceedings*

**INTRODUCTION**

Under Rule 102(e) of its Rules of Practice, the U.S. Securities and Exchange Commission (Commission) may sanction accountants, lawyers, and other professionals who "practice before the Commission." If the Commission provides the professional with notice and the opportunity for a hearing, it can sanction that professional on a determination that the professional engaged in what the rule describes as "improper professional conduct." *The Committee on Federal Regulation of Securities (Committee) of the American Bar Association's Section of Business Law (Section) formed this task force to consider the standards that the U.S. Securities & Exchange Commission should apply in imposing a sanction upon an accountant pursuant to Rule 102(e). This report sets forth the result of that consideration. The members of the Task Force on Rule 102(e) Proceedings (Task Force) are: Dixie L. Johnson (Co-Chair), John H. Sturc (Co-Chair), Kenneth B. Winer (Co-Chair), Jayne W. Barnard, Evan J. Falchuk, Jeffrey T. Gilleran, Thomas Gorman, David B. Hardison, Gloria K. Niemi, and Thomas L. Riesenberg. The Task Force is comprised of members of the Committee's Subcommittee on Civil Litigation and Securities and Exchange Commission Enforcement Matters. A draft of this report was circulated for comment among members of this subcommittee and the chairs and vice-chairs of the other subcommittees and task forces of the Committee, the officers of the Committee, the members of the Advisory Committee of the Committee, and the officers of the Section. A substantial majority of those who have reviewed the Report in draft form have indicated their general agreement with the views expressed. This report, however, does not represent the official position of the American Bar Association, the Section, or the Committee, nor does it necessarily reflect the views of all of those who have reviewed it.

1. 17 C.F.R. § 201.102(e) (1996). Prior to 1995, the authority was set forth in Rule 2(e) of the Commission's Rules of Practice, which was substantially identical to the current Rule 102(e). For ease of reference, this report refers to Rule 102(e) even when the rule in effect at the time of the precedents described was Rule 2(e).

2. While there has been substantial controversy surrounding the imposition of Rule 102(e) sanctions against lawyers, the American Bar Association has previously articulated its position with regard to lawyers. This report is not intended to address the imposition of Rule 102(e) sanctions against lawyers, and should not be read to suggest that its premises, analysis, or recommendation apply to the imposition of Rule 102(e) sanctions against lawyers.

3. 17 C.F.R. § 201.102(e).
Although Rule 102(e) is now in its seventh decade of existence, the criteria used by the Commission in determining what constitutes “improper professional conduct” remain far from well-defined. Concerns relating to the sanctioning of accountants have become particularly acute since the Commission’s 1992 opinion in In re Checkosky (Checkosky I), in which the Commission indicated that a negligent failure to adhere to auditing standards constituted improper professional conduct. Following an appeal of that decision, the U.S. Court of Appeals for the D.C. Circuit ordered the Commission to identify its standards for the imposition of Rule 102(e) sanctions, to clarify whether its position was that negligent conduct could give rise to 102(e) sanctions.

The Commission’s response, however, issued in its January 1997 In re

---


5. In re Checkosky (Checkosky I), Exchange Act Release No. 31,094, 52 S.E.C. Docket (CCH) 1122, 1133 (Aug. 26, 1992). As will be set forth in more detail, in Checkosky I, two accountants had argued, among other things, that a finding of improper professional conduct could only be made where there was willful misconduct of the sort that would constitute “scint of 10b(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act). 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1996). Noting that it could sanction accountants under Rule 102(e) in the absence of “scint of, the Commission found that the two accountants had acted recklessly and imposed Rule 102(e) sanctions on them. Checkosky I, 52 S.E.C. Docket (CCH) at 1132-33.

6. Checkosky v. SEC, 23 F.3d 452, 454 (D.C. Cir. 1994). A panel of judges of the U.S. Court of Appeals for the D.C. Circuit issued three separate opinions, evidencing the lack of judicial consensus as to the propriety of the Commission’s current use of Rule 102(e). Because two judges believed the Commission either had not articulated the standard of culpability applicable to Rule 102(e) proceedings, or had not explained why the standard adopted applied to the accountants’ conduct, the case was remanded to the Commission for a “more adequate explanation of its interpretation of Rule 2(e)(1)(ii) and its application to this case.” Id. (per curiam).
Checkosky opinion (Checkosky II), provides little clarification. Instead of identifying a threshold mental state for the imposition of sanctions on accountants, two commissioners, acting as a majority, stated that Rule 102(e) "does not mandate a particular mental state." Moreover, instead of clarifying whether or not negligent conduct alone provides a sufficient basis for the imposition of sanctions under Rule 102(e), the Commission maintained that "negligent actions by a professional may, under certain circumstances, constitute improper professional conduct." Because the Commission declined to identify these "certain circumstances," the Task Force believes that the Commission should undertake a reappraisal of the standards it will apply in determining what constitutes "improper professional conduct" by an accountant. The Task Force believes that, in light of a number of factors, including the extraordinary impact of Rule 102(e) sanctions, as well as the standards applicable to the imposition of similar sanctions in other contexts, the Commission should impose Rule 102(e) sanctions only where an accountant's prior activities, considered together with the accountant's current circumstances, demonstrate that he or she is presently substantially unfit to appear and practice before the Commission, and, therefore, poses a current threat to the Commission's processes.

Part I of this report provides a brief overview of the provisions of Rule 102(e), as well as the historical bases for the imposition of sanctions under the rule. Part II considers the limitations on the Commission's authority to impose Rule 102(e) sanctions. Part III examines the Commission's conception of what constitutes improper professional conduct by an accountant as announced in its recent Checkosky II opinion. Part IV discusses the standards applicable to other situations in which the Commission seeks to restrict the ability of an individual to participate in a particular business or profession. Part V surveys the other authorities that regulate the professionalism of licensed accountants. Part VI summarizes this report and sets forth the Task Force's recommendation.

OVERVIEW OF RULE 102(e)

PROVISIONS OF THE RULE

Rule 102(e) is currently comprised of three main provisions, the relevant text of which follows:

7. In re Checkosky (Checkosky II), Exchange Act Release No. 38,183, 63 S.E.C. Docket (CCH) 1691 (Jan. 21, 1997). It should be noted that the Commission did not respond to the D.C. Circuit's directive until January 1997, more than two and one-half years after it was given and more than 15 years after some of the facts underlying the proceeding occurred.

8. Checkosky II, 63 S.E.C. Docket (CCH) at 1700. As will be discussed more thoroughly, Commissioner Johnson issued a dissenting opinion in which he stated that the Commission "should not hold a professional liable for improper professional conduct under Rule 2(e)(1)(ii), absent a finding of scienter." Id. at 1705 (Johnson, Comm'r, dissenting).

9. Id. at 1700. The respondents, Messrs. Checkosky and Aldritch, have since filed a petition for review with the U.S. Court of Appeals for the D.C. Circuit. Checkosky v. SEC, No. 97-1137 (D.C. Cir. filed Mar. 17, 1997).
(e) **Suspension and disbarment.** (1) **Generally.** The Commission may censure a person or 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 opportunity for hearing in the matter:

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

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

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

(2) **Certain professionals and convicted persons.** Any attorney who has been suspended or disbarred by a court of the United States or of any State; or any person whose license to practice as an accountant, engineer, or other professional or expert has been revoked or suspended in any State; or any person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission.

(3) **Temporary suspensions.**

....

