Disciplinary Proceedings Against Accountants: The Need for a More Ascertainable Improper Professional Conduct Standard in the SEC's Rule 2(e)

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NOTE

DISCIPLINARY PROCEEDINGS AGAINST ACCOUNTANTS: THE NEED FOR A MORE ASCERTAINABLE IMPROPER PROFESSIONAL CONDUCT STANDARD IN THE SEC'S RULE 2(e)

INTRODUCTION

Congress enacted the federal securities laws\(^1\) and established the Securities and Exchange Commission (SEC or Commission)\(^2\) in order to ensure the stability and integrity of the nation's financial markets.\(^3\) The SEC administers numerous statutes,\(^4\) each providing the Commission with general rulemaking authority.\(^5\) Pursuant to this authority, the SEC has promulgated its Rules of Practice.\(^6\) Rule 2(e)(1)(ii) allows the Com-
mission to censure independent accountants or suspend them from practicing before it if, after notice and an opportunity to be heard, the accountant is found "to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."?

Although Rule 2(e)(1)(ii) should not be a vehicle for establishing fun-

spondent may submit briefs, proposed findings of fact and conclusions of law. Id. § 201.16(d). The administrative law judge's initial decision must include findings of fact and conclusions of law with supporting reasons on all material issues of fact, law or discretion presented in the record. Id. § 201.16(a). The respondent may seek review by the SEC, which may affirm, reverse or modify the initial decision based on its own review of the record. Id. § 201.17(g)(2). The rules do not provide for judicial review. The respondent may, however, seek a declaratory judgment and injunctive relief in a federal court after exhausting administrative remedies. See Touche Ross & Co. v. SEC, 609 F.2d 570, 573-75 (2d Cir. 1979).

7. See infra note 17.

8. For an accountant, such practice includes "the preparation of any statement, opinion or other paper . . . filed with the Commission . . . with [his] consent." 17 C.F.R. § 201.2(g)(2) (1984). Thus, an independent accountant who audits and reports on financial statements used in a client's annual report is considered to have practiced before the Commission.


[i]he 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 of 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 (15 U.S.C. §§ 77a to 80b-20) or the rules and regulations thereunder.

Id. at § 201.2(e)(1).

Despite the general rulemaking authority that the Commission possesses, there is disagreement about the SEC's authority to discipline professionals who appear before it. See Block & Ferris, SEC Rule 2(e)—A New Standard for Ethical Conduct or an Unauthorized Web of Ambiguity, 11 Cap. U.L. Rev. 501, 508-12 (1981); Note, Regulation of the Accounting Profession Through Rule 2(e) of the SEC's Rules of Practice: Valid or Invalid Exercise of Power ?, 46 Brooklyn L. Rev. 1159, 1172-87 (1980). The Second Circuit has upheld the rule as being "reasonably related to the purposes of the securities laws." Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979). The court noted that Rule 2(e) "represents an attempt by the Commission to protect the integrity of its own processes." Id. at 582. Rule 2(e) has generated much discussion. See, e.g., Downing & Miller, The Distortion and Misuse of Rule 2(e), 54 Notre Dame Law. 774 (1979); Gruenbaum, The SEC's Use of Rule 2(e) to Discipline Accountants and Other Professionals, 56 Notre Dame Law. 820 (1981); Krane, The Attorney Unshackled: SEC Rule 2(e) Violates Clients' Sixth Amendment Right to Counsel, 57 Notre Dame Law. 50 (1981); Comment, SEC Disciplinary Proceedings Against Accountants—A Study in Unbridled Discretion, 27 Ad. L. Rev. 235 (1975) [hereinafter cited as SEC Disciplinary Proceedings]. The Rule's applicability to attorneys has also been the subject of analysis. See, e.g., Kosek, Professional Responsibility of Accountants and Lawyers Before the Securities and Exchange Commission, 72 L. Libr. J. 453, 463-69 (1979); Comment, SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney, 1972 Duke L.J. 969, 988-93 (1972); Note, Attorney Liability Under SEC Rule 2(E): A New Standard?, 11 Tex. Tech. L. Rev. 83, 84 (1979). This Note will not question the SEC's authority to make disciplinary rules. Rather, it will examine Rule 2(e) and propose a revision.
fundamentally new professional standards, the Commission recently sought to apply the rule in such a manner. In addition, although the SEC in employing the rule ostensibly applies standards of reasonableness to accountants' conduct, in some instances it has apparently held accountants to a higher standard. For example, in many instances Generally Accepted Auditing Standards (GAAS) call upon an accountant to exercise professional judgment, yet the SEC uses disciplinary Rule

10. Burton, SEC Enforcement and Professional Accountants: Philosophy, Objectives and Approach, 28 Vand. L. Rev. 19, 20 (1975) (authored by the SEC's Chief Accountant); see In re Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,169-70 (1981) ("elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper"). See infra note 107.

11. On November 27, 1984, the Commission issued an "Opinion and Order" that settled a Rule 2(e) proceeding it had instituted against the accounting firm of Coopers & Lybrand and one of the firm's partners. See In re Coopers & Lybrand, Acct. Series Release No. 45, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,445, at 63,163 (1984). The controversy arose from Coopers & Lybrand's audits of Digilog, Inc. Digilog is a company that develops, manufactures and sells electronic equipment. Id. DBS, Inc. was created to market Digilog's products. Id. at 63,164. Digilog agreed to provide initial financing for DBS in return for convertible notes. Id. If converted, the notes would provide Digilog with 90% of DBS's authorized common stock. Id. Under the Digilog-DBS arrangement, DBS was required to employ management that was satisfactory to Digilog. Id. Furthermore, DBS would have to provide Digilog with periodic audited financial statements, and could not alter its bylaws or certificate of incorporation without Digilog's consent. Id. The deal was contingent on the issuance of a letter by Coopers & Lybrand stating that Digilog would not have to consolidate DBS's results. Id.

