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**THE TREADWAY COMMISSION REPORT:  
TWO YEARS LATER**

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The views expressed herein are those of the authors and do not necessarily represent those of the Commission, other Commissioners, or the Commission staff.

**THE TREADWAY COMMISSION REPORT:  
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I. THE TREADWAY COMMISSION

The National Commission on Fraudulent Financial Reporting was established in June 1985. Usually referred to by the name of its chairman, former SEC Commissioner James C. Treadway, Jr., the "Treadway Commission" was jointly sponsored and funded by five private accounting organizations: the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Financial Executive Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (NAA).

The early and mid-1980's saw such spectacular failures as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp., and E.S.M. Government Securities. Congressional hearings into the causes for these failures focused upon whether they could have been avoided by, among other things, better audit practice. See, e.g., Hearings on SEC Oversight, Authorization, and Other Matters Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, 99th Cong., 1st Sess. 2, 85-90 (Mar. 21, 1985). See generally "The Internal Auditor's Role In Deterring, Detecting and Reporting of Financial Frauds," Remarks of David S. Ruder, Chairman, SEC, Before the Institute of Internal Auditors' Business Issues and Audit Conference, Washington, D.C. (April 25, 1988) at 1 (hereinafter cited as Ruder, "The Internal Auditor's Role"); Tougher Role Urged for Firms' Auditors, Wash. Post, Oct. 22, 1986, at G-2.; Daily Report for Executives (BNA) at S-23, Jan. 20, 1987.

The Treadway Commission was formed amidst this climate of scrutiny. The mission it defined for itself was "to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." Report of the National Commission on Fraudulent Financial Reporting (October 1987) at 1 (hereinafter cited as Treadway Report). In October 1987, the Treadway Commission issued its final report presenting its findings, conclusions, and recommendations.

A. Definition of "Fraudulent Financial Reporting." For purposes of its study and report, the Treadway Commission defined "fraudulent financial reporting" as "intentional or reckless conduct, whether act or omission, that results in materially misleading

financial statements." Treadway Report at 2. The Commission pointed out that fraudulent financial reporting can take many forms, including "deliberate distortion of corporate records, such as inventory count tags," or "falsified transactions, such as fictitious sales or orders," or "misapplication of accounting principles." Id.

B. The Treadway Commission's Objectives. As set forth in its Report, the Treadway Commission had three major objectives:

"1. Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud may be the product of a decline in professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of this type of fraud.

"2. Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether changes in auditing standards or procedures--internal and external--would reduce the extent of fraudulent financial reporting.

"3. Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly." Treadway Report at 2.

C. The Treadway Commission's Recommendations--  
Generally. The Treadway Report recognized that improvement in the prevention and detection of fraudulent financial reporting involves action in all areas, by many persons and entities. Accordingly, the Report's recommendations are directed toward three groups: public companies, independent public accountants, and the SEC.

1. Recommendations for the Public Company. Recognizing that "[p]revention and detection of fraudulent financial reporting must start with the entity that prepares financial reports," the first focus of the Treadway Commission's recommendations is the public company. The recommendations for public companies deal with (1) the tone set by top management, (2) the internal accounting and audit function, (3) the audit committee, (4) management and audit committee reports, (5) the practice of seeking second opinions from independent public accountants, and (6) quarterly reporting. Treadway Report at 11, 31-48.
2. Recommendations for the Independent Public Accountant. The Treadway Report also noted that the independent public accountant plays a "crucial" role in detecting and deterring financial reporting. To improve the effectiveness of the independent public accountant, the Treadway Commission recommended changes in auditing standards, in procedures that enhance audit quality, in the independent public accountant's communications about his or her role, and in the process of setting auditing standards. Treadway Report at 12, 49-62.
3. Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment. The Treadway Commission also suggested that improvement could be made in the area of deterring fraudulent financial reporting. Treadway Report at 14. The Report's recommendations for increased deterrence involve new SEC sanctions, greater criminal prosecution, improved regulation of the public accounting profession, adequate SEC resources, improved federal regulation of financial institutions, and improved oversight by state boards of accountancy. The Treadway Commission also made two final recommendations in connection with the perceived insurance and liability crises. Id. at 14, 63-78.

In addition to these recommendations directed to participants in the financial reporting process, the Treadway Commission acknowledged the role that education can play in "providing knowledge, skills, and ethical values that

potentially may help prevent, detect, and deter fraudulent financial reporting." Accordingly, the Report recommended changes in business and accounting curricula, professional certification examinations, and continuing professional education in order to encourage initiatives toward that end. Treadway Report at 15, 79-86.

D. General Observations on the Treadway Report by Members of the Securities and Exchange Commission.

In general, the SEC has applauded the Treadway Commission's Report as "an important contribution to the efforts of the [SEC] and others" in their efforts to consider methods to improve financial reporting by public companies. See Hearings before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce concerning the Recommendations of the National Commission on Fraudulent Financial Reporting, 100th Cong., 2nd Sess. (May 2, 1988) (statement of David S. Ruder, Chairman, SEC) (hereinafter cited as SEC Testimony (May 2, 1988)). In addition, the individual members of the SEC have made separate remarks regarding the Treadway recommendations.

1. Chairman Ruder. Chairman Ruder's individual statements with respect to the work of the Treadway Commission have generally tracked the views set forth in the SEC's May 2, 1988 testimony. He believes that the Treadway Report provides "a number of constructive comments that may contribute to an improved financial reporting climate." Ruder, "The Internal Auditors' Role," supra p. 1, at 6; see also "Concerning The Report Of The National Commission on Fraudulent Financial Reporting," Remarks of David S. Ruder, Chairman, SEC, Before the 7th Annual SEC and Financial Reporting Institute Conference, Los Angeles, California (May 10, 1988).
2. Commissioner Cox. In a recent address, Commissioner Cox observed that "the Treadway recommendations that, if implemented, would have the greatest impact on reducing fraudulent financial reporting are basically hortatory statements directed to corporate managers and are not calls for regulatory action." "The Treadway Report--Any Results Yet?", Remarks by Commissioner Cox to the Annual Meeting of SEC Reviewing Partners Committee of Peat Marwick Main & Co., Washington, D.C. (Dec. 7, 1988) at

1 (hereinafter cited as "Cox Speech"). Commissioner Cox stated the SEC has a relatively "minor role to play in addressing the reforms proposed by Treadway." Id. In his view, the relative importance of the SEC's role is "reflected by its response over the past year--one that has exhibited a lack of urgency and has included the rejection of certain Treadway recommendations." Id.