(i) The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any attorney, accountant, engineer, or other professional or expert who has been by name:

(A) Permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder; or

(B) Found by any court of competent jurisdiction in an action brought by the Commission to which he or she is a party . . . to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.10

10. 17 C.F.R. § 201.102(e). Although the rule is currently comprised of three parts, when it was originally adopted in 1935, the sole provision was the current Rule 102(e)(1). Rules 102(e)(2) and 102(e)(3), whereby the Commission may automatically temporarily suspend a professional without notice or a hearing, were added to the Rules of Practice as part of a series of amendments adopted in 1970.
As previously indicated, Rule 102(e)(1)(ii), pursuant to which the Commission may impose sanctions where it determines a professional has engaged in "improper professional conduct," is the focus of this report.

**IMPACT OF A RULE 102(e) SANCTION**

A Rule 102(e) sanction restricts an accountant's ability to "practice before the Commission." Since at least 1938, when the Commission issued its first definition of the concept of "practice before the Commission," its interpretation of the activities constituting "practice before the Commission" has been broad and inclusive. Under Rule 102(f), "practice before the Commission" includes, but is not limited to:

(1) Transacting any business with the Commission; and
(2) The preparation of any statement, opinion or other paper by any attorney, accountant, engineer, or other professional or expert, filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney, accountant, engineer or other professional or expert. A suspension or bar from practice before the Commission has severe effects on an accountant; almost all of his or her work involving a public company, whether undertaken as an internal or independent accountant or auditor, becomes prohibited conduct. The Commission repeatedly has indicated that practice before the Commission as an accountant includes the preparation and review of financial statements, and the assumption of responsibility (when functioning as an accountant) for their preparation and review, as well as the issuance of audit reports. Under these circumstances, suspending or barring an accountant from practice before the Commission frequently has the practical effect of making it impossible for the account-

---

12. 17 C.F.R. § 201.102(f).
13. In a number of orders imposing Rule 102(e) sanctions against accountants, the Commission has provided that the accountant may, after a designated period of time, apply to resume appearing and practicing before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, or a person responsible for the preparation or review of financial statements required to be filed with the Commission. See, e.g., In re Ferraro, Exchange Act Release No. 37,474, 62 S.E.C. Docket (CCH) 1040 (July 24, 1996); In re Stern, Exchange Act Release No. 36,382, 60 S.E.C. Docket (CCH) 1272 (Oct. 17, 1995); In re Hoffman, Exchange Act Release No. 33,409, 55 S.E.C. Docket (CCH) 2174, 2175 (Jan. 4, 1994); In re Schiemann, Exchange Act Release No. 32,983, 55 S.E.C. Docket (CCH) 225, 230 (Sept. 29, 1993).
ant to work as a public accountant.14 Although the Commission, in its discretion, may merely censure an accountant rather than impose a bar or suspension, a censure may carry with it collateral consequences that have the same general characteristics as those experienced by accountants who are suspended from practice before the Commission.

**COLLATERAL CONSEQUENCES OF A RULE 102(e) SANCTION**

Aside from the direct effects on an accountant's ability to pursue his or her profession during the period of the suspension, a Rule 102(e) sanction often has significant collateral consequences.15 A Rule 102(e) proceeding often is accompanied by publicity that can have an adverse impact on the accountant's reputation.16 Employers might hesitate to employ or promote individuals who have been the subject of a Rule 102(e) sanction. Where the accountant is an employee, officer, or director of a public company, the company might be advised to disclose such a sanction.17 Indeed, before

14. See, e.g., Checkosky v. SEC, 23 F.3d 452, 479 (D.C. Cir. 1994) (opinion of Randolph, C.J.) (stating a proceeding under Rule 2(e) threatens "to deprive a person of a way of life to which he has devoted years of preparation and on which he and his family have come to rely" (quoting Henry J. Friendly, "Some Kind of Hearing," 123 U. PA. L. REV. 1267, 1297 (1975)).

15. Cf. Johnson v. SEC, 87 F.3d 484, 488-89 (D.C. Cir. 1996) (noting that a Commission order which censured a registered representative and suspended her for six months from acting as a supervisor "not only restricted [her] ability to earn a living as a supervisor during her six-month suspension, but . . . was also likely to have longer-lasting repercussions on her ability to pursue her vocation").

16. This has become a much greater concern since the 1988 amendments to Rule 102(e), which reversed the Commission's prior practice by providing that the initiation of all subsequent Rule 102(e) proceedings would be made public unless the Commission otherwise ordered. See Disciplinary Proceedings Involving Professionals Appearing or Practicing before the Commission, Exchange Act Release No. 23,893, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,248, at 89,238 (July 7, 1988) [hereinafter Disciplinary Proceedings Release].

17. In 1994, in a release announcing proposed amendments to its rules "that would expand the types of legal proceedings required to be disclosed in Commission filings," the Commission solicited comment as to whether Commission registrants should be required to disclose all Rule 102(e) proceedings initiated by the Commission against, among others, any of the registrant's executive officers, directors, and persons nominated to become directors. Disclosure Concerning Legal Proceedings Involving Management, Promoters, Control Persons and Others, Securities Act Release No. 7106, 59 Fed. Reg. 55,385 (1994). Although the Commission has not adopted the proposed rules, in the release it indicated that certain Rule 102(e) proceedings should be disclosed:

Where Rule 2(e) orders relate to violations of the federal securities laws, disclosure would be required under both the current and proposed rules. Should the requirements be expanded to encompass Rule 2(e) orders based on lack of professional qualifications, lack of character or integrity, or unethical or improper professional misconduct, the conviction of a felony or of a misdemeanor involving moral turpitude, or the disbarment
accepting a public company as an audit client, accounting firms almost certainly consider the circumstances of any Rule 102(e) sanction against the company's senior personnel. Similarly, an underwriter is likely to consider the circumstances of any Rule 102(e) sanction against the company's senior personnel before agreeing to underwrite an offering of the company's securities. Further, the NASDAQ Stock Market and the stock exchanges might consider the circumstances surrounding a Rule 102(e) sanction against a company's senior personnel in deciding whether to list the company's securities.

**AUTHORIZED RULE 102(e) SANCTIONS SERVE ONLY REMEDIAL PURPOSES**

Although none of the federal securities statutes expressly authorize the Commission to censure, suspend, or disbar professionals from practice before the Commission, four federal courts of appeal have specifically upheld the Commission's authority to promulgate Rule 102(e) as "reasonably related" to the purposes of the federal securities laws. Each of these courts has held, however, that the Commission's authority to impose sanctions under Rule 102(e) is limited by the principle that the sanctions may be imposed for the sole purpose of prospectively protecting the Commission's processes. Stated differently, Rule 102(e) sanctions must serve only a remedial, not punitive, purpose.

While the distinction between "punitive" and "remedial" sanctions has

Id. at 55,391 (footnotes omitted).

18. Sheldon v. SEC, 45 F.3d 1515, 1518 (11th Cir. 1995) (stating "[w]e join the Second and Ninth Circuits in rejecting the contention that the SEC's Rule 2(e) is improper"); Checkosky, 23 F.3d at 455 (opinion of Silberman, C.J.) (adopting reasoning of the Second and Ninth Circuits); Davy v. SEC, 792 F.2d 1418, 1421 (9th Cir. 1986) (finding "[t]he authority of the SEC to discipline accountants and bar them from practice before the Commission under Rule 2(e) was expressly upheld in a thorough opinion by Judge Timbers of the Second Circuit, whose reasoning we adopt") (citing Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979)); Touche Ross & Co., 609 F.2d at 582 (stating Rule 102(e) "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") (citing Mourning v. Family Publications Serv., Inc., 411 U.S. 356 (1973)).