The Commission's Regulation S-X prohibits consolidation of a subsidiary's operations when the parent does not own a majority of the voting shares. See 17 C.F.R. § 210.3A-02(a) (1984) (registrant shall not consolidate the operations of any subsidiary that is not majority owned); id. § 210.1-02(m) (majority-owned subsidiary is one whose parent and/or the parent's other majority-owned subsidiaries own more than 50% of the subsidiary's outstanding voting shares). Although Digilog owned convertible notes, it did not own any outstanding voting shares. In re Coopers & Lybrand, Acct. Series Release No. 45, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,445, at 63,164-65. The Commission asserts in its Opinion and Order, however, that DBS's results should have been consolidated with those of Digilog. Id. at 63,168. According to the SEC, the agreements between the two companies gave Digilog control over DBS. Id. at 63,164. Therefore, the Commission argues that regardless of Regulation S-X, consolidation was appropriate. Id. at 63,167-68. In its Opinion and Order, the Commission declared that situations arise "in which control, apart from actual majority ownership, strongly suggests the need for consolidation in order to accurately depict the economic realities of the relationship between two entities." Id. at 63,167. The Commission then asserted that "consolidation may be required in the absence of majority ownership in form where one entity in substance achieves the same effect as majority ownership through control by contract or otherwise." Id. Although Coopers & Lybrand was ultimately not sanctioned in any manner for its decisions and conduct during the Digilog-DBS engagement, it appears that the Commission initially sought to change, or at least modify, its consolidation rule during a disciplinary proceeding.


13. Generally Accepted Auditing Standards (GAAS) govern the auditor's judgment-
2(e)(1)(ii) to second-guess that judgment.\(^\text{14}\)

The result is tension between accountants who seek to follow the rules and standards that the profession and SEC require, and the Commission, which seeks to ensure the integrity of the financial information provided to the investing public.\(^\text{15}\) This Note contends that the Commission should utilize the reasonable accountant standard when reviewing an accountant’s judgments. Part I demonstrates that a change in the current Rule 2(e)(1)(ii) is mandated by the due process clause. Specifically, due process requires a more substantive standard than “improper professional conduct.” Alternatively, the “improper professional conduct” standard is unconstitutionally vague. Part II outlines possible revisions of the rule. A revised rule should enable the Commission to discipline accountants who negligently fail to comply with professional or SEC rules. When applying a rule that requires professional judgment,\(^\text{16}\) however, certain limitations should be placed on the sanctions available to the Commission.\(^\text{17}\) This Note concludes that the Commission should not hold an accountant to a higher standard than his profession mandates, unless the Commission promulgates a formal rule to that effect.\(^\text{18}\)

making process during the audit and the subsequent issuance of the audit report. In addition, GAAS outlines the professional qualities expected of an auditor. American Institute of Certified Public Accountants (AICPA), Professional Standards AU § 150.01 (1983) [hereinafter cited as Professional Standards].


15. Id. at 32.

16. Professional judgment is required throughout GAAS. For example, the auditor must use his judgment when "obtaining and evaluating evidential matter concerning the assertions in . . . financial statements," Professional Standards, supra note 13, AU § 326.02, determining the amount and type of financial data to be tested, id. AU § 327.11, deciding what procedures to use during the audit, id. AU § 326.12, determining whether an investor is able to exercise significant influence over an investee, id. AU § 332.07, considering whether to obtain written representations from his client's management, id. AU § 333.03, deciding whether or not to utilize a specialist during an audit, id. AU § 336.02, and deciding what, if any, disclosure should be made concerning principal conditions that raise questions about an entity's ability to continue in existence, id. AU § 340.10. The SEC's accounting regulations are contained in its Regulation S-X. 17 C.F.R. § 210.1-01 to .12-29 (1984). These rules set forth “the form and content of and requirements for financial statements” to be filed with the Commission. Id. § 210.1-01(a). These rules are generally more specific than GAAS. See id. § 210.3-01 to .3-21.

17. Rule 2(e) authorizes disbarment of professionals who practice before the Commission. 17 C.F.R. § 201.2(e)(1) (1984). The Commission has also used Rule 2(e) to censure accountants. See SEC Disciplinary Proceedings, supra note 9, at 266-72 (discussing the SEC's use of sanctions). See infra note 55.

18. The Federal Home Loan Bank Board has recently adopted its own rules of procedure which appear to be modeled after those of the SEC. The Board's rules state in part that it
I. DUE PROCESS RESTRICTIONS ON AGENCY DISCIPLINE

The Administrative Procedure Act (APA or Act) permits the SEC to establish rules of procedure. The Act does not "authorize or limit the discipline, including disbarment, of individuals who appear in a representative capacity before an agency." The Commission's use of its rules of procedure to discipline accountants has in some instances entailed the second-guessing of professional judgments. For example, the defendant in In re Touche Ross was disciplined for, among other things, its judgment concerning a client's accounting treatment of a particular series of transactions. The firm's decision was based on research into the relevant industry's practices, and representations received during the audit. Touche Ross did not obtain the written contract detailing the transactions because the client informed the firm that "there might be 'antitrust problems' in securing" the document. Instead, the firm requested and received from the company with which the client contracted a letter that described the arrangement.

Touche Ross' judgment to make its characterization of the transaction without examining the written contract involved the gathering of evidence during an audit. The professional standards provide that the amount of evidence necessary to support the accountant's opinion is to be determined by the auditor in the exercise of his professional judgment. Although the Commission has not stated that it will hold an accountant to a standard higher than reasonableness, its analysis of Touche Ross' behavior raises the question whether an accountant who makes an incorrect, but reasonable, judgment will be subject to discipline. According to the SEC, Touche Ross "incorrectly concluded" that it was unnecessary to obtain a copy of the contract. Thus, despite the alternative investigations made in light of the client's legal concerns with securing the contract, the firm was censured.

obstructionist, egregious, contemptuous, contumacious or other unethical or improper professional conduct before the Board.