Commissioner Cox also emphasized the need for careful cost-benefit analysis of the Treadway recommendations, and notes that the Treadway Report is "candid in stating that companies would incur considerable costs in implementing its recommendations, and that costs would be especially significant for smaller, newly public companies." Id. Unfortunately, as Commissioner Cox observed, generalizations about the costs of not implementing the Treadway recommendations are "too vague," and involve considerations such as "investor confidence" that are "highly subjective and inherently unquantifiable." Id. at 1-2.

3. Commissioner Grundfest. Commissioner Grundfest views the Treadway Report as addressing problems in optimal quality control and in optimal deterrence. Because of the high probabilistic component in the audit procedure, some incidence of audit failure may be inevitable absent costs far out of proportion to the benefits that complete elimination of such failures might bring. From a social perspective, economic well-being is maximized when the social marginal cost of punitive measures equals the marginal social benefits. Absolute elimination of all possibilities of audit failure is thus too extreme a position because it would require marginal costs in excess of benefits. Moreover, because the costs and benefits of specific Treadway recommendations can differ dramatically from company to company--most notably by increasing costs for smaller firms without generating commensurate social benefits--Commissioner Grundfest recommends that policymakers avoid "pounding square pegs into round holes" by forcing all companies to comply with standardized requirements, regardless of their specific circumstances. Commissioner Grundfest instead recommends strategies that permit

greater flexibility, recognize the implications of differential compliance costs, and apply appropriate sanctions in order to induce optimal levels of compliance. See, e.g., Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611 (1985), for a discussion of an optimal deterrence approach to securities law enforcement that carries over well to many of the situations addressed in the Treadway Report.

4. Commissioner Fleischman. In an address delivered last fall, Commissioner Fleischman stated that the Treadway Report's emphasis on "the tone at the top" should be "trumpeted from the financial rooftops" because, in calling on financial executives "to set the tone by identifying and understanding the factors that can lead to fraudulent financial reporting and by assessing the risk of fraudulent reporting that those factors create \* \* \*," it puts the primary responsibility for proper reporting exactly where it belongs. "Great Expectations," Address to the Financial Executives Institute, New York City, at 6 (Oct. 31, 1988). In his view, "if the tone \* \* \* is professional, the likelihood of fraudulent reporting is minimized." Id. at 7.

Commissioner Fleischman believes that no measures of legislation or government regulation can do more to prevent financial fraud than ethos of honesty in management--from the top down:

[Y]ou as financial executives can "help establish [a control] environment where open communication is expected, accepted, and protected. . . ." Each of you expects no less of yourself, and your audit committee, your company's shareholders, your CEO, the SEC and the oversight committees of Congress also expect no less of you. And I do believe that the obligations inherent in that expectation are coupled with assurances that regulatory policies focussed on protecting the integrity of the financial reporting process, and thereby on safeguarding the

fairness and efficiency of the public securities markets, have been, are and will be applied in such a manner as to credit your professional efforts in that regard. Id.

5. Commissioner Schapiro. Commissioner Schapiro joined the SEC on December 5, 1988, and has as yet expressed no views regarding the Treadway Commission or any of its recommendations.

## II. THE TREADWAY COMMISSION'S RECOMMENDATIONS FOR THE SEC AND THE SEC'S RESPONSE

Of the forty-nine specific recommendations made by the Treadway Commission, thirteen require rulemaking by the Securities and Exchange Commission, or legislative action. This section of the outline sets forth each of these recommendations, the Treadway Commission's reasons for each recommendation, the SEC's response, the reasons for that response, and the basis for any dissents expressed by members of the Commission. In summary form, the recommendations involve:

1. A requirement that publicly traded firms have independent audit committees;
2. A requirement that a management report addressing responsibility for financial statements and controls accompany the issuer's annual report;
3. A requirement that an audit committee letter describing the committee's activities accompany the annual report;
4. A requirement that any change in auditors be accompanied by disclosure of material auditing issues that arose during three years preceding the change;
5. A requirement that independent accountants review quarterly financial data prior to release;
6. A suggestion that the SEC seek legislative authority to impose civil money penalties in injunctive and administrative proceedings;
7. A suggestion that the SEC seek legislative authority to issue cease and desist orders;



8. A suggestion that the Commission seek specific legislative authority to bar or suspend corporate officers and directors;
9. A suggestion that the Commission affirmatively promote increased criminal prosecutions of fraudulent reporting cases through greater cooperation with criminal enforcement agencies;
10. A requirement that all auditors of publicly traded firms be members of organizations with SEC approved peer review functions;
11. A suggestion that the SEC take enforcement action against firms that fail to correct deficiencies identified in peer reviews (peer review enforcement);
12. A suggestion that the SEC's budget be increased; and
13. A suggestion that the SEC reconsider its policy against indemnification of independent directors.

A. Mandatory Independent Audit Committees

1. Recommendation. "The board of directors of all public companies should be required by SEC rule to establish audit committees composed solely of independent directors." Treadway Report at 40.
2. Treadway Commission's Rationale. Audit committees composed of independent directors would enhance the board of directors' ability to carry out its responsibility to oversee top management, which is primarily responsible for a company's financial reporting. The Treadway Commission's research indicated that the audit committee's assessment of the independence of the public accountant and its review of the adequacy of, and compliance with, internal accounting controls contribute significantly to the integrity of the financial reporting process. For example, the Report noted one study which found that, while 85% of all public companies have audit committees, a significantly smaller percentage (69%) of the public companies involved in the fraudulent financial reporting cases brought by the SEC from 1981 to

1986 had audit committees. Treadway Report at 40.

The Treadway Commission recognized the difficulties that smaller, newly public companies may have in attracting qualified independent directors. The Report therefore recommends that, although the rule should apply regardless of the company's size, the SEC should be able to exempt a company from the audit committee rule if the company can demonstrate that it is unable, after a diligent attempt, to attract independent directors and has instituted procedures and controls that are the functional equivalent of an audit committee. Id. at 41.

3. The SEC Response. On December 7, 1988, the SEC sent letters to the NASD and all stock exchanges, except the New York Stock Exchange (which already requires all listed domestic companies to maintain independent audit committees), urging these self-regulatory organizations ("SROs") to consider upgrading and expanding their listing and quotation standards relating to audit committees.
4. Reasons for the SEC's Response. The Commission unanimously rejected the specific Treadway recommendation that the Commission, by rule, require independent audit committees. Chairman Ruder and Commissioners Peters and Fleischman, however, supported a letter to the SROs urging them to upgrade their listing standards, while Commissioners Cox and Grundfest, for separate reasons, opposed sending such a letter.
  - a. The Majority's Decision. The SEC decided not to propose a rule mandating independent audit committees, but rather to urge the SROs to consider upgrading their quotation and listing standards with respect to such committees. The SEC's letters to the SROs explained that:

[t]he Commission believes that the SROs' experience, particularly with respect to corporate listing standards, puts [them] in a position to exercise flexibility in the formulation and implementation of new audit committee

standards. This flexibility would, for example, enable you to formulate appropriate independence standards for audit committee members and to determine the extent to which it is feasible to require audit committees to be composed of independent directors. In addition, SROs are well equipped to consider whether an exemption, in whole or in part, from audit committee requirements should be available for smaller companies.