19. Sheldon, 45 F.3d at 1518 (adopting the reasoning of the Second and Ninth Circuits); Checkosky, 23 F.3d at 456 (noting "[t]he Commission had promulgated Rule 2(e) not to augment its enforcement arsenal but to protect its administrative processes, and the court correctly recognized that the Commission may not 'usurp the jurisdiction of the federal courts to deal with "violations" of the securities laws'") (quoting Touche Ross & Co., 609 F.2d at 579) (opinion of Silverman, C.J.); Davy, 792 F.2d at 1421 (adopting reasoning of Second Circuit in Touche Ross & Co.); Touche Ross & Co., 609 F.2d at 582 (finding "Rule 2(e) . . . represents an attempt by the Commission to protect the integrity of its own processes").
been the topic of some debate in the courts, the Commission recently argued, in the context of an appeal of a broker-dealer disciplinary proceeding, that the test for determining whether a particular sanction is punitive or remedial is whether the sanction is for "the purpose of punishing past misconduct" or "is based on present unfitness." In the context of Rule 102(e) proceedings, the Commission and the federal courts have articulated the same standard, consistently maintaining that the imposition of Rule 102(e) sanctions is based on a determination that a professional's conduct demonstrates that he or she presents a current threat to the integrity of the Commission's processes:

Rule 2(e) proceedings are designed not to punish a person, but to protect the integrity of Commission proceedings. In keeping with this purpose, the sanctions imposed in a Rule 2(e) proceeding should be limited to those sanctions necessary to protect the Commission's proceedings, such as suspensions or bars from appearing before the Commission.


21. See, e.g., Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, reprinted in Securities Law Enforcement: Hearing Before the Subcomm. on Telecommunications and Fin. of the House Comm. on Energy and Commerce on H.R. 975, 101st Cong. 1st Sess. 46-49 (1989) [hereinafter Commission Memorandum]; Checkosky, 23 F.3d at 493 (stating that "[t]he Commission has the authority to issue Rule 2(e) in order to 'protect the integrity of its own processes' (e.g. to assure honest and accurate financial filings) by revoking the privileges of professionals whose conduct threatens those processes") (Reynolds, D.J., concurring in part and dissenting in part); Touche Ross & Co., 609 F.2d at 579 (stating that the purpose of Rule 102(e) is "to preserve the integrity of its own procedures, by assuring the fitness of those professionals who represent others before the Commission"); see also Davy, 792 F.2d at 1421.

22. Commission Memorandum, supra note 21, at 49. At the time the Commission submitted its memorandum, Congress was considering the possibility of expanding the Commission's authority under Rule 102(e) by granting it the ability to impose civil monetary penalties in such proceedings. In the memorandum, the Commission specifically argued against the opportunity, stating: "[p]aying a penalty will not make a professional fit to practice before the commission. Rather, penalties serve enforcement goals of punishing past misconduct and deterring future misconduct." Id.; see also United States v. Halper, 490 U.S. 435 (1989). In Halper, a case relating to the Double Jeopardy Clause prohibition on multiple punishments, the U.S. Supreme Court observed:

"[T]he determination whether a given civil sanction constitutes punishment in the relevant sense requires a particularized assessment of the penalty imposed and the purposes that the penalty may fairly be said to serve. Simply put, a civil as well as a criminal sanction constitutes punishment when the sanction as applied in the individual case serves the goals of punishment.

These goals are familiar. We have recognized in other contexts that punishment serves the twin aims of retribution and deterrence. . . . From these premises, it follows that a civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather
Task Force on Rule 102(e) Proceedings

To this end, the federal courts and the Commission have emphasized that Rule 102(e) is not an additional weapon in the Commission’s enforcement arsenal, but is rather a means of protecting the Commission’s processes if a professional’s prior activities demonstrate he or she poses a current threat to those processes.23

**RECENT RULE 102(e) PROCEEDINGS**

The Task Force shares the views of the federal courts and the Commission that Rule 102(e) sanctions should serve solely a remedial purpose. The Task Force believes, however, that the lack of clearly defined standards for what constitutes improper professional conduct has, in many cases, led to the inappropriate employment of Rule 102(e) to punish prior alleged failures by accountants to comply with professional standards, rather than to protect the Commission’s processes from individuals found to present a current threat to the integrity of those processes. The Commission’s recently issued *Checkosky II* opinion provides not only a discussion, but also an example, of the difficulties facing both the Commission and the accounting profession relating to the proper use of Rule 102(e).

**IN RE CHECKOSKY**

In the Commission’s opinion in *Checkosky I*,24 which preceded the court of appeals decision previously described, the Commission found that

> can only be explained as also serving either retributive or deterrent purposes, is punishment, as we have come to understand the term.

*Id.* at 448. Thus, because authorized Rule 102(e) sanctions must serve only a remedial purpose, a Rule 102(e) sanction may not also carry a retributive or deterrent purpose. The Task Force recognizes, however, that, even without a deterrent purpose, the imposition of a Rule 102(e) sanction on an individual accountant may have the effect of deterring similar conduct by other accountants. The Task Force does not believe that the mere existence of such a deterrent effect transforms what would otherwise be a remedial Rule 102(e) sanction, *a fortiori*, into a punitive sanction.

23. *See, e.g.*, *Checkosky*, 23 F.3d at 493 (noting that “Rule 2(e) is separate from the SEC’s arsenal against violations of the Act’s substantive provisions, because suspensions under the Rule are necessary to aid the Commission in the regulation and administration of the Act”) (Reynolds, D.J., concurring in part and dissenting in part) (footnotes omitted); *Touche Ross & Co.*, 609 F.2d at 579. The *Touche Ross & Co.* court stated:

> [i]ndeed, the Commission has made it clear that its intent 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 Commission.


"proof of bad faith or willful misconduct is not a prerequisite for the imposition of sanctions pursuant to Rule 2(e)(1)(ii) of the Commission’s Rules of Practice." In Checkosky I, the Commission determined that two auditors had incorrectly interpreted GAAP and had violated GAAS by failing to: (i) qualify their opinion as to whether the issuer’s financial statements were prepared in accordance with GAAP, (ii) conduct the audit with sufficient skepticism and due care, and (iii) obtain sufficient competent evidential matter to support their opinion. Although the Commission characterized the auditors’ conduct as reckless, the Commission asserted, in finding that the auditors had engaged in “improper professional conduct,” that “a mental awareness greater than negligence is not required to impose sanctions against an accountant pursuant to Rule 2(e).”

A challenge to the Commission’s order ensued. As previously noted, a panel of judges of the U.S. Court of Appeals for the D.C. Circuit determined that it was unclear whether the Commission had applied a negligence standard in finding that the auditors had engaged in improper professional conduct. Indeed, one of the judges indicated that the Commission’s prior Rule 102(e) decisions demonstrated that the Commission had never been clear about what standard of conduct should give rise to a 102(e) sanction. Accordingly, the matter was remanded, with instructions for the Commission to clarify the standard of conduct, and how it applied to the case.