20. See id. § 552(a)(1)(C).
21. Id. § 500(d)(2).
22. See supra note 12 and accompanying text.
24. Id. at 63,080.
25. Id. at 63,079-80.
26. Id. at 63,079.
27. Id. at 63,079-80.
by this decision is underscored by the Commission's recent enforcement proceeding against the firm of Coopers & Lybrand. There, the accounting firm's judgment involved determining whether the operating results of two entities should be consolidated, despite an SEC regulation that appeared to prohibit consolidation on the facts presented.

Serious constitutional questions are presented by the Commission's apparent application of the improper professional conduct rule to avoid standards of reasonableness applicable to the accounting profession. Two alternative due process inquiries reveal the constitutional infirmity of Rule 2(e) proceedings in which the accountant's conduct is measured by something more than a common law negligence standard. Under the first approach, the improper professional conduct standard is unconstitutionally vague. Under the second analysis, Rule 2(e)(1)(ii) is constitutionally suspect because due process requires some substantive, as well as procedural, standards to control agency discretion. The two approaches differ only in that the vagueness doctrine concerns statutory enactments while the substantive standards approach applies to agency discretion.

A. Triggering Due Process Protection

Due process is implicated whenever a property or liberty interest is adversely affected by state action. The Supreme Court has recognized that traditional common law concepts of property do not adequately cat-

one of these audits, the Commission clearly second-guessed the firm and even appeared to establish a standard of conduct:

We recognize that the action taken by PMM [Peat, Marwick, Mitchell & Co.] was considerable, especially in the face of what appeared to the Firm to be countervailing positions taken by two prominent law firms. PMM's letter communication to both boards of directors was appropriate and put them in a position to take necessary action. Nonetheless, we believe that independent auditors in such circumstances should insist on revised financial statements being sent to shareholders when they are professionally associated with such statements, whether audited or unaudited. Further, while we believe that primary responsibility rests with management and directors of public companies, where they refuse to resolicit shareholders, under these circumstances, we believe that independent public accountants have an obligation to notify the Commission. Id. at 62,419-20. Although this situation is distinguishable from Touche Ross because it does not involve the application of a GAAS provision requiring an exercise of professional judgment, it underscores the vulnerable position accounting firms are in due to certain applications of Rule 2(e). The possibility that Rule 2(e) may be abused is heightened by the fact that most proceedings result in settlements without adjudications of law or fact. See infra note 109.

32. See id. at 63,165, 63,167. See supra note 11.
33. See supra notes 11, 12, 16, 23-32 and accompanying text.
34. See infra notes 57-76 and accompanying text.
35. See infra notes 77-89 and accompanying text.
egorize many forms of existing wealth. For this reason, due process protection extends beyond interests in real estate, chattels and money. Property interests in welfare benefits, a driver's license, a license to practice law or psychology and the privilege to practice accounting before the Board of Tax Appeals have all been held to be protected by the due process clause. A government-sponsored entitlement gives rise to a property right so long as the government does not "[retain] unrestricted discretion over future enjoyment of the [entitlement]." An accountant's privilege to appear before the SEC is properly viewed as an entitlement because it is derived from federal regulations that do not provide the Commission with unrestricted discretion to prohibit or suspend such appearances. Rather, its Rules of Practice set forth the grounds and procedures for such disciplinary action. Thus, the accountant has a property interest in his right to practice before the SEC that may not be terminated without due process.

The concept of a liberty interest is premised on the notion that a person has the right to enjoy his good name and reputation.

37. See Goldberg v. Kelly, 397 U.S. 254, 262 n.8 (1970); see also Logan v. Zimmermann Brush Co., 455 U.S. 422, 430 (1981) (quoting National Mut. Ins. Co. v. Tidewater Transfer Co., 337 U.S. 582, 646 (1949) (Frankfurter, J., dissenting)) ("the types of interests protected as 'property' are varied and, as often as not, intangible, relating 'to the whole domain of social and economic fact'.")


To have a property interest in a benefit, a person clearly must have more than an abstract need or desire for it. He must have more than a unilateral expectation of it. He must, instead, have a legitimate claim of entitlement to it. . . . Property interests, of course, are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law—rules or understandings that secure certain benefits and that support claims of entitlement to those benefits.

Id. at 577.


41. See In re Ming, 469 F.2d 1352, 1355 (7th Cir. 1972); J. Nowak, R. Rotunda & J. Young, supra note 36, at 542.


46. See 17 C.F.R. §§ 201.1 to .29 (1984). Due process limits the power of government to terminate an entitlement, regardless of whether the entitlement is classified as a "right" or a "privilege." Bell v. Burson, 402 U.S. 535, 539 (1971).

47. See, e.g., Paul v. Davis, 424 U.S. 693, 722-23 (1976) (Brennan, J., dissenting) ("Certainly the enjoyment of one's good name and reputation has been recognized repeatedly in our cases as being among the most cherished of rights enjoyed by a free people, and therefore as falling within the concept of personal 'liberty.'"); Wisconsin v. Constantineau, 400 U.S. 433, 437 (1971) ("Where a person's good name, reputation, honor, or integrity is at stake because of what the government is doing to him, notice and an opportunity to be heard are essential."); see also Board of Regents v. Roth, 408 U.S. 564, 572
courts have held that one can assert a liberty interest when one has been stigmatized by state conduct and the stigmatization results in tangible loss.\(^4\) Although these courts have not defined exactly what constitutes a stigma,\(^4\) liberty interests have been found when bank officers were discharged for dishonesty,\(^5\) a harness racing driver was discharged for "inconsistent driving,"\(^5\) a college football coach was discharged for allegedly violating conference rules\(^5\) and a psychologist was prohibited from designating himself a Ph.D. because he did not comply with statutory requirements.\(^5\) In each of these cases the court found stigmatizing government conduct coupled with tangible loss of employment opportunity.