- b. The Dissent. Commissioners Cox and Grundfest dissented from the majority's decision. Commissioner Cox, while recognizing that "audit committees are often beneficial," has expressed the view that the SEC should not "use its authority and influence over the securities self-regulatory organizations as a 'back-door' for regulating indirectly corporate governance matters that have traditionally been the province of state law, and that are arguably beyond the agency's ability to regulate directly." Cox Speech, supra p. 5, at 2.

Commissioner Grundfest objected to the letter because of concern that pressure to create independent audit committees was not necessarily the most efficient means to achieve the desired result. Increased financial and other penalties for fraudulent reports would create a greater incentive to comply with the law and simultaneously provide for valuable corporate flexibility in determining the most cost-effective means of compliance. Thus, Commissioner Grundfest argued that the Commission should focus on establishing appropriate incentives for compliance and thereafter allow companies substantial flexibility in determining the methods they would use to improve the quality of their financial reports.

See SEC to Ask Congress for Power to Impose Civil Monetary Fines, 20 Sec. Reg. & L. Rep. (BNA) 636 (April 29, 1988).

- c. Note: Prior SEC Support for Audit Committees. As early as 1940, the SEC endorsed the formation of audit committees composed of non-officer directors with the responsibilities of selecting, for the board's approval, the company's outside auditors and of specifying the terms of the outside auditors' engagement. Exchange Act Rel. No. 2707 (Dec. 5, 1940). In 1972, the SEC advocated that all publicly held companies establish audit committees composed of outside directors, for the purpose of promoting reliability in financial reporting. Securities Act Rel. No. 5237 (Mar. 23, 1972). Subsequently, by letter to NYSE Chairman William Batten dated May 11, 1976, Chairman Roderick M. Hills suggested that the Exchange revise its listing policies to encourage corporation to establish independent audit committees. The SEC has also endorsed the creation of independent audit committees in occasional reports to Congress. See Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2nd Sess., 67-69 (Committee Print 1976); Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, Subcomm. on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, 95th Cong., 2nd Sess., 96-107, 145-48 (Committee Print 1978); Staff Report on Corporate Accountability, Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2nd Sess., 486-510 (Committee Print 1980).

B. Management Report

1. Recommendation. "All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and the chief accounting officer and/or the chief financial officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment

of the effectiveness of the company's internal controls." Treadway Report at 44.

2. Treadway Commission's Rationale. Management reports, tailored to a company's individual circumstances, would improve communication to financial statement users regarding the nature of financial information and the processes that surround its preparation and presentation. Management's opinion on internal control is significant because the internal control system provides the basis for the preparation of financial statements, and the overall system of accountability. The signatures of the CEO and the CFO and/or CAO would underscore their roles in, and responsibilities for, the financial accounting process. Treadway Report at 45.

Despite the support of several private sector organizations, such as the FEI and AICPA, a significant number of public companies do not include management reports in their annual reports to stockholders. Id.

3. The SEC Response. On April 27, 1988, the SEC unanimously agreed with the staff's recommendation to propose for comment a rule that would require issuers to include a report by management similar to the report recommended by the Treadway Commission annual reports on Form 10-K and annual reports to security holders. See generally SEC Testimony (May 2, 1988), supra p. 4, at 10-14. The SEC's proposed rule requiring that registrants include a report of management's responsibilities in Forms 10-K and N-SAR and annual reports to security holders was published for comment on August 2, 1988. See Securities Act Rel. No. 6789, 41 S.E.C. Dkt. 681 (Aug. 2, 1988). The staff is currently reviewing the comment letters received.

Proposed Item 703(a) to Regulation S-K would require a description of management's responsibilities for the preparation of the registrant's financial statements, the determination of the estimates and judgments used therein, and the preparation of other financial information included in a document containing the registrant's financial statements. Proposed Item 703(b) would require a description or statement of management's responsibilities for establishing and maintaining a system of internal control over

financial reporting. It would also require an assessment, as of the registrant's most recent fiscal year end, of the effectiveness of the registrant's system of internal control that encompasses material matters. Finally, management would be required to state how it has responded to the recommendations of the auditors concerning the company's internal control.

4. Reasons for the SEC's Response. The SEC has long emphasized the importance of effective systems for internal control of the financial reporting process. See Accounting Series Rel. No. 278 (June 6, 1980), 45 Fed. Reg. 40134. In its release proposing that management reports be required, the SEC reaffirmed its view that "some assurance concerning the existence of an effective system is important to investors." Securities Act Rel. No. 6789, 41 S.E.C. Dkt. at 681. The SEC believes that management reports will provide evidence that senior management has attended to preparation of reliable financial information and to the internal control system, thus reflecting the "tone at the top," which the Treadway Commission characterized as "the most important factor contributing to the integrity of the financial reporting process." Treadway Report at 11. However, the proposed rule will not increase management's existing responsibility for the preparation of financial information, but merely require management to acknowledge that responsibility. Id.

The SEC also believes that additional benefits will flow from the auditor's increased involvement with internal controls, coupled with the auditor's responsibility to read and consider other information, such as the proposed management report, included in a document containing audited financial statements. Id.

The SEC's proposal should not, however, significantly enlarge the scope of the auditor's review in accordance with Generally Accepted Auditing Standards ("GAAS").

Because of the auditor's review in accordance with Statement on Auditing Standards ("SAS") 8, A.U. Sec. 550, the auditor will be associated with the report on the company's internal controls. Under a newly adopted auditing standard, SAS 55, auditors must gain an

understanding of a company's internal control structure in all audits, regardless of whether they intend to rely on controls in conducting the audit. Another new standard, SAS 60, requires that auditors communicate to management and the audit committee significant deficiencies in the design or operation of the internal control structure, including material weaknesses that come to the auditor's attention during and audit of the financial statements. Pursuant to SAS 8, auditors must read any management report included in an annual report and inform the company of anything therein that the auditor concludes is materially inconsistent with the financial statements or a material misstatement of fact. Thus, an auditor's review of disclosure in accordance with SAS 8 would include a review of any management statement regarding its response to the auditor's recommendations for internal control. See SEC Testimony (May 2, 1988), supra p. 4, at 12; see generally the discussion of the role of independent accountant in the SEC's Proposing Release, 41 S.E.C. Dkt. at 684-85.