In its response, the majority of the Commission began by reiterating and explaining its conclusion that the auditors’ conduct had been “reckless.” Thus, a finding as to whether the respondents had been negligent, and whether negligent conduct alone was a sufficient basis for a finding of sanctionable improper professional conduct, was unnecessary to a decision in the proceeding. Nevertheless, the Commission took the occasion to point out that Rule 102(e) is a means by which the Commission holds “those professionals who practice before us to generally recognized norms

25. Id. at 1123.
26. Id. at 1131-32.
27. Id. at 1132 (quoting Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 84,150 (finding a sanction under Rule 102(e) is “limited to that necessary to protect the investing public and the Commission from the future impact on its processes of professional misconduct”)).
28. See supra text accompanying note 6.
29. Checkosky v. SEC, 23 F.3d 452, 462 (stating that the Commission has “variously indicated that different levels of mental culpability are needed” to make out a Rule 102(e) violation) (opinion of Silberman, C.J.).
30. Id. at 454 (per curiam).
31. In re Checkosky (Checkosky II), Exchange Act Release No. 38,183, 63 S.E.C. Docket (CCH) 1691, 1696 (Jan. 21, 1997). The Commission noted that recklessness has been defined as “not merely a form of ordinary negligence; it is an ‘extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.’” Id. at 1696 n.23 (quoting SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992)).
of professional conduct... To do so upsets no justifiable expectations, since the professional is already subject to those norms. In the case of accountants, those standards include GAAS and GAAP. Examining the conduct of accountants in light of these standards, the Commission stated that it had, in the past, "found improper professional conduct committed under circumstances evidencing a variety of mental states." Improper professional conduct by accountants thus "encompasses a range of conduct," including not just willful acts of malfeasance, but also conduct that is "incompetent or unethical," even conduct that was the result of mental and physical exhaustion. Given these precedents, the Commission deduced that "varying degrees of care or mental state" could give rise to Rule 102(e) sanctions.

As for the specific question of whether negligent conduct could give rise to a Rule 102(e) sanction, the Commission conceded that its processes "are not necessarily threatened by innocent or even certain careless mistakes." Indeed, the majority emphasized that it wished to "make clear" that "the fact that GAAP and GAAS are professional standards against which we measure the conduct of accountants does not mean that every deviation from GAAP and GAAS is improper professional conduct warranting discipline" under Rule 102(e). Nonetheless, the Commission warned that Rule 102(e) "does not mandate a particular mental state... negligent actions by a professional may, under certain circumstances, constitute improper professional conduct."

The majority deliberately declined to identify the "certain circumstances" of nonreckless or nonintentional conduct that would warrant sanctions, except to briefly describe several broad areas of deficiency, lack of independence, misapplication of GAAP, lack of skepticism, lack of factual basis for an opinion, and failure to perform auditing procedures, that had in the past been instances in which it had imposed sanctions. Indeed, the majority indicated that, while repeated "mistakes" could give rise to sanctions, "isolated failures may be so serious as to warrant discipline,

33. Checkosky II, 63 S.E.C. Docket (CCH) at 1699.
34. Id. at 1700 (stating "we have not hesitated to sanction auditors for such conduct").
35. Id. (quoting Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 84,148 (finding "[a]n incompetent or unethical practitioner has the ability to inflict substantial damage on the Commission's processes, and thus the investing public") (quoting In re Keating, Muething & Klekamp, Exchange Act Release No. 15,982, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124, at 81,991 (July 2, 1979) (Williams, Chairman, concurring)).
36. Checkosky II, 63 S.E.C. Docket (CCH) at 1701.
37. Id.
38. Id. at 1703.
39. Id.
40. Id. at 1700.
even where the isolated failure is merely "careless and unprofessional." As such, the Commission stated that its "conclusions about the propriety of particular professional conduct are driven by the impact on Commission processes of the specific facts presented in a given proceeding before us." Commissioner Johnson filed a separate opinion, dissenting from the majority's conclusion that accountants could be sanctioned under Rule 102(e) "based on conduct that is merely negligent." In Commissioner Johnson's view, the Commission should impose Rule 102(e) sanctions "only when it is demonstrated that [the professional] acted with scienter." According to Commissioner Johnson:

A professional often must make difficult decisions, navigating through complex statutory and regulatory requirements, and, in the case of accountants, complying with [GAAS] and applying [GAAP]. These determinations require the application of independent professional judgment and sometimes involve matters of first impression. For this reason, I believe that an earlier Commission was correct to assert that, if a professional is to exercise his or her "Best independent judgment . . . [the professional] must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of losing the ability to practice before" us.

Commissioner Johnson further emphasized that the Commission should exercise "an appropriate degree" of self restraint:

I simply do not believe that we should recast negligent violations of an accounting standard as improper professional conduct. . . . That

41. Id. at 1703. The Commission cited one case intended to support this proposition, In re Bollt & Shapiro, 38 S.E.C., 815, 823 (1959). Bollt & Shapiro involved a two-partner accounting firm in which one partner, Shapiro (whose conduct the Commission characterized as "careless and unprofessional"), reported on the financial statements of a client even though the other partner, Bollt, was the promoter, principal officer, and controlling shareholder of the client, a clear violation of independence rules. In that proceeding, the Commission found that, even though Shapiro had been concerned about his independence, he relied on the opinion of the client's lawyer (who was himself an officer and director of the client) that he was qualified to certify the client's financial statements. Such extreme indifference to independence requirements would seem to constitute reckless conduct, not mere negligence.

42. Checkovsky II, 63 S.E.C. Docket (CCH) at 1700.

43. Id. at 1704 (opinion of Johnson, Comm'rs, dissenting). Commissioner Johnson also questioned the "appropriateness of disciplining the respondents considering the age of this proceeding." Id.

44. Id.


46. Id.
is not an appropriate role for this Commission. Difficult ethical and professional responsibility concerns are generally matters most appropriately dealt with by professional organizations or, in certain cases, malpractice litigation. Nor do I believe that mere misjudgments or negligence establishes either professional incompetence warranting Commission disciplinary action or the likelihood of future danger to the Commission's processes.47

As indicated by Commissioner Johnson, the Commission's determination to apply a negligence standard in Rule 102(e) proceedings raises doubts as to how a negligent auditor, whose conduct has already been completed, poses a threat to the Commission's processes. The Task Force believes that the Commission's willingness to rely on an accountant or auditor's past conduct as the sole basis for the imposition of a Rule 102(e) sanction presents a potentially serious problem for the continued validity of Rule 102(e), particularly where the past conduct is merely negligent. Indeed, as Circuit Judge Silberman emphasized in his opinion in Checkosky:

If the Commission were to determine that an accountant's negligence is a per se violation of Rule 2(e), it would have to consider not only the administrative burden such a position would entail but also whether it would constitute a de facto substantive regulation of the profession and thus raise questions as to the legitimacy of Rule 2(e)(1)(ii)—or at least its scope.48

Whether one agrees with the majority's position that state of mind is not determinative of whether to find improper professional conduct, or Commissioner Johnson's view that scienter is required, the Task Force believes that the criteria discussed in the Checkosky opinions fail to address what should be the central focus of a disciplinary proceeding: whether, taking into account all of the facts concerning a respondent, including his or her past conduct and current circumstances, the respondent poses a current threat of future conduct harmful to the Commission's processes. In a variety of other contexts, the Commission seeks to preclude individuals who are alleged to have engaged in past misconduct from engaging, in the future, in particular professional pursuits. The standards articulated as applicable in determining whether to impose sanctions in these contexts

47. Id. at 1705.
48. Checkosky v. SEC, 23 F.3d 452, 459 (D.C. Cir. 1994). Such substantive regulation of the accounting profession by the Commission would run contrary to the clearly stated intent of Congress, which, more than 30 years ago, stripped the authority of federal agencies to impose their own admissions standards on professionals practicing before them. See H.R. REP. No. 89-1141, at 4173 (1965), reprinted in 1965 U.S.C.C.A.N. 4170, 4173 (stating that "there is a presumption that members in good standing of the professions of the law and certified public accountancy are of good moral character, and that surveillance by State bar associations and State associations of certified public accounts [sic] will sufficiently insure the integrity of practice by such persons").
provide a model for the manner in which the Commission should determine whether to impose sanctions in the Rule 102(e) context.