SEC disciplinary proceedings can affect an accountant's liberty interest in one of two ways. If he is suspended or barred from appearing before...
the Commission, the stigma placed on the accountant is clearly coupled
with a loss of employment opportunities. If a Rule 2(e) action results
only in censure, the stigma placed on his business reputation can still
seriously damage his employment opportunities. Although in the latter
circumstance it is unlikely that a liberty interest arises unless censure
results in an actual loss of professional opportunity, one court has viewed
injury to one's business reputation as sufficient to establish a liberty inter-

B. A Vagueness Analysis Under the Due Process Clause

The void-for-vagueness doctrine is a product of due process analysis,
which incorporates notions of fair notice and warning. The doctrine is
frequently referred to in terms of the common intelligence test articu-
lated more than a half century ago by the Supreme Court in Connally v.
General Construction Co.: "[a] statute which either forbids or requires
the doing of an act in terms so vague that men of common intelligence
must necessarily guess at its meaning and differ as to its application, vio-
lates the first essential of due process of law." The Court has recently

54. Disciplinary proceedings can result in temporary or permanent suspension from
appearing before the Commission, see 17 C.F.R. 201.2(e)(1) (1984); see, e.g., In re Wil-
son, Acct. Series Release No. 30, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,430, at 63,128 (1984);
In re Mayo, Acct. Series Release No. 29, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,429, at 63,125
(1984); In re Goldberg, Acct. Series Release No. 13, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,413,
at 63,061 (1983), and limitations on an accounting firm's business, see In re Peat,
Sec. L. Rep. (CCH) ¶ 72,195, at 62,455 (1975) (firm prohibited from accepting new SEC
clients for six months). See generally Bialkin, Sanctions Against Accountants, 8 Rev. of
Sec. Reg. 823 (1975) (sanctions employed in Rule 2(e) proceedings).

55. Rule 2(e) proceedings can result in censure. See, e.g., In re Wade, Jr., Acct. Series
Release No. 32, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,422, at 63,137 (1984); In re Murphy,
¶ 73,418, at 63,089 (1983); In re Touche Ross, Acct. Series Release No. 16, 6 Fed. Sec. L.
Sec. L. Rep. (CCH) ¶ 73,412, at 63,052 (1983).

(plaintiff had tangible interests not only in employment, but also in "his professional
reputation which . . . determine[s] . . . future employment opportunities").

Dorey, 711 F.2d 125, 128 (9th Cir. 1983); Robinson v. Berman, 594 F.2d 1, 3 (1st Cir.
1979); United States v. Peden, 556 F.2d 278, 280 (5th Cir.), cert. denied, 434 U.S. 871
(1977); Bambu Sales, Inc. v. Gibson, 474 F. Supp. 1297, 1304 (D.N.J. 1979); Cicero v.

58. 269 U.S. 385 (1926); accord Papachristou v. City of Jacksonville, 405 U.S. 156,
162 (1972); Bouie v. City of Columbia, 378 U.S. 347, 351 (1964); Owens v. Wainwright,
698 F.2d 1111, 1115 (11th Cir.), cert. denied, 104 S. Ct. 117 (1983); Casbah, Inc. v.
Thone, 651 F.2d 551, 558 (8th Cir. 1981), cert. denied, 455 U.S. 1005 (1982); Geiger v.
City of Eagan, 618 F.2d 26, 28 (8th Cir. 1980); United States v. Hawes, 529 F.2d 472, 479
(5th Cir. 1976).

59. Connally, 269 U.S. at 391.
recognized that the most important aspect of the doctrine is its prohibition against arbitrary enforcement.\textsuperscript{60}

Although generally used in examinations of penal statutes,\textsuperscript{61} the void-for-vagueness doctrine has also been strictly applied\textsuperscript{62} to quasi-criminal ordinances\textsuperscript{63} and administrative regulations.\textsuperscript{64} There is also authority for applying the doctrine to business license statutes.\textsuperscript{65} Rule 2(e) disciplinary proceedings, like those of a bar association,\textsuperscript{66} may properly be

\begin{footnotes}
\item[60] See Smith v. Goguen, 415 U.S. 566, 574 (1974). Vague laws offend three "important values": such laws do not provide a person of "ordinary intelligence" with a reasonable opportunity to know what is prohibited so that he may act accordingly; they permit arbitrary and discriminatory enforcement; and they may "abut" upon and thereby inhibit basic first amendment freedoms. Grayned v. City of Rockford, 408 U.S. 104, 108-09 (1972).
\item[61] See Kolender v. Lawson, 103 S. Ct. 1855, 1856 (1983) (criminal statute that required loitering individuals to provide "credible and reliable" identification was unconstitutionally vague); Grayned v. City of Rockford, 408 U.S. 104, 107 (1972) (anti-noise ordinance was not unconstitutionally vague); Papachristou v. City of Jacksonville, 405 U.S. 156, 162 (1972) (vagrancy ordinance was unconstitutionally vague); Cole v. Arkansas, 338 U.S. 345, 354 (1949) (law preventing individuals from acting in concert to disrupt lawful activities at the site of a labor dispute was not unconstitutionally vague); New England Accessories Trade Ass'n v. Tierney, 528 F. Supp. 404, 412 (D. Me. 1981) (state drug act was not unconstitutionally vague), aff'd, 691 F.2d 35 (1st Cir. 1982); Amusement Devices Ass'n v. Ohio, 443 F. Supp. 1040, 1051 (S.D. Ohio 1977) (statute prohibiting persons from furnishing legal services to a criminal syndicate with the purpose of establishing a criminal syndicate or facilitating any of its activities was impermissibly vague).
\item[62] See infra note 69.
\item[63] See Village of Hoffman Estates v. Flipside, Hoffman Estates Inc., 455 U.S. 489, 499 (1982). The Court indicated that the stigmatizing effect of a quasi-criminal ordinance "may warrant a relatively strict [vagueness] test." \textit{Id.} at 499. As discussed previously, a Rule 2(e) proceeding may attach a significant stigma to its subject. See supra notes 47-56 and accompanying text. The Court in \textit{Flipside} also noted that "economic regulation is subject to a less strict vagueness test." \textit{Flipside}, 455 U.S. at 498. Economic regulation is frequently narrower than other laws, and subject businesses are expected to consult the pertinent regulations before acting. \textit{Id.} The Court remarked that regulated enterprises may be able to clarify vague regulations either by their own inquiry or through an administrative process. \textit{Id.} To characterize Rule 2(e) as economic regulation, however, would be to ignore its pervasive disciplinary effect. In addition, the nature of auditing makes it impractical for an accountant to seek the Commission's recommendation each time a question arises regarding the amount of evidence to be gathered or the tests to be conducted. Moreover, the SEC has no desire to play such a supervisory role. See Downing & Miller, supra note 9, at 786.
\item[64] See Boyce Motor Lines, Inc. v. United States, 342 U.S. 337, 340 (1952) (common intelligence test applied to an Interstate Commerce Commission regulation).
\item[65] The Supreme Court has implied that a void-for-vagueness test applies to business licenses. See City of Mesquite v. Aladdin's Castle, Inc., 455 U.S. 283, 290 (1982) (Court assumed without deciding that a vagueness analysis would apply to a business license). Similarly, the Seventh Circuit has assumed without deciding that a vagueness analysis can be used for statutes governing licenses. See Baer v. City of Wauwatosa, 716 F.2d 1117, 1124 (7th Cir. 1983); cf. Brennan v. Occupational Safety & Health Review Comm'n, 505 F.2d 869, 872 (10th Cir. 1974) (common intelligence test was applied to safety regulation imposing a $30 fine).
\item[66] See \textit{In re} Ruffalo, 390 U.S. 544, 550 (1968) ("Disbarment, designed to protect the public, is a punishment or penalty imposed on the lawyer.").
\end{footnotes}
viewed as quasi-criminal.\textsuperscript{67} Rule 2(e) cases also involve revocation or suspension of the privilege to practice before the Commission\textsuperscript{68} and are therefore similar to business license cases. Under either category, Rule 2(e)'s improper professional conduct standard should undergo a relatively stringent vagueness review.\textsuperscript{69}