In light of the existing responsibilities of management in the financial reporting process, and the auditors standards promulgated under SAS 8, 55 and 60, the recommended management report appeared to have relatively low marginal cost.

Note: The SEC's 1979 Proposal. In 1979, the SEC proposed rules that would have required that Forms 10-K and annual reports to shareholders contain a statement of management's opinion as to whether the systems of internal accounting control of the company and its subsidiaries provides the reasonable assurances, required by the Foreign Corrupt Practices Act ("FCPA"), that accurate books and records are maintained and that assets are safeguarded. The proposal would have also required that an independent accountant examine and report on the management statement. The proposal was withdrawn in 1980 following criticism concerning the close correlation between disclosure of management's opinion on internal control and compliance (or the lack of compliance) with the internal accounting control provisions of the FCPA. See SEC Testimony (May 2, 1988), supra p. 4, at 13; see also Securities Act Rel. No. 6789, 41 S.E.C. Dkt. at 685-86. Many commentators suggested that the proposal

was apparently intended not to give stockholders useful information, but rather to establish the existence of violations of the FCPA for enforcement purposes. 41 S.E.C Dkt. at 686; Treadway Report at 45. The commentators also objected to the impact the rule might have on the role of the auditor in examining companies' internal controls. SEC Testimony (May 2, 1988), supra p. 4, at 13-14.

The SEC believes that, by emphasizing a materiality standard, its new proposal for a management report would avoid several of the objections to the earlier proposal. Id. In addition, the new proposal would not require the auditors to do more than they are currently required to do under present generally accepted auditing standards. Id. at 14.

C. Audit Committee Chairman's Letter

1. Recommendation. "All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year." Treadway Report at 46.
2. Treadway Commission's Rationale. The audit committee chairman's letter would make the role of the audit committee more visible and would more effectively communicate to investors the committee's role. The Treadway Commission's research also indicated a need to reinforce the audit committee members' awareness and acceptance of the importance of their responsibilities. Although certain contents of the suggested audit committee letter duplicate existing proxy statement disclosures, the Treadway Commission believed such a letter would provide more flexible and illuminating disclosure than most proxy statements do at present. Treadway Report at 46.
3. The SEC Response. The SEC unanimously concluded that an audit committee chairman's letter is not needed. SEC Testimony (May 2, 1988), supra p. 4, at 15-16.
4. Reasons for the SEC Response. Most companies with actively traded securities have audit committees as a result of the NYSE's listing



requirements and the corporate governance standards imposed by the NASD on companies with OTC securities designated as National Market System securities. Companies that have a security registered under Section 12 of the Exchange Act, if they solicit proxies, are currently subject to SEC proxy rules requiring disclosure concerning the existence of the audit committee's functions. As noted, the Treadway Commission acknowledges that certain information in the proposed audit committee letter would duplicate existing proxy statement disclosures. The SEC therefore believes that the proposed audit committee letter would not provide investors with significant additional information and is thus unnecessary. SEC Testimony (May 2, 1988), supra p. 4, at 15-16.

D. Seeking A Second Opinion

1. Recommendation. "When a public company changes independent public accountants, it should be required by SEC rule to disclose the nature of any material accounting or auditing issue discussed with both its old and new auditor during the three-year period preceding the change." Treadway Report at 47.
2. Treadway Commission's Rationale. This is the second of two recommendations the Treadway Commission made regarding the practice of seeking a second opinion regarding accounting issues. The first recommendation is that "management should advise the audit committee when it seeks a second opinion on a significant accounting issue." Treadway Report at 47. The Treadway Commission expressly acknowledged that legitimate differences of opinion in financial reporting can arise. Id. However, the Treadway Commission noted that when a company decides to seek an opinion from a different accounting firm, "commercial pressures are introduced into the process of resolving the financial reporting issue. Recent cases have shown that these commercial pressures sometimes lead to fraudulent financial reporting." Id. Thus, although management may, and sometimes should, seek a second opinion, management should discuss the issue with the audit committee and explain why the particular accounting treatment was chosen. Id.

The Treadway Commission's second recommendation in this area is an SEC rule requiring certain disclosures in the event the company changes independent public accountants "[a]s a further deterrent to possible fraudulent financial reporting." Id. Although the Treadway Commission did not specifically articulate how such disclosures would deter fraudulent financial reporting, the inclusion of this recommendation with the discussion of the process of seeking second opinions suggests that the Treadway Commission saw the same types of "commercial pressures" as affecting the decision to seek a new accounting firm.

3. The SEC Response. The SEC has effectively implemented this recommendation. In a public meeting on April 7, 1988, the SEC voted unanimously to amend Regulation S-K, Form 8-K, and Schedule 14A regarding disclosure by companies of changes in independent accountants and potential opinion shopping situations. Financial Reporting Rel. No. 31 (Apr. 12, 1988); 40 S.E.C. Dkt. 1140 (Apr. 26, 1988).

In addition to adopting rules related to potential opinion shopping situations, the SEC also voted unanimously to propose for comment amendments to Regulation S-K which would accelerate the timing for filing Forms 8-K relating to changes in accountants and resignations of directors. Sec. Act Rel. No. 6767 (Apr. 12, 1988); 40 S.E.C. Dkt. 1147 (Apr. 26, 1988).

4. Reasons for the SEC's Response. The SEC adopted its new disclosure requirements "[i]n order to provide increased public disclosure of possible opinion shopping situations \* \* \*." 40 S.E.C. Dkt. at 1143. The SEC's release recognized that companies may change auditors at their discretion. Id. However, when a new auditor is engaged, that auditor must possess the integrity, objectivity, and independence required by the standards of the profession and the SEC. Id. As the SEC's release explained,

The auditor must, at all times, maintain a "healthy skepticism" to ensure that a review of a client's accounting treatment is fair and impartial. The willingness of an

auditor to support a proposed accounting treatment that is intended to accomplish the registrant's reporting objectives, even though that treatment might frustrate reliable reporting, indicates that there may be a lack of such skepticism and independence on the part of the auditor. The search for such an auditor by management may indicate an effort by management to avoid the requirement for an independent examination of the registrant's financial statements. Engaging an accountant under such circumstances is generally referred to as "opinion shopping." Id.

- a. Disclosure of Disagreements and Reportable Events. The SEC's rules continue to require that a company disclose disagreements and certain reportable events involving a former auditor. The revisions to these rules require new disclosures concerning consultations between the company and the newly-engaged accountant that occurred during the two full fiscal years and any subsequent interim period preceding the accountant's engagement, if those consultations:
  - (1) were or should have been subject to SAS No. 50, which sets forth guidelines for public accountants when the accountant is preparing a proposal to obtain a new account or when preparing reports or giving advice on the application of accounting principles to actual or hypothetical transactions; or,
  - (2) concerned the subject matter of a disagreement or a reportable event with the former accountant.
  