**STANDARDS APPLIED BY THE COMMISSION IN IMPOSING SUSPENSIONS AND BARS IN ITS ADMINISTRATIVE PROCEEDINGS AND SEEKING COURT-ORDERED SUSPENSIONS AND BARS**

Under the Exchange Act, the Commission has the authority to suspend or bar persons from associating with broker-dealers. Similarly, under the Exchange Act, the Commission has the authority to seek a court-ordered suspension or bar precluding a person from serving as an officer or director of a public company for the period of the suspension. In each of these situations, the Commission or a court is required to determine whether the person in question presents a current threat to the public, such that a suspension or bar is necessary to protect the public from future wrongdoing.49

49. Consideration by the Commission of the need to protect the public from the likelihood of future wrongdoing is not limited to the question of suspensions and bars. The issue has been analyzed repeatedly by courts in the context of requests for injunctive relief in actions brought by the Commission. Courts generally award permanent injunctions where the Commission has established a past violation and made a proper showing that "a reasonable likelihood exists" that future violations would occur absent an injunction. See, e.g., SEC v. Holschuh, 694 F.2d 130, 144 (7th Cir. 1982). In determining whether there is a reasonable likelihood of a recurrence, courts have considered a number of factors including: (i) the egregiousness of the violations; (ii) the isolated or repeated nature of the violations; (iii) the degree of scienter involved; (iv) the sincerity of the defendant's assurances, if any, against future violations; (v) the defendant's recognition of the wrongful nature of his conduct; (vi) opportunities presented (or lack thereof) by the defendant's occupation for future violations; (vii) the defendant's age and health; (viii) the time elapsed since the violation; and (ix) the severe economic and professional consequences that an injunction can have on a defendant. See, e.g., SEC v. Pros Int'l, Inc., 994 F.2d 767, 769 (10th Cir. 1993); SEC v. Washington County Util. Dist., 676 F.2d 218, 227 (6th Cir. 1982); SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1048 (2d Cir. 1976). Moreover, the U.S. Supreme Court has recognized that, to establish a likelihood of future misconduct, it will almost always be necessary for the Commission to demonstrate that the defendant's past misconduct was the result of more than negligence. See, e.g., Aaron v. SEC, 446 U.S. 680, 702 (1980) (stating "[t]he Court of Appeals affirmed the issuance of the injunction in this case in the misapprehension that it was not necessary to find scienter in order to support an injunction under § 17(a)(1) of the 1933 Act, § 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder"); see also id. at 703 (Burger, J., concurring) (opining that "[t]o make such a showing, it will almost always be necessary for the Commission to demonstrate that the defendant's past sins have been the result of more than negligence").

Although the Commission has asserted, without citation, that "the standards for fraud or for injunctive relief 'have no bearing' on Rule 2(c)(1)(ii) proceedings," Checkosky II, 63 S.E.C. Docket (CCH) at 1700 n.51 (citing In re Checkosky (Checkosky I), 52 S.E.C. Docket (CCH) 1122, 1133 n.38 (1992)), the Task Force believes, as previously indicated, that, because a consideration of the need to protect the public from the likelihood of future wrongdoing is common to each of these contexts, the carefully developed standards applied in the fraud and injunctive relief contexts (as well as the similar standards applied in the other contexts discussed below) provide a model for the imposition of sanctions in the Rule 102(e) context.
CENSURES, SUSPENSIONS, AND BARS FROM ASSOCIATION WITH A BROKER-DEALER

Under the Exchange Act, the Commission may censure, suspend, or bar a person from associating with a broker-dealer or place limitations on the activities or functions of such person, if the Commission finds that the person engaged in specified misconduct and that a sanction would serve the public interest.50 The Commission recently took the position that the purpose of this provision is not to punish a person for past misconduct, but rather to protect the public from persons who are currently unfit and pose a threat to the public:

"[T]he purpose of this proceeding is not to punish past misconduct but to protect the public from future harm by unfit persons. Commission proceedings under §§ 15(b) and 19(h) are meant to assure the integrity and competence of the securities industry professionals on whom public investors rely. Evidence of past misconduct is relevant in such a proceeding to the extent it sheds light on current fitness and likely future behavior."51

The decision of the U.S. Court of Appeals for the D.C. Circuit in Johnson v. SEC provides a clear articulation of the standards applied in determining whether an individual should be suspended or barred from association with a broker-dealer.52 The issue in Johnson was whether an order censuring and suspending a broker-dealer's branch manager from acting as a supervisor for six months should be deemed a civil penalty or a remedial sanction.53 In arguing that the order imposing the censure and suspension was not a civil penalty, the Commission recognized that the test for whether a license suspension or revocation is punitive or remedial is whether the suspension or revocation is for the "purpose of punishing past misconduct" or "is based on present unfitness."54 The Commission argued that the

51. See SEC Brief, supra note 20, at 4. The Commission also stated that "[t]he overarching purpose of these provisions, as reflected in the public interest requirement, is to protect the public from persons who are professionally unfit." Id. at 22.
52. 87 F.3d 404 (D.C. Cir. 1996). Following this decision, the Commission filed a motion for an en banc hearing with the U.S. Court of Appeals for the D.C. Circuit, which denied the motion. The Solicitor General of the United States subsequently refused to give the Commission permission to seek certiorari.
53. This characterization was relevant for the purposes of determining whether the Commission's action was timely commenced because 28 U.S.C. § 2462 provides a five-year limitations period for proceedings brought to enforce any "civil fine, penalty, or forfeiture, pecuniary or otherwise."
suspension of Ms. Johnson was remedial because it was rooted in her present unfitness.

The U.S. Court of Appeals for the D.C. Circuit disagreed, holding that the order imposing the censure and suspension on Ms. Johnson was a penalty.55 In particular, the court objected to the lack of evidence demonstrating Ms. Johnson’s present unfitness, noting that the order imposing the censure and suspension “would less resemble punishment if the SEC had focused on Johnson’s current competence or the degree of risk she posed to the public.”56 Thus, both the Commission and the court seemed to agree that a truly remedial suspension or bar would be based on present unfitness, and the court further suggested that past misconduct alone would be insufficient to demonstrate that unfitness.57 The Commission’s view in this context is entirely consistent with the view it holds with regard to suspensions and bars of officers and directors.