The common intelligence test is not satisfied when the Commission seeks to use the improper professional conduct rule to sanction accountants who have acted reasonably. If an accountant makes a reasonable professional judgment where GAAS so mandates, he must still guess at the meaning of "improper professional conduct" in order to avoid discipline.\textsuperscript{70} Clearly, an accountant who ignores established rules and standards has behaved improperly. Similarly, an accountant who violates the

\textsuperscript{67} Cf. Kennedy v. Mendoza-Martinez, 372 U.S. 144, 168-69 (1963) (in determining whether an Act of Congress is penal or regulatory, one should consider "[w]hether the sanction involves an affirmative disability or restraint, whether it has historically been regarded as a punishment, whether it comes into play only on a finding of scienter, whether its operation will promote the traditional aims of punishment—retribution and deterrence, whether the behavior to which it applies is already a crime, whether an alternative purpose to which it may rationally be connected is assignable for it, and whether it appears excessive in relation to the alternative purpose assigned." (emphasis in original) (footnotes omitted)); Charlton v. FTC, 543 F.2d 903, 906 (D.C. Cir. 1976) (disciplinary proceeding before the FTC considered quasi-criminal). \textit{But cf.} United States v. Ward, 448 U.S. 242, 250-51 (1980) (factors set forth in \textit{Mendoza-Martinez} are neither exhaustive nor dispositive). In quasi-criminal proceedings courts have been reluctant to afford all the protections that adhere to a criminal action. \textit{See, e.g., In re Phelps, 637 F.2d 171, 176 (10th Cir. 1981)} (attorney has no due process right to present a closing argument in a disciplinary proceeding); \textit{In re Daley, 549 F.2d 469, 474-75 (7th Cir.)} (fifth amendment safeguards against self-incrimination do not apply in a disciplinary proceeding), \textit{cert. denied}, 434 U.S. 829 (1977); \textit{Children v. McCord, 420 F. Supp. 428, 432 (D. Md. 1976) (same)}, \textit{aff'd sub nom. Children v. Schlitz, 556 F.2d 1178 (4th Cir. 1977).}


\textsuperscript{69} \textit{See In re Bithoney, 486 F.2d 319, 323 (1st Cir. 1973) ("[I]n view of the gravity of the punishment . . . which includes stiff fines, or even suspension or disbarment with all of the consequential damage which that entails, the test which must be employed as to the constitutionality of the disciplinary machinery to be used must be a very severe one.") (footnotes omitted)). Professor Davis has noted the importance of vagueness analysis in the context of administrative agencies. \textit{See} 2 K. Davis, Administrative Law Treatise § 7:26, at 131 (2d ed. 1979) ("Vagueness of enforcement policy or of any other policy may be held unconstitutional because it permits arbitrary and discriminatory action; courts may accordingly require that the vagueness be corrected by guiding standards or rules."). \textit{See supra} notes 63-65 and accompanying text. When a vagueness examination is made, the Court has indicated that a scienter requirement in the challenged enactment may serve to mitigate vagueness problems. \textit{See Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489, 499 (1982). The improper professional conduct standard lacks any culpability requirement.}

\textsuperscript{70} \textit{See} L. Tribe, American Constitutional Law 718-19 (1978) ("The conclusion that a statute is too vague and therefore void as a matter of due process is thus unlikely to be triggered without two findings: that the individual challenging the statute is indeed one of the entrapped innocent, and that it would have been practical for the legislature to draft more precisely." (footnotes omitted)). \textit{See supra} notes 11, 12, 23-32 and accompanying text.
law is a proper target for a Rule 2(e) improper professional conduct action.\textsuperscript{71} When, however, the Commission, without warning, holds the accountant to a stricter standard than negligence, actual notice of what constitutes improper behavior is lacking and arbitrary enforcement exists.\textsuperscript{72}