- b. Note Regarding Definitions. The term "disagreement" includes any difference of opinion between a registrant and its independent accountant concerning any matter of accounting principle or practice, financial statement

disclosure, or auditing scope or procedure, which if not resolved to the satisfaction of the former accountant would have caused the accountant to make reference to the matter in its report. Instruction to Item 304, Regulation S-K; see also Securities Act Rel. 6766, 40 S.E.C. Dkt. at 1141-42.

A "reportable event" is similar to a disagreement in that it involves a situation where the position of management may be considered to be generally at odds with that of the accountant. However, a reportable event does not require that there be an express difference of opinion, but is triggered when the accountant advises a registrant of certain concerns. Under the adopted rules, reportable events include instances where the auditor has advised the registrant that the internal controls necessary for the registrant to develop reliable financial statements do not exist; where the accountant has advised the registrant that it is no longer able to rely on management's representations or be associated with the registrant's financial statements; where the accountant has advised the registrant of the need significantly to expand the scope of its audit; and where the accountant has advised the registrant of unresolved issues that the accountant has concluded materially impact the fairness or reliability of current or past financial statements or audit reports.

The amendments adopted by the SEC differ slightly from the Treadway recommendation in three respects. First, the Treadway recommendation would require disclosure only of those issues discussed with both the old and new accountants. Because a company ordinarily would have discussions with its former accountant concerning any matter discussed with the new accountant, the SEC believed this difference would have little practical

effect. SEC Testimony (May 2, 1988), supra p. 4, at 20.

Second, the Treadway recommendation would require disclosure of discussions concerning any material accounting or auditing issue. The SEC's proposed rules would have required the same disclosures. Commentators on the SEC's proposal were concerned that such a requirement would result in voluminous disclosure that would not highlight the areas of most concern to investors. In response to those concerns, the SEC adopted rules requiring disclosure of those consultations that would most likely be relied upon by companies (i.e., which are given the circumstances described in SAS 50), and that have been the subject of contention between the company and the former accountant. Id. at 20.

Third, the SEC's rules provide for disclosure of potential opinion shopping situations during the two fiscal years preceding the accountant's engagement, while the Treadway recommendation would require disclosure during the three-year period preceding the change in accountants. Because the SEC's rule will normally cover a company's three most recent audits, the SEC did not believe this difference to be significant. Id. at 20-21.

E. Timely Review of Quarterly Financial Data

1. Recommendation. "The SEC should require independent public accountants to review quarterly financial data of all public companies before release to the public." Treadway Report at 53.
2. Treadway Commission's Rationale. Investors rely on, and react quickly to, quarterly results. However, under existing SEC rules, quarterly financial information is not audited or reviewed by an independent auditor prior to its public release. The Treadway Commission believes that public accountant's timely involvement with quarterly financial data would improve the

reliability of quarterly reporting and increase the likelihood of preventing or detecting fraudulent financial reporting. The review of quarterly financial data before public release assures investors of more frequent review of the reporting practices of public companies by an independent and objective party. The Report notes the increasing frequency and high percentage of fourth-quarter write-offs (nearly 2/3 of total dollar value, based on a sample of 1,088 companies from 1980-85). Id. at 53-54.

The Treadway Commission recommends a "limited" review, as described in existing ASB guidelines, rather than an audit. A review differs from an audit in the degree of evidence the independent public accountant must obtain to support the financial information, and in the degree of assurance a user may place on such information. Id. at 53. A review is not designed to express an opinion on the financial information. It therefore requires significantly less supporting evidence than an audit. Treadway Report at 53.

3. The SEC's Response. On October 25, 1988, the SEC approved the issuance of a concept release soliciting comment on timely review of interim financial information. The release is expected to be issued shortly. Commissioner Fleischman dissented from this Commission decision.
4. Reasons for the SEC's Response. As the Treadway Commission noted in its Report, the SEC currently requires larger, more widely traded public companies to include selected quarterly data in their annual financial statements. Pursuant to Item 302(a) of Regulation S-K, these quarterly data must be reviewed, but not audited, in accordance with GAAS. The SEC has also indicated its belief that "all registrants would find it useful and prudent to have independent public accountants review quarterly financial data on a timely basis \* \* \* ." Codification of Financial Reporting Policies Section 304.01.

The SEC's concept release will presumably solicit comment on the costs of implementing the Treadway recommendation vis a vis any additional benefits of disclosure in addition to that required under existing SEC disclosure rules in this area. See SEC Testimony (May 2, 1988), supra p. 4, at 23; Cox Speech, supra p. 5, at 4, ("To me, the

comments from independent accountants on the costs and benefits of timely review will be particularly important in determining what action, if any, should be taken.")

F. Civil Money Penalties

1. Recommendation. "The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding." Treadway Report at 65.
2. Treadway Commission's Rationale. Except for cases subject to the Insider Trading Sanctions Act, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. Sec. 78c, 78o, 78t, 78u, and 78ff), the SEC lacks the ability to impose civil money penalties. The SEC thus lacks the flexibility and breadth of response in dealing with such violations that the CFTC and the SROs have in seeking or imposing monetary penalties for violations of the laws and/or rules under their respective jurisdictions. Treadway Report at 65.

The Treadway Commission believes that the authority to impose fines would enable the SEC to calibrate the penalties imposed on perpetrators of fraudulent financial reports, by imposing heavy fines, in addition to other sanctions, for egregious violations, and imposing smaller fines in lieu of excessively harsh sanctions for violations at the other end of the spectrum. Id.

The Treadway Commission also noted that the SEC has settled some enforcement actions involving ancillary relief in the form of disgorgement of the value of compensation received based on fraudulently reported earnings or profits. In the Treadway Commission's view, the authority for such relief is subject to debate if it is viewed as punitive rather than remedial. Express statutory fining authority would remove any doubt as to the validity of such relief. Depriving perpetrators of fraudulent financial reporting of any ill-gotten gains would also help maintain public confidence in the integrity of the financial reporting process. Id.

3. The SEC Response. On September 28, 1988, the SEC transmitted to Congress its legislative proposal entitled the "Securities Law Enforcement Remedies Act of 1988." This proposed legislation would amend the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act to authorize the assessment of civil money penalties in administrative and civil proceedings under these Acts. Commissioner Fleischman dissented from the SEC's decision to propose this legislation. See infra p. 24.

Note: The proposed legislation would also permit the SEC and the courts to suspend or bar violators of these Acts from serving as an officer or director of any company that files reports with the SEC, and would add violations of Section 16(a) of the Securities Exchange Act to the bases for instituting administrative proceedings under Section 15(c)(4) of that Act.