OFFICER AND DIRECTOR SUSPENSIONS AND BARS

Under section 20(e) of the Securities Act of 1933 (Securities Act) and Exchange Act section 21(d)(2),58 a federal court may suspend or bar a defendant from serving as an officer or director of a public company at the Commission’s request where the court finds that (i) the defendant has violated either Securities Act section 17(a)(1) or Exchange Act section 10(b), and (ii) the defendant’s “conduct demonstrates substantial unfitness to serve as an officer or director.”59 The Commission obtained explicit statutory authority to seek court orders suspending or barring individuals from serving as officers and directors of public companies with the enactment of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.60 In testifying in support of the suspension or bar authority, then-Commission Chairman Richard Breeden told Congress that the Commission would seek the remedy “only in those cases ... that involve egregious fraudulent conduct.”61

55. Johnson, 87 F.3d at 491-92.
56. Id. at 489.
57. Cf. Steadman v. SEC, 603 F.2d 1126, 1141 (5th Cir. 1979), aff’d, 450 U.S. 91 (1981) (stating that “[i]t would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations”).
58. 15 U.S.C. §§ 77t(e), 78u(d)(2).
59. Id.

The report of the so-called “Treadway Commission,” issued in October 1987, made the initial recommendation that Congress grant the Commission the authority to suspend or bar corporate officers and directors. See generally SEC, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (Oct. 1987). In written testimony to Congress
The first courts to consider whether an officer should be suspended or barred under these provisions have applied a list of factors first enunciated by Professor Jayne W. Barnard in 1992:62 "(1) the 'egregiousness' of the underlying securities law violation; (2) the defendant's 'repeat offender' status; (3) the defendant's 'role' or position when he engaged in the fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood that misconduct will recur."63

**OTHER AUTHORITIES REGULATING THE PROFESSIONAL ACTIVITIES OF ACCOUNTANTS**

A "substantial unfitness" standard would not operate in a vacuum. A variety of other public and private entities regulate both the accounting profession and the professionalism of licensed accountants. These entities have procedures in place for policing the accounting profession and systems designed to ensure the integrity of accountants practicing before the Commission.64

regarding the genesis of the idea, former SEC Commissioner James Treadway, who chaired the Treadway Commission, stated:

First, the independent auditor, who in [the Treadway] Commission's view is secondarily responsible for accurate financial statements is subject to bars and suspensions. Why, we asked, should those with primary responsibility—management of the issuer—be subject to lesser sanctions? Second, when you survey the field of those subject to the SEC's reach who are subject to bars and suspensions—broker dealers and those associated with them, investment companies and those associated with them, independent accountants and those associated with them, and professionals practicing before the SEC—why is it that officers and directors of reporting companies are not subject to the same sanctions?

Securities Law Enforcement Hearing Before the Subcomm. on Telecommunications and Fin. of the House Comm. on Energy and Commerce on H.R. 975, 101st Cong. 99 (1989) (statement of James C. Treadway, Comm'r, SEC). The Task Force believes that, while officers and directors of public companies are now subject to the same sanctions, the standards applied by the Commission in determining whether an officer or director should be barred and whether an auditor should be barred remain unjustifiably different.


63. SEC v. Shah, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,374, at 90,592 (S.D.N.Y. July 28, 1993); see also SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995) (approving the application of these factors in making "the unfitness assessment"). These factors are largely based on those applied in determining whether to grant the Commission an injunction against future violations of the federal securities laws, as well as those factors discussed in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979).

64. As Congress recently observed in the legislative history of the Private Securities Litigation Reform Act of 1995:

The Conference Committee expects that the SEC will continue its long-standing practice of looking to the private sector to set and to improve auditing standards. The SEC should not act to "modify" or "supplement" generally accepted auditing standards for
**AICPA REGULATION**

Since 1977, the American Institute of Certified Public Accountants (AICPA) has administered a quality control and peer review program for members of its SEC Practice Section (Section). Members of the Section include most of the firms nationwide that audit “SEC clients,” the Section’s term for companies making an initial filing under the Securities Act or any registrant that files periodic reports with the Commission under the Exchange Act (except brokers or dealers registered only because of section 15(a) of the Exchange Act). The Section has established the Quality Control Inquiry Committee, which investigates specific allegations concerning the professional conduct of Section members in auditing SEC clients. In addition, the Section’s Peer Review Program examines selected audits to determine whether they were conducted properly and in accordance with the firm’s and the profession’s quality control standards. If the Section’s Peer Review Committee finds that an audit was not done in accordance with GAAS or that financial statements were not prepared in accordance with GAAP, the firm is expected to take appropriate corrective action. If the firm does not do so, the Section’s Executive Committee is empowered to impose sanctions, which have included: (i) corrective measures by the firm, including measures involving personnel; (ii) additional continuing professional education; (iii) accelerated or special peer reviews; (iv) admonishments, censures, or reprimands; (v) suspension from membership in the Section; or (vi) expulsion from Section membership.

Finally, all members of the AICPA are subject to that organization’s Code of Professional Conduct (Code). Members found to have violated any of the rules contained, or any standards referred to, in the Code may be subject to sanction; the maximum sanction is expulsion from membership. Expulsion from AICPA or a state CPA society membership, however, has no effect on the person’s license to practice as an accountant.65

**GOVERNMENT REGULATION**

**State Licensing Authorities**

Every state and U.S. territory has some form of licensing authority that governs the certification or licensing of public accountants within its jurisdiction. These authorities may, in compliance with applicable procedures, suspend or revoke the license of an accountant who fails to meet that state’s standards of conduct. Typical grounds for disciplinary actions against ac-

---

countants include “gross negligence,”66 “unprofessional conduct,”67 “dishcreditable conduct,”68 “dishonesty in the practice of public accounting,”69 prior suspension before a governmental body or agency,70 failure to comply with GAAS,71 or conviction of a crime.72

Proceedings to suspend or revoke an accountant’s license must afford the licensee at least minimum due process. A person facing license revocation must have access to all documents considered by the hearing officer and licensing board, for example,73 and must be provided “a definite charge, adequate notice, and a full, fair and impartial hearing.”74 Typically, judicial review is available.

**Other Commission Sanctions Applicable to Accountants**

The Commission has a number of enforcement measures available that it can apply to accountants whose conduct it determines warrants the imposition of sanctions. These measures demonstrate that the Commission has great flexibility to address conduct that it deems objectionable. For example, the Commission may issue orders requiring a respondent to cease and desist from violating now, or in the future, any provision of the federal


67. Preusch v. University of N.Y., 490 N.Y.S.2d 927, 929 (App. Div. 1985) (confirming determination to revoke an accountant's license where he orchestrated a client's loans to companies in which he had a financial interest).


69. Arnold v. Board of Accountancy, 619 P.2d 912, 913-17 (Or. Ct. App. 1980) (affirming revocation of an accountant's license where he overcharged clients and falsified billings); Keene v. Board of Accountancy, 894 P.2d 582, 587-88 (Wash. Ct. App. 1995) (affirming revocation of license where accountant: (i) induced an elderly client to make a loan to the accountant's corporation, (ii) made an unsecured loan of the client's money to a friend of the accountant, and (iii) withdrew funds from the client's account without informing the client).


securities laws. The Commission may also order a respondent to comply or take steps to effect compliance with provisions of the federal securities laws upon such terms and conditions and within such time as the Commission may specify. Moreover, the Commission may seek a federal court order enjoining violations of the federal securities laws. If a defendant profited from his or her misconduct, the Commission may seek a federal court order requiring such person to disgorge any profit obtained as a result of the violation, and, in addition, may also seek from the federal court the imposition of civil penalties against the defendant.