Unfortunately, because most vagueness challenges fail,\textsuperscript{73} courts will hesitate to strike down Rule 2(e)(1)(ii) on this ground. The Supreme Court prefers to uphold challenged legislation by construing it narrowly.\textsuperscript{74} On one occasion the Court noted that it will strike down a statute as unconstitutional “[o]nly if no construction can save the Act from [the] claim of unconstitutionality.”\textsuperscript{75} It is therefore possible that a vagueness challenge to Rule 2(e) could succeed as applied to a particular accountant, but leave the improper professional conduct standard facially intact.\textsuperscript{76}

**C. The “Substantive Standard” Due Process Analysis**

The concept that administrative agencies must exercise their discretion in accordance with substantive standards is fairly new to due process analysis.\textsuperscript{77} Although not uniformly accepted,\textsuperscript{78} the principle has been

\textsuperscript{71} See Parker v. Levy, 417 U.S. 733, 756 (1974) (“One to whose conduct a statute clearly applies may not successfully challenge it for vagueness.”); Pordum v. Board of Regents, 491 F.2d 1281, 1285 (2d Cir.) (vagueness claim failed because appellant could not be surprised to learn that felony conviction might bar him from teaching in the public schools), cert. denied, 419 U.S. 843 (1974). In the case of an accountant who violates the law, however, the SEC may be able to sanction the accountant under another part of Rule 2(e). See 17 C.F.R. § 201-2(e)(1)(iii) (1984) (an accountant who willfully violates, or willfully aids and abets the violation of any provision of the federal securities laws may be sanctioned).


\textsuperscript{75} Screws v. United States, 325 U.S. 91, 100 (1945).

\textsuperscript{76} See Vagueness Doctrine, supra note 74, at 86.


\textsuperscript{78} Compare Western Pioneer, Inc. v. United States, 709 F.2d 1331, 1339 (9th Cir. 1983) (due process does not require Coast Guard to publish substantive guidelines for allowable cargo of tenders because governing statutes do not involve discretion) and Jarecha v. INS, 417 F.2d 220, 224 (5th Cir. 1969) (Attorney General’s failure to establish standards to guide discretion of the Board of Immigration Appeals does not violate due
applied in a variety of contexts that are relevant to due process analysis of SEC disciplinary rules. The Second Circuit has held that due process requires a municipal housing authority to employ “ascertainable standards” when selecting among applicants for public housing. Similarly, the Seventh Circuit found due process lacking in a municipal assistance program that operated without any published standards of eligibility. The state actor in these cases had been able to exercise “virtually unfettered discretion.”

The SEC is currently in an analogous position with regard to the standards to be applied in disciplinary proceedings. The Commission’s discretion is limited only by the procedural safeguards contained in its

process) and Baker v. Cincinnati Metropolitan Hous. Auth., 490 F. Supp. 520, 530 (S.D. Ohio 1980) (presence of informal standards satisfied due process requirements), aff’d, 675 F.2d 836 (6th Cir. 1982) with White v. Roughton, 530 F.2d 750, 754 (7th Cir. 1976) (per curiam) (due process mandates that welfare assistance program have written standards) and Holmes v. New York City Hous. Auth., 398 F.2d 262, 265 (2d Cir. 1968) (due process requires selection among applicants for public housing be made in accordance with ascertainable standards) and 2 K. Davis, supra note 69, at 131 (“in some circumstances the lack of rules or standards is so unreasonable that due process is denied”). See supra notes 11, 12, 23-32 and accompanying text and infra note 90 and accompanying text.


81. See White v. Roughton, 530 F.2d 750, 753-54 (7th Cir. 1976) (per curiam).

82. See id. at 754 (administrator of welfare program had unfettered discretion over distribution of benefits); Holmes v. New York City Hous. Auth., 398 F.2d 262, 265 (2d Cir. 1968) (lack of ascertainable standards in selection among applicants for public housing left unfettered discretion in hands of administrators); Baker-Chaput v. Cammett, 406 F. Supp. 1134, 1139 (D.N.H. 1976) (administrator of welfare program had complete discretion); 2 K. Davis, supra note 69, at 129 (“[T]housands of federal, state, and local administrators are annually deciding millions or billions of cases, formal and informal, without ‘written standards and regulations’ and without a system of precedents, and written standards or regulations are feasible for a large portion of them.”).

83. See supra notes 11, 12, 23-32 and accompanying text. The Commission does publish a topical index of enforcement proceedings involving accountants. See Index of Acct. & Auditing Enforcement Releases, Acct. Series Release No. 1, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,401, at 63,011, 63,012 (1982) (“The Commission announces the publication of a topical index to its Accounting Series Releases that have announced enforcement actions involving accountants. The topical index is intended to facilitate reference to the Commission’s views on particular accounting and auditing matters that have given rise to Commission enforcement actions...[but is not] a comprehensive representation of the Commission’s views on these matters.” (emphasis added)).
Rules of Practice. The improper professional conduct standard enables the Commission to sanction accountants for violating GAAS when the accountant has actually complied with GAAS by exercising reasonable professional judgment. For example, the Commission has imposed sanctions for failing to accumulate enough evidence, but it has not indicated the amount of evidence that would be sufficient. Thus, an accountant who diligently and reasonably exercises professional judgment in accordance with GAAS can be sanctioned for engaging in improper professional conduct even though he is without notice of what the SEC considers to be proper professional conduct.

Although the improper professional conduct standard provides accountants with some guidance, the SEC retains broad discretion to determine, in the individual case, whether an accountant's conduct was proper. A more ascertainable standard, such as the one proposed later in this Note, is necessary to control the Commission's almost unbridled discretion and thereby bring SEC procedures into compliance with "substantive standard" due process requirements. Moreover, a nebulous disciplinary rule that can be used to "trap the innocent" serves only to diminish the credibility of the SEC's disciplinary mechanism.