Although Congress has taken no action on the SEC's proposed legislation, Section 3 of the Insider Trading and Securities Fraud Enforcement Act, Pub. L. No. 100-704 (Nov. 19, 1988), directs the SEC to submit to Congress, within 60 days of enactment, "any recommendations the [SEC] considers appropriate with respect to the extension of the [SEC's] authority to seek civil penalties or impose administrative fines for violations other than [insider trading]." As of the date this outline was submitted, the SEC had not submitted those recommendations.

4. Reasons for the SEC's Response. The SEC supported the recommendation to seek legislative authority for civil monetary penalties for much the same reasons cited in the Treadway Commission's Report. In its transmittal letter to Congress, the SEC noted the following factors that it considered in determining to seek this authority.
  - a. Penalties Against Issuers. In May 1988, the SEC endorsed further examination of whether civil penalties should be imposed against corporate issuers under circumstances where shareholders will bear the costs of the penalty. SEC Testimony (May 2, 1988), supra p. 4, at 24.



Subsequently, on September 28, 1988, the SEC proposed the authority to impose or seek a court order imposing civil penalties against issuers for several reasons. First, the proposed legislation would not require the SEC to seek penalties from an issuer. Rather, the SEC would be permitted to proceed against the appropriate individual offenders acting for a corporate issuer, rather than against the issuer itself. The SEC has stated that, as a matter of enforcement policy, it will seek civil money penalties against issuers only where the violation resulted in an improper economic benefit to shareholders. Moreover, the SEC has indicated that it would not seek penalties against registered investment companies because, as with other expenses incurred by investment companies, these fines would simply be passed on to their shareholders. Memorandum of Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1988 (Sept. 28, 1988) at 4-5 (hereinafter cited as SEC Memorandum on Remedies Act).

- b. Rule 2(e) Proceedings. The SEC determined not to seek authority to impose penalties in Rule 2(e) proceedings, as recommended by the Treadway Commission. In the SEC's view, Rule 2(e) proceedings are designed to protect the integrity of its proceedings, and the sanctions imposed should be limited to those necessary to meet that end, such as suspensions or bars from appearing before the SEC. As the SEC noted, "[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." SEC Memorandum on Remedies Act, supra, at 7.

Commissioner Fleischman's Dissent. At an open meeting held on April 27, 1988, Commissioner Fleischman dissented from the SEC's decision to seek authority to impose or to seek civil monetary penalties because he feared that the agency, if given that authority, would use it regularly and inflexibly, without regard to the merits of each particular case.

G. Cease and Desist Orders

1. Recommendation. "The SEC should have the authority to issue a cease and desist order when it finds a securities law violation." Treadway Report at 65.
2. Treadway Commission's Rationale. Cease and desist authority would provide the SEC with greater flexibility in tailoring remedies to the circumstances of a particular case. By providing a "milder" alternative to an injunctive action, cease and desist authority would assist the public in distinguishing degrees of culpability. In addition, although not as strong a sanction as a civil injunction, cease and desist authority would provide a degree of deterrence in situations in which the SEC might lack evidence of a likelihood of future violations, or in which the SEC hesitates to pursue injunctive relief because the side-effects of an injunction seem too harsh and therefore inappropriate. Treadway Report at 66.
3. SEC Response. The SEC unanimously concluded that legislation providing cease and desist authority is not necessary. However, to expand the remedies available for additional types of reporting violations that may not warrant an injunctive action, the SEC's proposed Securities Law Enforcement Remedies Act of 1988 would add violations of Section 16(a) of the Securities Exchange Act (requiring officers, directors, and ten percent beneficial owners to report purchases of their company's stock) to the bases for instituting administrative proceedings under Section 15(c)(4) of that Act. See SEC Memorandum on Remedies Act, supra p. 24, at 2-3.
4. Reasons for the SEC's Response. The SEC concluded that the need for an enforcement remedy that is "milder" than an injunction is satisfied in most financial fraud cases by Exchange Act Section 15(c)(4), which authorizes the Commission to issue an order requiring any person found, after notice and opportunity for hearing, to have violated or to have been a cause of a violation of Exchange Act Sections 12, 13, 14, 15(d), or the rules thereunder, to comply with the violated provisions. Id.

In order to increase the range of cases in which this remedy is available, the SEC has proposed that the scope of Section 15(c)(4) be expanded to encompass violations of Section 16(a) of the Exchange Act and the rules thereunder, thus providing the SEC with an administrative remedy to address additional types of reporting violations that may not warrant an injunction.

Commissioner Fleischman's Dissent. At the SEC's open meeting on April 27, 1988, Commissioner Fleischman dissented from the SEC's decision to expand the scope of Section 15(c)(4) because he was of the view that the agency's enforcement authority was already sufficient.

H. Bars or Suspensions from Serving as Corporate Officer or Director

1. Recommendation. "The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company." Treadway Report at 66.
2. Treadway Commission's Rationale. The authority to bar or suspend corporate officers and directors would provide a sanction when the Commission's disclosure rules regarding prior enforcement actions and the other collateral effects of an injunction would not serve as sufficient deterrents to future involvement in fraudulent financial reporting. This recommendation would afford the SEC greater flexibility in its enforcement actions and would stiffen sanctions against individual offenders who commit egregious and/or repeated violations. The Commission's limited use of this remedy to date has taken place in the context of settled cases and its authority to impose such bars or suspension has been the subject of extensive legal debate. Treadway Report at 66.
3. The SEC's Response. The SEC's proposed "Securities Law Enforcement Remedies Act of 1988" would give the SEC the express authority to impose, or seek a court order imposing, a bar or suspension prohibiting violators from serving as officers or directors of "any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act \* \* \*

or that is required to file reports pursuant to [Section 15(d)] of such Act."

4. Reasons for the SEC's Response. As a form of ancillary relief in SEC injunctive actions, the SEC has successfully obtained court orders barring or suspending individuals from serving as officers or directors of a public company. Nevertheless, the SEC recommended legislation giving the Commission and the courts express authority to impose such bars and suspensions so as to remove any doubts about the propriety of this remedy, which has been obtained in SEC injunctive actions by consent. See SEC Memorandum on Remedies Act, supra p. 24, at 3.

Commissioner Cox's Views. Commissioner Cox has stated that although he supports seeking statutory authority to bar officers and directors, he does not support the imposition of such bars under existing law. He believes that, absent express statutory authority, "the better view is that Congress intended that investors would rely on disclosure [of past securities laws violations, see Regulation S-K, Item 401] to protect themselves from officers and directors who have violated the securities laws." Cox Speech, supra p. 5, at 6.