SANCTIONS IMPOSED IN CONNECTION WITH CRIMINAL PROCEEDINGS

It is not uncommon for courts in criminal cases to condition the availability of probation on the defendant’s willingness to forego certain types of employment or to disengage himself from a particular working environment. Where the defendant is an accountant and has been convicted of a crime, it may be appropriate for a court to condition the availability of probation on the defendant’s agreement to wind up his accounting business and to refrain from performing general accounting services for the term of his probation. This condition was imposed by the trial judge and upheld by the appellate court in State v. Graham, a case in which the

75. The Commission may enter an administrative cease-and-desist order against: (i) any person that is, was, or is about to violate any provision of the federal securities laws; and (ii) any person “that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation.” See, e.g., 15 U.S.C. § 77h-l (a) (1994). The legislative history of the Remedies Act, by which the Commission was granted the authority to enter such cease-and-desist orders, noted that it would be appropriate for the Commission to use the cease-and-desist remedy against persons “who commit isolated infractions and present a lesser threat to investors,” and to avoid protracted litigation or settlement negotiations resulting from concerns regarding the severe collateral consequences that arise from an injunction. S. REP. No. 101-337 (1990); see also H. R. REP. No. 101-616 (1990).

76. The most frequently invoked provision is 15 U.S.C. § 78t(d), which authorizes the Commission to bring an action in district court “[w]henever it shall appear ... that any person is engaged or is about to engage in any acts or practices which constitute ... a violation of the [Exchange Act] or of any rule, regulation, or order thereunder.” See also id. §§ 77(b), 79(c), 80a-41(d), 80b-9(d), 77cmm.

77. See, e.g., SEC v. Huffman, 996 F.2d 800, 802 (5th Cir. 1993); SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989).

78. For example, for insider trading and tipping cases, the Insider Trading Sanctions Act of 1984 authorized the Commission to seek, and the courts to impose, a penalty of up to three times the profit gained or loss avoided. Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. § 78u-1(a)). For all other violations of the federal securities laws, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 authorized the Commission to seek, and the courts to impose, civil penalties on a natural person of up to $100,000 or, if greater, the gross gain to the defendant. Pub. L. No. 101-429, § 101, 104 Stat. 931 (codified at 15 U.S.C. § 77j(d)).

defendant-accountant had sold unregistered securities to several of his clients. Similar conditions to probation may be imposed in other circumstances, creating the practical effect of a temporary suspension of the accountant's license.

**RECOMMENDATION OF THE TASK FORCE**

The Task Force believes that the test for deciding whether to impose a censure, suspension, or bar pursuant to Rule 102(e) for improper professional conduct on independent public accountants should be a determination of whether the accountant presents a current threat of future misconduct harmful to the Commission's processes. We believe the existing regime regarding officer and director suspensions and bars and suspensions and bars from association with broker-dealers provides the appropriate model for this determination. Each of these types of suspensions and bars prevents a person from pursuing a particular livelihood in the future, prohibiting activities that go beyond the dealings with the particular business entity that gave rise to the sanctions, indeed, prohibiting what would otherwise be legal conduct. Given these similarities, we believe that the application of differing standards by which accountants may be sanctioned cannot be justified. The application of similar standards in the Rule 102(e) context would provide consistency, predictability, and results far superior to that which has been the case in recent years, and which has raised so much understandable concern.

Accordingly, the Task Force recommends that the Commission impose a Rule 102(e) sanction for improper professional conduct only upon a finding by the Commission that the accountant is presently "substantially unfit" to practice before the Commission. While we believe that the Commission is justified in expressing concern regarding instances of past negligent conduct by accountants, we believe that, in determining whether to impose a Rule 102(e) sanction on an accountant, the Commission must consider much more than the mere existence of past negligent conduct. Rather, we believe that a finding of "substantial unfitness" requires that the Commission examine the accountant's alleged misconduct, subsequent behavior, and current circumstances.

Specifically, the Commission ought to consider and expressly discuss the egregiousness of the underlying conduct, whether the conduct involved an isolated failure or was part of a continuing pattern of misconduct, the

---

80. Many public companies employ accountants to prepare the financial statements that the company files with the Commission. A Rule 102(e) sanction, as applied to such employees, is a de facto form of regulation of employees of public companies. The imposition of such a de facto officer and director bar is suspect, especially in light of the 1990 statutory provision pursuant to which the Commission must seek federal court approval to impose a bar against service as an officer or director of a publicly held company. See supra note 60 and accompanying text.
accountant’s “role” or position when he or she engaged in the conduct, the accountant’s degree of scienter, and the accountant’s economic stake in the violation.\textsuperscript{81} These issues must be evaluated in light of the likelihood of the misconduct to recur. In this regard, the Commission should take into account such factors as: (i) where appropriate, whether the accountant has pursued educational measures to correct deficiencies in his or her conduct; (ii) whether the accountant’s employer has disciplined the accountant; (iii) whether there is heightened firm supervision of the accountant; (iv) whether the accountant has engaged in additional misconduct; and (v) the current employment status of the accountant.

The Task Force believes that focusing on these factors will, in general, eliminate the concern shared by many ethical, competent accountants that a single act or judgment, deemed not to comply with professional standards (and, therefore, arguably negligent) by the Commission, could cause them to lose their ability to engage in their profession. Accountants often audit numerous public companies in a single year, and each audit is fraught with numerous procedures and judgment calls:

\begin{quote}
\begin{small}
\begin{itemize}
\item an audit report is not a simple statement of verifiable fact that . . .
\item can be easily checked against uniform standards of indisputable accuracy. Rather, an audit report is a professional opinion based on numerous and complex factors. . . . The report is based on the auditor’s interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage.
\end{itemize}
\end{small}
\end{quote}

Using different initial assumptions and approaches, different sam-

\begin{quote}
\begin{small}
\begin{itemize}
\item the egregiousness of the defendant’s actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant’s assurances against future violations, the defendant’s recognition of the wrongful nature of his conduct, and the likelihood that the defendant’s occupation will present opportunities for future violations.
\end{itemize}
\end{small}
\end{quote}

\textsuperscript{81} These factors are largely based on those discussed in Steadman, where the owner of an investment adviser appealed the Commission’s imposition of an order permanently barring him from associating with any investment adviser or affiliating with any registered investment company. Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979). The Fifth Circuit held that, when the Commission imposes the most drastic sanctions at its disposal, it must articulate carefully the grounds for its decision. In that context, the court observed, “[t]o say that past misconduct gives rise to an inference of future misconduct is not enough. What is required is a specific enumeration of the factors in Steadman’s case that merit permanent exclusion.” \textit{Id.} Among the factors that the court held the Commission should specifically consider are:

\begin{quote}
\begin{small}
\begin{itemize}
\item the egregiousness of the defendant’s actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant’s assurances against future violations, the defendant’s recognition of the wrongful nature of his conduct, and the likelihood that the defendant’s occupation will present opportunities for future violations.
\end{itemize}
\end{small}
\end{quote}

\textit{Id.} (quoting SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)); \textit{see also supra} note 62 and accompanying text.
pling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.82

In short, even competent and ethical accountants may engage at least once in conduct that, in retrospect, could be viewed as negligent.83 Even though an accountant who engages in this kind of conduct presents a substantially different situation than that presented by an accountant whose conduct poses a continuing and immediate threat to the Commission’s processes, the standards currently applied by the Commission fail to distinguish these two situations. This failure has been among the significant reasons for the concerns raised in recent years regarding the imposition of Rule 102(e) sanctions on accountants.

