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Upholding SEC Authority To Discipline Accountants

Law360, New York (August 27, 2009) -- Late last month, in Dearlove v. Securities & Exchange Commission,[1] the U.S. Court of Appeals for the D.C. Circuit upheld a decision of the U.S. Securities and Exchange Commission suspending an accountant from practice before the SEC pursuant to Commission Rule of Practice 102(e).

The decision is the first litigated proceeding upholding a suspension of an accountant for audit work that the SEC has found negligent under subsection (B)(2) of the rule.

It reflects a dramatic change in approach from that employed by the same court a decade ago, when it invalidated the predecessor to Rule 102(e) in Checkosky v. SEC.[2]

In contrast to Checkosky, the D.C. Circuit in Dearlove was highly deferential to the SEC's determination of "negligence" and the process by which it reached that determination.

This article discusses the developments during the past decade that have culminated in the more deferential Dearlove approach.

After reviewing the Checkosky decision and the SEC's response to that decision through rulemaking and obtaining express legislative authority for its revised rule, the article addresses the significance and implications of Dearlove.

Checkosky Rejects the SEC's Effort to Preserve — But Avoid Litigating — Its Position that it is Authorized to Suspend Accountants from Practice for Audit Negligence

In Checkosky, the D.C. Circuit overturned an SEC decision suspending accountants from practice under former SEC Rule 2(e).

The court previously had remanded the case to the SEC so that it could specify the applicable standard of care under Rule 2(e) — in particular, whether "improper professional conduct" within the meaning of the rule encompassed not only intentional or reckless conduct, but also negligence.[3]

On remand, however, the SEC "fail[ed] to articulate a discernible standard" for finding a violation of Rule 2(e).[4]

Indeed, the court caustically observed:

In something of a tour de force, the commission's 1997 opinion manages to both embrace and reject standards of (1) recklessness, (2) negligence and (3) strict liability — or so a careful (and intrepid) reader could find.[5]

The Checkosky court concluded:

In view of the commission's repeated failure to articulate a discernible standard for violations of Rule 2(e)(1)(ii), the extraordinary duration of these proceedings, and the apparent unlikelihood of a clear resolution on remand, we conclude that it would be futile to allow the SEC a third "shot at the target."[6]

The SEC Adopts — And Congress Subsequently Endorses — A Negligence Standard

The SEC promptly responded to Checkosky by adopting an amended rule. Rule 102(e) purported to clarify the standards to be applied and, in particular, expressly to authorize SEC action in matters involving repeated acts of negligence.

The rule provides that the SEC may "deny, temporarily or permanently, the privilege of appearing or practicing before [the SEC] in any way to any person who is found by the commission ... to have engaged in unethical or improper professional conduct."[7] It defines three classes of "improper professional conduct" for accountants:

"(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards"[8];

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

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards ... [9]; and

(2)Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the commission."[10]

New Rule 102(e) more clearly articulated the SEC's position with respect to the required mental state. But it did not — and could not — resolve the underlying question at issue in Checkosky, which the court never had to decide: whether the SEC possessed the statutory authority to take action against an accountant for negligent conduct.

Congress resolved any doubts as to that issue in 2002, when it enacted the Sarbanes-Oxley Act.[11] Section 602 of the act amended the Securities Exchange Act of 1934 to add a new Section 4C which expressly granted the SEC the authority it had asserted under Rule 102(e) in language identical to that of the rule.[12]

Dearlove Upholds the SEC's Application of its Negligence Standard

Dearlove is the first litigated proceeding involving only subsection (B)(2) of Rule 102(e), which the SEC, in promulgating the rule, characterized as "an ordinary or simple negligence standard."[13]

The case arose out of Dearlove's service as the engagement partner on the audit of Adelphia Corporation's financial statements for 2000.[14]

The SEC, upon review of an administrative law judge's decision after trial, held that Adelphia's financial statements materially failed to comply with Generally Accepted Accounting Principles in several respects, including netting of certain accounts receivable and payable; accounting for co-borrowing of debt by Adelphia and other entities; accounting for other debts; and classification of certain debt transactions as stock sales.[15]

The SEC also held that Dearlove's conduct with respect to the audit, including with respect to evaluation of the netting and contingent liability issues, as well as other issues, departed from Generally Accepted Auditing Standards ("GAAS").[16]

The SEC concluded that Dearlove had engaged in "repeated instances of unreasonable conduct" within the meaning of Rule 102(e)(1)(iv)(B)(2) and denied him the privilege of practicing before the SEC, subject to a provision that he might apply for reinstatement in four years.[17]

On appeal, Dearlove challenged the SEC's holding that his conduct was "unreasonable" within the meaning of Rule 102(e).

Specifically, he argued that, as a matter of law, proof of departures from GAAS and GAAP was insufficient, standing alone, to support such a conclusion.

Rather, an "unreasonableness" determination could only be based on expert testimony sufficient to establish that any such departures were negligent when compared to the conduct of auditors generally.

Moreover, he noted that the fact that prior audit engagement partners had accepted the same accounting treatments he did was evidence of the reasonableness of his conduct.[18]

The SEC rejected this position and the D.C. Circuit affirmed. The court's opinion is striking in its briskness and deference to the SEC:

We reject Dearlove's legal argument and conclude the appropriate standard of care in this case is supplied by the GAAS; therefore, the SEC need not have received expert testimony to establish the standard of care or to determine whether Dearlove's conduct was unreasonable.[19]

All violations of the Rule [102(e)], whether by intentional, knowing, highly unreasonable, or merely unreasonable conduct, are also violations of the GAAS; the term "unreasonable"as used in the rule serves only to distinguish among degrees of deviation.