## I. Increased Criminal Prosecution

1. Recommendation. Criminal prosecution of fraudulent reporting cases should become a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers." Treadway Report at 67.
2. Treadway Commission's Rationale. A basic premise of the Treadway Report is that fraudulent financial reporting is a significant problem requiring more attention from many constituencies, including regulatory and law enforcement agencies. SEC civil and administrative proceedings alone cannot provide the degree of deterrence that is needed to protect against fraudulent financial reporting. Treadway Report at 67-68.

3. The SEC's Response. In an effort to enhance cooperation among agencies responsible for criminal enforcement, officials from the SEC, CFTC, FBI, IRS, and the United States Postal Inspection Service met on March 29, 1988, with representatives of the North American Securities Administrators Association, the National Association of Attorneys General, and several self-regulatory organizations. The purpose of this meeting was to consider formation of a Securities and Commodities Fraud Working Group. During this meeting, a framework for further communication was established so that the agencies could discuss enforcement priorities, improvements in current systems of information exchange, and initiatives to improve enforcement in the areas regulated by the participating agencies. SEC Testimony (May 2, 1988), supra p. 4, at 29-30.
  
4. Reasons for the SEC's Response. As the SEC indicated in its testimony before the Subcommittee on Oversight of the House Energy and Commerce Committee on May 2, 1988, "[t]he Commission supports criminal prosecution of offenses involving fraudulent financial reporting and, accordingly, conducts an active program to assist and educate officials with criminal enforcement responsibilities." SEC Testimony (May 2, 1988), supra p. 4, at 29. The meeting on March 29, 1988 was just one of a number of programs in which the SEC participates to coordinate enforcement activities by the various federal and state administrators charged with this responsibility.

As noted in the Treadway Report, the Commission maintains an active liaison with criminal enforcement authorities, provides access to investigative files, and provides expert assistance on a case-by-case basis. See Treadway Report at 68. In some instances, Commission staff members are assigned to assist in criminal investigations and trials. Each year, the Division of Enforcement and members from the Department of Justice and United States Attorney's Offices participate in cooperative enforcement training programs. SEC Testimony, supra p. 4, at 29.

J. Professional Organization Membership

1. Recommendation. "The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms." Treadway Report at 71.
2. Treadway Commission Rationale. Mandatory membership in a quality assurance program is necessary for effective regulation of the accounting profession and to implement the securities laws. The quality of audit practice is related directly to the prevention, detection, and deterrence of fraudulent financial reporting. Treadway Commission research claimed to find an unacceptably higher incidence of failure to detect fraudulent financial reporting by accountants that were not members of the SECPS. Mandatory membership in a quality assurance program is essential to ensure that independent accountants have the requisite qualifications to audit and opine on companies' financial statements. Treadway Report at 72.
3. The SEC's Response. On April 1, 1987, the SEC proposed for public comment a rule that would amend the Regulation S-X definition of "certified" financial statements to require that such financial statements be examined by an independent accountant who has undergone an objective review by other independent accountants within three years preceding the date of the completion of the examination. Securities Act Rel. No. 6695 (Apr. 1, 1987), 37 S.E.C. Dkt. 1825 (Apr. 14, 1987).

The Commission's proposal would provide that an accountant may satisfy this "peer review" requirement by (1) undergoing a peer review under the auspices of an acceptable peer review organization ("PRO"), or (2) by having its review supervised directly by the Commission. A PRO would be required to supervise peer reviews performed under its auspices to ensure that they are conducted in accordance with standards proposed in the rule. PROs would be subject to Commission oversight, including Commission review

of peer review workpapers. Accountants choosing not to participate in a peer review program under the auspices of a PRO would select a peer reviewer meeting requirements specified in the rule. The Commission staff would perform the supervisory functions otherwise performed by a PRO.

The Commission staff is reviewing the comment letters received and preparing a recommendation with respect to this proposal.

4. Reasons for the SEC's Response. The SEC's release proposing mandatory peer review noted its long support of the concept "as a way of providing added assurance to investors, creditors and clients that an accountant is consistently complying with professional standards." 37 S.E.C. Dkt. at 1827. Although recognizing that peer review cannot identify all factors affecting the quality of an accountant's practice and prevent all audit failures, the SEC believes that "undergoing a peer review reinforces an accountant's commitment to the maintenance of adequate audit quality controls." Id. at 1829. The SEC noted its staff's favorable experience with quality control reviews performed pursuant to settlement of its enforcement actions and in overseeing the peer review program of the SECPS. The SEC also observed the strong support for peer review programs among diverse private and governmental bodies such as the AICPA, the Treadway Commission, the "Big Eight" accounting firms, the House Committee on Government Operations, and the Rural Electrification Administration. Id. at 1827.

The SEC has broad authority to establish the form, content and requirements for financial statements required to be filed under the federal securities laws, including requiring independent audits of registrants, defining technical and accounting terms, prescribing the reports and information to be filed, and prescribing the form in which information is set forth and the methods to be followed in the preparation of reports. In addition, the SEC has general authority to make such rules and regulations as may be necessary to implement the provisions of the securities laws. See id. at 1827-28, and citations included therein. Because peer review would benefit

investors by improving the disclosure process, the SEC believes that its proposed rule is reasonably related to implementing the provisions of the securities laws. Id. at 1828.

Separate Views of Commissioner[s] Cox.

Commissioner Cox has indicated that he has doubts about whether the SEC's peer review proposal "is justified, from either a cost-benefit or a legal standpoint." In his view, "requiring membership in a group which purports to confer net benefits on its members is counter-intuitive, and that an organization that imposes quality control and practice standards on its members should stand or fall on its merits." Cox Speech, supra p. 5, at 4. He also questions the SEC's authority to mandate peer review pursuant to its power to define "certified" financial statements. Id.

K. Enforcement

1. Recommendation. "The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited by the public accounting professional's quality assurance program." Treadway Report at 72.
2. Treadway Commission's Rationale. The public accounting profession's quality assurance efforts require credible enforcement with meaningful sanctions. The SEC should provide this function, and can do so within its existing regulatory and enforcement framework. Implicit in an SEC rule requiring membership in a professional quality assurance program is compliance with that program's standards and requirements. Thus, the failure to remedy cited deficiencies would constitute violation of an SEC rule. Treadway Report at 72.

Under SEC Rule 2(e) the SEC may discipline a professional who practices before the agency if that person is found "not possess the requisite qualifications to represent others." A finding of noncompliance with the requirements of the public accounting profession's quality assurance program would constitute a lack of "the requisite qualification to represent others" within the meaning of SEC Rule 2(e). A Rule 2(e) proceeding allows the SEC to impose a meaningful sanction: temporary or permanent denial of the



privilege of performing audits of public companies for the inclusion of an audit report in public disclosure documents. Id. at 73.