Reserving Rule 102(e) sanctions for accountants whom the Commission finds to be presently substantially unfit and, therefore, posing a current threat of future misconduct harmful to the Commission’s processes is especially appropriate in light of the severe impact a Rule 102(e) sanction imposes on an accountant. A Rule 102(e) finding that an accountant has engaged in “improper professional conduct” can substantially impede the efforts of the individual to continue with his or her career (or, for that matter, make a fresh start in another field of endeavor).84


83. See, e.g., Checkosky v. SEC, 23 F.3d 452, 479 (D.C. Cir. 1994) (“Accounting principles must be interpreted. Judgments must be made about specific transactions. [R]easonable preparers of financial statements”—often management—“and auditors can disagree about those interpretations and judgments.’”) (quoting JERRY D. SULLIVAN ET AL., MONTGOMERY’S AUDITING 19 (10th ed. 1985)) (opinion of Randolph, C.J).

84. While the Task Force believes there must be a threshold test for the imposition of Rule 102(e) sanctions, the Task Force suggests that once the criteria for the imposition of a Rule 102(e) sanction are met, the Commission should consider structuring Rule 102(e) sanctions in light of a respondent’s particular deficiencies. The Commission currently imposes censures, suspensions, or bars designed to address specific circumstances. In addition, the Commission might consider the possibility that a respondent who has demonstrated unfitness in a specific area could, through education and training, correct his or her unfitness. Thus, if a respondent is deemed to be substantially unfit to practice as an accountant because the respondent has demonstrated an inadequate understanding of GAAS, then the Commission might consider limiting the respondent’s practice before the Commission as an independent public accountant unless he or she is adequately supervised or until he or she has undertaken training and education in the requirements of GAAS. A respondent who understands GAAP but has an inadequate appreciation of GAAS, however, should not be precluded from participating in the preparation of financial statements as, for example, a member of the finance and accounting department of a public company, as opposed to having ultimate responsibility for the application of the auditing standards to those financial statements.
Moreover, Rule 102(e)'s continued viability is open to renewed, and perhaps fatal, challenge if the Commission determines to rely on isolated negligent conduct as a predicate for the initiation of Rule 102(e) proceedings. Such a course may provide a strong basis for challenging the validity of particular sanctions, and the Rule itself, as not “reasonably related” to the purposes of the federal securities laws. The federal courts have previously signaled their receptivity to such a challenge to Rule 102(e). As the U.S. Court of Appeals for the Ninth Circuit observed in Davy: “We do not consider whether cases can arise in which the SEC in Rule 2(e) matters exceeds its proper jurisdictional boundaries. The precise reach of the SEC in these situations has not been defined and we leave that task for a future case which implicates that question directly.”

Under these circumstances, the Commission's efforts to impose Rule 102(e) sanctions would also be frustrated if a higher proportion of Rule 102(e) proceedings were litigated and appealed, rather than settled.

**CONCLUSION**

As a matter of policy, the Commission should administer Rule 102(e) in light of its remedial purpose and require that Rule 102(e) sanctions not be imposed unless the entire record, including the respondent’s overall professional qualifications, experience, and conduct, demonstrates that the respondent is presently substantially unfit to practice before the Commission and, therefore, poses a current threat of future misconduct harmful to the Commission's processes. Although the consideration of these factors in determining whether an accountant engaged in “improper professional conduct” may be viewed by some as restricting the Commission’s Rule 102(e) authority, in fact, the Task Force believes that such a clarification of the standard applied by the Commission will confirm and add legitimacy to such authority, and is entirely appropriate given the need for at least minimal due process when a person's livelihood is at stake.

85. See supra note 18 and accompanying text.
86. Davy v. SEC, 792 F.2d 1418, 1422 (9th Cir. 1986). As previously discussed, Judge Silberman of the U.S. Court of Appeals for the D.C. Circuit made a similar observation in his opinion in Checkosky:

> If the Commission were to determine that an accountant's negligence is a per se violation of Rule 2(e), it would have to consider not only the administrative burden such a position would entail but also whether it would constitute a de facto substantive regulation of the profession and thus raise questions as to the legitimacy of Rule 2(e)(1)(ii)—or at least its scope.

*Checkosky*, 23 F.3d at 459 (opinion of Silberman, C.J.).

87. Although not the subject of this report, we note that the Commission already has imposed restrictions on its ability to initiate Rule 102(e) proceedings against lawyers. See Disciplinary Proceedings Release, supra note 16 (stating that Rule 102(e) proceedings against lawyers are “a vehicle for protecting the Commission against further practice by attorneys
Task Force on Rule 102(e) Proceedings

direct focus on professional fitness would better serve to protect the investing public, would better tailor the use of remedial sanctions to circumstances of particular professionals, is consistent with the Commission's mission, and would be far more likely than a “past negligence” standard to pass judicial muster.

who have been the subject of other judicial or administrative proceedings involving securities law violations"). The practice of premising Rule 102(e) proceedings on judicial orders was questioned when the U.S. Supreme Court eliminated the viability of the primary means by which lawyers had been sanctioned: aiding and abetting a Rule 10b-5 violation. See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994); Simon M. Lorre, Securities and Exchange Commission Disciplinary Proceedings Against Lawyers After Central Bank, Address to the 27th Annual Securities Regulation Seminar (Oct. 3, 1994) (“With the decision of the U.S. Supreme Court in Central Bank, the Commission’s options in cases involving lawyers may have been narrowed to an extent that raises vexing questions.”). This objection was eliminated in 1995 when Congress reinstated the Commission’s authority to prosecute aiding and abetting violations of the Exchange Act. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 756 (1995) (codified at 15 U.S.C. § 78t(f) (Supp. I 1995)); see also SEC Commissioner Norman S. Johnson, Remarks before the Committee on Federal Regulation of Securities of the American Bar Association’s Section of Business Law (Nov. 8, 1996) (confirming the continued viability of this approach) (on file with The Business Lawyer, University of Maryland School of Law). In this regard, however, it should be noted that the Commission has a statutory anchor for the regulation of accounting practices which it does not have in connection with the regulation of the practice of law. See, e.g., 15 U.S.C. § 77s(a) (1994) (stating that the Commission has the authority to “define[] accounting, technical and trade terms used in this title”); id. § 77aa(25), (26) (stating that balance sheets and profit and loss statements filed as part of a registration statement shall be “in such detail and such form as the Commission shall prescribe”); id. § 78b(1)(J), (K) (stating that balance sheets and profit and loss statements filed as part of an application for registration on a national securities exchange shall be “in such detail” as the Commission may require); id. § 78m(b)(1) (stating that the Commission may prescribe “methods to be followed” in preparation of accounting reports). In a Commission release, the Commission expressly distinguished the authority it exercises under Rule 102(e) with regard to accountants from that which it exercises with regard to lawyers:

The Commission has express statutory authority under the federal securities laws to prescribe the requirements for financial statements that have been filed with the Commission. Expertise to determine whether these standards have been properly applied is a corollary of that power.

With respect to attorneys, the Commission generally has not sought to develop or apply independent standards of professional conduct. . . . [T]he Commission, as a matter of policy, generally refrains from using its administrative forum to conduct de novo determinations of the professional obligations of attorneys.

Disciplinary Proceedings Release, supra note 16, at 89,244.