Therefore, the SEC need not establish a standard of care separate from the GAAS in order to give meaning to Rule 102(e)(1)(iv)(b)(2).

The rule simply requires the SEC to engage in an objective inquiry whether [petitioner's] conduct was unreasonable in the specific factual circumstances at issue.

Prior audits involving similar treatment of similar transactions may serve as evidence that a particular audit was not unreasonable, but the SEC is entitled to weigh that evidence along with other record evidence to determine, in its own expert view, whether the conduct at issue was unreasonable."[20]

This standard vests enormous discretion in the SEC. As a practical matter, liability will turn on the SEC's post hoc exercise of its expert judgment, which is subject only to highly deferential judicial review.[21]

Dearlove also is notable because the D.C. Circuit's deference extended beyond the SEC's substantive legal position to the SEC's procedural ruling denying Dearlove's request for a 60-day extension of the normal schedule for the administrative trial proceeding.

Dearlove sought the extension so that he would have more than four months to review the massive record developed by SEC staff during several years of investigation of the Adelphia matter out of which the Rule 102(e) proceeding arose.[22]

The D.C. Circuit rejected Dearlove's objection that the SEC's denial of his request violated his due process right to adequate time to prepare his defense.[23]

The court observed that the SEC's procedural rules contained a five-factor test that provided constitutionally adequate flexibility to consider such an extension request and,

citing the “broad discretion the agency has in ordering the conduct of its proceedings,” deferred to the SEC’s judgment.[24]

The Significance of Dearlove

Dearlove represents the end point of a process that began in the 1970s with the Touche Ross[25] case, which challenged the SEC’s authority to act under old Rule 2(e), and reached its high-water mark in Checkosky, which overturned SEC sanctions where the SEC refused to articulate the applicable standard.

Those cases challenging the SEC’s legal authority ultimately compelled the agency forthrightly to embrace a negligence standard and to seek express statutory authority for it.

Enron and other high-profile accounting scandals highlighting the importance of effective independent audits undoubtedly facilitated the SEC’s success in obtaining that authority.

Those changes in the law, coupled with the highly deferential standards of judicial review applicable to administrative proceedings[26], have substantially narrowed the grounds for accountants charged with “improper professional conduct” to challenge SEC enforcement decisions.

From one perspective, this may be viewed as an example of the appropriate interplay among the three branches of government to achieve the rule of law. Yet, from another perspective, the result is troubling.

The deferential Dearlove approach vests enormous discretion in the SEC effectively to disbar professional firms and their principals and employees based on its post hoc judgments regarding extremely complex accounting and auditing issues.

While the importance of effective, swift enforcement is undeniable, it is also important to remember that enforcement agencies are not infallible. Times like these pose special challenges to the administrative state and to the courts.

Notwithstanding the pressures for swift, aggressive enforcement that exist in the current environment, enforcement authorities should remain mindful of their obligation to act fairly and wisely and courts must be willing to enforce those obligations.

Judicial deference to administrative agency expertise and discretion cannot and should not be unlimited.

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[1] ___ F.3d ___ , 2009 WL 2194872 (D.C.Cir. July 24, 2009).

[2] 139 F.3d 221 (D.C. Cir. 1998).

[3] Id. at 223-24. In the prior circuit court proceeding, which produced separate opinions by each panel members, Judge Randolph expressly questioned whether the SEC had authority to impose a practice suspension based on negligence. See Checkosky v. Sec. & Exch. Comm'n, 23 F.3d 452, 482-87 (D.C. Cir. 1994) (Opinion of Randolph, J.).

[4] Id. at 227.

[5] Id. at 223.

[6] Id. at 227.

[7] 17 C.F.R. § 201.102(e)(1)(ii) (2006).

[8] Id. § 201.102(e)(1)(iv)(A).

[9] Id. § 201.102(e)(1)(iv)(B)(1).

[10] Id. § 201.102(e)(1)(iv)(B)(2).

[11] Pub. L. No. 107-204, 116 Stat. 745.

[12] Compare 15 U.S.C. § 78d-3 with 17 C.F.R. § 201.102(e).

[13] See In re Dearlove, Exchange Act. Rel. No. 57244, Accounting and Auditing Release No. 2779 (Jan. 31, 2008) ("SEC Decision") at 40-41, quoting Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, 57,166 (Oct. 26, 1998).

[14] Dearlove, 2009 WL 2194872, at *1. The SEC also brought and settled actions against Adelphia, certain of its officers and the public accounting firm that audited Adelphia's financial statements. Id. at *2.

[15] See id. at *4-*5 & n.2; SEC Decision at 23-26.

[16] Dearlove, 2009 WL 2194872, at *5; SEC Decision §§ IV-VII.

[17] Dearlove, 2009 WL 2194872, at *2.

[18] Id. at *4.

[19] Id. at *3.

[20] Id. at *4.

[21] The court endorsed a reading of the SEC's Rule 102(e) as vesting discretion in the SEC: "Rule 102(e) does not require the SEC to hold every violation of the GAAS amounts to improper professional conduct." Id. at 4, 6 & n.1. See also id. at *3 (noting that SEC's "findings of fact are conclusive if supported by substantial evidence" and that legal conclusions may not be set aside unless they are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law).

[22] Id. at *6.

[23] Id.

[24] Id.

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

[26] See supra n. 22.