3. The SEC's Response. The SEC has said that if its peer review proposal is adopted, the SEC may be able to examine, in an administrative proceeding, an accounting firm's failure to remedy deficiencies cited in a peer review and its eligibility to provide certified financial statements. See SEC Testimony (May 2, 1988), supra p. 4, at 33-34.
4. The Reasons for the SEC's Response. The failure to implement measures to address peer review deficiencies would not, in itself, violate the securities laws. The SEC therefore has no express statutory authority to take enforcement action based on an accounting firm's failure to remedy such deficiencies. Moreover, under GAAS, an accountant need not participate in a peer review program or remedy particular deficiencies cited by such a program. SEC Testimony (May 2, 1988), supra p. 4, at 33-34.

However, SAS 25 indicates that, in order to comply with generally accepted auditing standards, a firm of independent accountants should establish quality control policies and procedures to provide it with reasonable assurance of conforming with those standards in its auditing engagements. The failure to remedy deficiencies cited in a peer review may indicate that a firm has failed to establish the quality control policies and procedures required by SAS 50. If adopted, the SEC's peer review proposal would permit the SEC to examine an accounting firm's failure to remedy deficiencies cited in a peer review and to determine in an administrative proceeding the firm's continued eligibility to provide certified financial statements. Id.

#### L. SEC Resources

1. Recommendation. "The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting." Treadway Report at 73.
2. Treadway Commission's Rationale. The SEC's resources should be adequate for effective

performance of its existing functions as well as the new functions recommended by the Treadway Commission. Adequate SEC resources for its enforcement of the public accounting profession's quality assurance standard would obviate the need for an ultimately more costly SRO for the profession. Treadway Report at 73.

The sheer volume of new issues and other pressures has inevitably led to a reduction in the Commission's review of filings. Adequate resources should extend beyond funding to salary and grade-level mechanisms that would enable the SEC to attract and retain highly qualified personnel. Id.

3. The SEC's Response. The SEC's 1989 budget request of \$160.9 million represented an increase of \$25.7 million over the SEC's 1988 appropriation. The actual SEC appropriation for 1989 was \$142.6 million. See Pub. L. No. 100-459 (Oct. 1, 1988).

In December 1988, the SEC submitted to Congress a study prepared by the SEC's Office of the Executive Director. The SEC staff's study recommends that the SEC be given authority to:

- a. set staff salaries that would take into account competitive salary differentials and would provide regional pay differentials;
- b. offer retention bonuses to professional staff based on performance;
- c. fill 100 positions at compensation up to Level IV of the executive pay scale for highly qualified lawyers, accountants, or other professionals for specific cases or program management;
- d. develop and implement pay bands for classifying professional and support staff positions; and,
- e. lease space itself and obtain exemptions from GSA space management regulations in order to meet specialized SEC space requirements.

Because these proposals would involve a substantial cost to the agency, the staff's study offers options for increased funding. The first option involves separate Congressional consideration of the SEC's budget request. The second and third options present choices which utilize a revolving account or fund account that would take the SEC off-budget. Under the second option, the OMB and Congressional authorization and appropriation committees would retain their current roles over the agency's budget. The third option would establish a permanent SEC trust-revolving fund outside the traditional appropriation process. Using this approach, the SEC would request authorization for expenditures from the trust-revolving fund through biennial requests to the oversight committee. The understanding is that any funding option employing the agency's fee collections would result in reduced payments to the General Fund of the Treasury.

The SEC expects to consider the staff's study, and make its own recommendations to Congress shortly.

4. Reasons for the SEC's Response. In response to extensive testimony that the SEC lacks sufficient overall resources and faces difficulty in recruiting and retaining the top quality staff necessary for effective regulation, the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs directed the SEC to study the possibility of transforming the agency from appropriated to self-funded status. See Senate Rep. No. 100-105, 100th Cong., 2nd Sess. (July 9, 1987). The SEC staff submitted its self-funding study in partial response to the Subcommittee's direction.

M. Reconsidering Corporate Indemnification

1. Recommendation. "The SEC should reconsider its long-standing position, insofar as it applies to independent directors, that the corporate indemnification of officers and directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable." Treadway Report at 77.

2. The Treadway Commission's Rationale. Independent directors are necessary components of an effective audit committee, which in turn is a key to preventing fraudulent financial reporting. The perceived liability crisis and the difficulties in obtaining directors' and officers' insurance make it more difficult to recruit qualified independent directors. If limited indemnification, particularly of independent directors, is permitted, it may be easier to attract and retain directors qualified to serve on audit committees. Thus, the benefits of permitting such indemnification may outweigh the public policy concerns underlying the SEC's traditional position. Treadway Report at 77-78.
3. The SEC's Response. The SEC believes that no change in its position is warranted. SEC Testimony (May 2, 1988), supra p. 4, at 36.
4. Reasons for the SEC's Response. Historically, the SEC has taken the position that indemnification of officers, directors, or control persons of an issuer from liability arising under the Securities Act is against public policy and is, therefore, unenforceable. See Securities Act Rel. No. 3791 (May 27, 1957) The SEC believes that, where the Securities Act imposes monetary liability on individuals, Congress did not intend that those liabilities be transferred to the public shareholders of the issuer by means of indemnification. If indemnification were permitted, public investors--who are victimized by false statements in Securities Act registration statements--would bear the costs of injuries caused by false filings. This would nullify the liability provisions of the Securities Act. SEC Testimony (May 2, 1988), supra p. 4, at 36-37.

Courts that have considered this matter have agreed with the SEC's position, and have refused to enforce indemnification agreements as contrary to public policy. In Globus v. Law Research Service, Inc., 418 F. 2d 1276 (2d Circ. 1969), cert. denied, 397 U.S. 913 (1970), the court held that it would be "against the public policy embodied in the federal securities legislation" for an underwriter who had actual knowledge of misstatements contained in a Regulation A offering circular to obtain indemnification. The court limited its decision to circumstances where

the "has committed a sin graver than ordinary negligence." Id. at 1288. See also Heiser Corp. v. Ross, 601 F. 2d 330 (7th Cir. 1979) (reckless conduct under Section 10(b) and rule 10b-5 precludes indemnification). Other courts, however, have refused to permit indemnification for liability arising as a result of negligent conduct. See, e.g., Laventhol, Krekstein, Horwath & Horwath v. Horwitch, 637 F. 2d 672 (9th Cir. 1980), cert. denied, 452 U.S. 963 (1981); Odette v. Shearson, Hammill & Co., Inc., 394 F. Supp. 946 (S.D.N.Y. 1975); SEC Testimony (May 2, 1988), supra p. 4, at 36.