II. SUGGESTED AMENDMENTS TO RULE 2(e)(1)(ii)

As discussed in Part I, the current version of Rule 2(e) allows the Commission, in the course of a disciplinary proceeding, to make ad hoc determinations of whether an accountant's conduct was proper. In addition, the present rule's lack of an explicitly stated culpability standard
is of critical, and possibly constitutional, importance.\textsuperscript{96}

Under the amended rule proposed here, an accountant who negligently fails to follow a black-letter accounting or auditing principle should be subject to discipline. An accountant who contravenes GAAS—for example, by failing to confirm receivables through direct communication\textsuperscript{97} or by referring to the work of a specialist when expressing an unqualified audit opinion\textsuperscript{98}—could be sanctioned for his negligent failure to follow the applicable GAAS provision. The vast majority of accounting and auditing rules, however, involve professional judgment.\textsuperscript{99} In these cases, an amended Rule 2(e)(1)(ii) should also require proof that an accountant behaved at least negligently. Negligence should be measured by the standard of the reasonable accountant.\textsuperscript{100} This proposal recognizes that judgment often involves consideration of complex facts not amenable to exact determination.\textsuperscript{101} In fact, the pervasive role of judgment in GAAS\textsuperscript{102} strongly indicates that an accountant cannot be a guarantor of his judgment.\textsuperscript{103} An accountant, like any other professional, is obligated to act in good faith and with reasonable competence.\textsuperscript{104} GAAS recognizes, however, that even the reasonable accountant might not detect material errors during an audit.\textsuperscript{105} Such errors do not in themselves indicate inad-

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\item \textsuperscript{96} See Downing and Miller, \textit{supra} note 9, at 782 ("Unlike the statutory requirements for compliance with section 10(b) and Rule 10b-5 of the 1934 Act, 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 the SEC might deem 'improper professional conduct' in a given situation."). See \textit{supra} pt. I.
\item \textsuperscript{97} See \textit{Professional Standards, supra} note 13, AU § 331.03 (1983).
\item \textsuperscript{98} See id. AU § 336.12.
\item \textsuperscript{99} See \textit{supra} note 16.
\item \textsuperscript{100} Courts have recognized that accountants, like other professionals, are held to the degree of care, skill and competence exercised by reasonably competent members of their profession under the circumstances. \textit{See, e.g.,} Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1972); \textit{In re Hawaii Corp.}, 567 F. Supp. 609, 617 (D. Hawaii 1983); Gammel v. Ernst & Ernst, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955). If the Commission were to adopt expressly the standard of reasonableness in the profession, vagueness concerns would be mitigated. \textit{Cf.} A.B. Small Co. v. American Sugar Ref. Co., 267 U.S. 233, 241-42 (1925) ("A standard thus developed and accepted in actual practice, when made the test of compliance with legislative commands or prohibitions, usually meets the requirement of due process of law in point of being sufficiently definite and intelligible.").
\item \textsuperscript{101} See Middleton, \textit{supra} note 14, at 32.
\item \textsuperscript{102} See \textit{supra} note 16.
\item \textsuperscript{104} Gammel v. Ernst & Ernst, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955). See \textit{supra} note 100.
\item \textsuperscript{105} An examination made in accordance with generally accepted auditing standards is subject to the inherent limitations of the auditing process. As with certain business controls, the costs of audits should bear a reasonable relationship to the benefits expected to be derived. As a result, the concept of selective testing of the data being examined, which involves judgment both as to the number of transactions to be examined and as to the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an
equate professional performance and should not be the basis of SEC disciplinary proceedings. If the Commission believes that the professional standards of reasonableness should not govern particular auditing decisions, the Commission should promulgate rules delineating the precise manner in which the auditor should make such decisions. For example, if the Commission finds GAAS insufficient in areas of evidence gathering or selective testing, it should promulgate a rule that specifically sets forth the amount of evidence or testing required in a given circumstance.

A negligence standard adequately protects clients and the investing

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opinion on financial statements. Thus, the auditor's examination, based on the concept of selective testing of the data being examined, is subject to the inherent risk that material errors or irregularities if they exist, will not be detected.

Professional Standards, supra note 13, AU § 327.11.

106. See id. AU § 327.13.

107. The Administrative Procedure Act authorizes federal agencies to promulgate rules. 5 U.S.C. § 553 (1982). This process permits those who are regulated to have a voice in formulating the standards and rules to be followed. See NLRB v. Wyman-Gordon Co., 394 U.S. 759, 781 (1969) (Harlan, J., dissenting); B. Schwartz, Administrative Law 149, 195-96 (2d ed. 1984). The result is wide-ranging discussion of important issues, which leads to more responsible administrative action. See Wyman-Gordon, 394 U.S. at 779 (Douglas, J., dissenting); B. Schwartz, supra, at 149. Such broad discourse does not occur during an adversarial adjudication. See B. Schwartz, supra, at 195-96. See generally 2 K. Davis, supra note 69, § 10.3 (limits of the adjudicatory process).

Moreover, in heavily regulated industries such as the accounting profession, rulemaking not only provides guidance and predictability but also fosters sound policy development. See National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 692 (D.C. Cir. 1973), cert. denied, 415 U.S. 951 (1974); American Airlines, Inc. v. CAB, 359 F.2d 624, 629 (D.C. Cir.) (en banc), cert. denied, 385 U.S. 843 (1966). Despite the benefits of rulemaking, the Supreme Court has repeatedly indicated that each agency may determine whether rulemaking or adjudication should be used in a given circumstance. See, e.g., NLRB v. Bell Aerospace Co., 416 U.S. 267, 290-94 (1974) (NLRB legitimately used adjudication to determine whether certain types of buyers were managerial employees); NLRB v. Wyman-Gordon Co., 394 U.S. 759, 766 (1969) (NLRB properly used adjudication to direct respondent to furnish an employee list for the purposes of a union election); SEC v. Chenery Corp., 332 U.S. 194, 203 (1947) (SEC properly used adjudication despite the lack of general rules regarding the transaction at issue). In declining to mandate that the SEC follow rulemaking procedures, the Court in Chenery noted that the Commission should use its "informed discretion" when choosing between rulemaking and adjudication. Chenery, 332 U.S. at 203. The Court enunciated three instances in which administrative agencies need flexibility: when confronted with problems that are not reasonably foreseeable, when involved in areas where the agency lacks experience, and when dealing with problems that are not susceptible to a general rule. Id. at 202-03. The third factor is implicated in Rule 2(e) cases involving auditing standards that require the exercise of professional judgment. See supra notes 11, 12, 16, 23-32 and accompanying text. In these instances the Commission should have the flexibility to utilize disciplinary adjudications because the problems that arise may not be amenable to solution by general rule. For example, the SEC might be unable to spell out exactly how much evidence should be gathered during an audit. See, e.g., In re Wilson, Acct. Series Release No. 30, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,430, at 63,126-27 (1984); In re Touche Ross & Co., Acct. Series Release No. 16, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,416, at 63,077 (1983); In re Simon, Acct. Series Release No. 12, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,412, at 63,033-35 (1983). Therefore, despite the general benefits of rulemaking, it is unlikely that the SEC will employ this mechanism in regulating areas that clearly demand professional judgment.
public\textsuperscript{108} from accountants who act in an incompetent manner. The accountant, however, needs additional safeguards to ensure that he is not unduly disciplined in the sensitive area of professional judgment.\textsuperscript{109} Due to the severity of available sanctions,\textsuperscript{110} one commentator has suggested that once a Rule 2(e) violation is established, the SEC should not impose sanctions unless it can prove by a preponderance of the evidence that there is a likelihood that the respondent will repeat the actionable conduct.\textsuperscript{111} Although this approach is viable, a more comprehensive alternative is to amend Rule 2(e) to provide explicitly for the types of sanctions available when the accountant's judgment-making process is found to have been deficient. For example, if an accountant is found to have been negligent in making a judgment, no sanction greater than censure could be imposed. If such an infraction occurs a second time, how-

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  \item \textsuperscript{108} See Touche Ross & Co. v. SEC, 609 F.2d 570, 581 (2d Cir. 1979) ("[T]he Commission must necessarily rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors."). In addition to serving the client, an accountant provides investors with important financial information that often forms the basis of investment and economic decisions. See Note, Reassessing the Validity of SEC Rule 2(e) Discipline of Accountants, 59 B.U.L. Rev. 968, 985 (1979).
  \item \textsuperscript{109} See SEC v. Republic Nat'l Life Ins. Co., 378 F. Supp. 430, 440 (S.D.N.Y. 1974) ("an accountant is not a guarantor of the reports he prepares and is only duty bound to act honestly, in good faith and with reasonable care in the discharge of his professional obligations"); Professional Standards, supra note 13, AU § 327.13 ("The auditor is not an insurer or guarantor"). The SEC's disciplinary rules provide that a party may propose an offer of settlement which will be accepted by the Commission if it serves the public interest to do so. See 17 C.F.R. § 201.8 (1984). Almost all Rule 2(e) proceedings result in these settlement letters. See, e.g., In re Feldhake, Acct. Series Release No. 27, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,427, at 63,104 (1984); In re Murphy, Hauser, O'Connor & Quinn, Acct. Series Release No. 18, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,418, at 63,089 (1983); In re Goldberg, Acct. Series Release No. 13, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,412, at 63,061 (1983); In re Simon, Acct. Series Release No. 12, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,412, at 63,052 (1983). In these settlements, the respondent neither admits nor denies the factual assertions, findings or conclusions set forth by the Commission in the SEC's Opinion and Order. One commentator has referred to them as a "breeding ground for injustice," partially because "the extent of the accountant's actual indiscretion is never really reached." See SEC Disciplinary Proceedings, supra note 9, at 272. "The potential penalty of [license] revocation . . . is so threatening to the survival of accounting firms [however] that such firms are under strong pressure to try to negotiate a settlement." Bialkin, supra note 54, at 831. The result is that the Commission need not prove its allegations before an administrative law judge, and the respondent neither admits nor denies the factual assertions, findings or conclusions set forth by the Commission in the SEC's Opinion and Order.
  \item \textsuperscript{110} See supra notes 54-55 and accompanying text.
  \item \textsuperscript{111} See Hellerstein, Safeguards in SEC Disciplinary Proceedings, 16 Rev. of Sec. Reg. 915, 918 (1983). Mr. Hellerstein's article came in the wake of Steadman v. SEC, 450 U.S. 91, 102 (1981), where the Supreme Court held that the standard of proof to be applied in SEC administrative proceedings is the preponderance-of-the-evidence standard. According to Mr. Hellerstein, requiring the SEC to prove before the imposition of sanctions that an individual is likely to repeat his violation would "lessen the risk that a respondent who fairly believed that his conduct conformed to the applicable laws and regulations could be sanctioned." Hellerstein, supra, at 918. Of course, Mr. Hellerstein discusses only the remedy to be applied when a Rule 2(e) violation is found; he does not address the critical question of what constitutes improper professional conduct.
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ever, or if the offense indicates that the accountant exercised no care in making his judgment, the sanction could include either censure or suspension. This approach is in accord with proportionality principles established by the Supreme Court. The result would be a balance between the Commission's duty to protect the investing public and the accountant's need to make numerous decisions based on judgment.

CONCLUSION

The SEC has a critical role to play in preserving honesty and integrity in the nation's financial markets. Toward this end, disciplinary rules should be employed to prevent the incompetent, dishonest or reckless accountant from practicing before the Commission. In recent years, however, the Commission has employed the "improper professional conduct" standard of its Rule 2(e) to place its own gloss on professional standards of reasonableness. As a result, the accountant does not know what behavior will constitute actionable conduct.

To limit the vagueness problems of the current improper professional conduct rule, the SEC should substitute a more specific standard. Such a standard would be provided by an approach permitting discipline of accountants who have negligently applied accounting rules but limiting the sanctions available to the Commission when the accountant has violated a rule that requires professional judgment. This standard strikes an appropriate balance between the SEC's duty to protect the investing public and the accountant's need to exercise his judgment without fear of jeopardizing his business reputation.

Michael J. Crane


113. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); SEC v. Southwest Coal & Energy Co., 624 F.2d 1312, 1318 (5th Cir. 1980).

114. See supra notes 16, 101-06.