An Address by
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on

The Responsibility of Professionals
under the Federal Securities Laws

at the

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Corporate Counsel Institute held at
Northwestern University

on

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1/ This speech was prepared with the assistance of Theodore Sonde, Assistant General Counsel. Mr. Sonde also delivered substantially the same speech on October 27 and 28, 1972 at the National Conference on Liability of Lawyers and Accountants under the Securities Laws.

I will attempt today to describe briefly a professional's responsibility under the federal securities laws. That topic is quite obviously far more comprehensive than I could reasonably expect to cover in the time allowed or which I might realistically assume I could explain in any great detail. I hope, however, that I can briefly outline some areas of concern, the sources of that concern and by some illustrations, indicate where I think things may be going.

I should note at the outset that the Securities and Exchange Commission as a matter of policy disclaims responsibility for any private publication or speech by any of its employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or my colleagues on the Commission's staff.

The effective functioning of the federal securities laws contemplates the involvement of professionals. In the case of accountants and attorneys they are explicitly recognized in the statutes. 1(a)/ The full scope of professional involvement is not, however, fully set forth. Thus, for example, there is a requirement that financial statements be

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1(a)/ See e.g., Sections 7 and 11(a)(4) and 11(b)(3) of the Securities Act of 1933, Items 23 and 29 (counsel) and Item 25 (accountants) of Schedule A to the Securities Act of 1933; Item 4 of Form 1-A of Regulation A, 17 CFR Section 230.255 (1972); see also generally Securities Act Rel. No. 4936 (1968) - Items 37 and 38; Sections 12(b)(1)(j) and (K) and 13(a)(2) of the Securities Act of 1934.

reported on by independent accountants and that counsel who have passed on the legality of the issue be named in and their opinions filed as an exhibit to the registration statement. Although there is no requirement that disclosure documents filed with the Commission be reviewed by attorneys, it would as a practical matter be difficult for a layman fully to comply with all of the statutory requirements without assistance of counsel.

In the enactment of the federal securities laws Congress accepted the philosophy of full disclosure as the method best designed to protect the investing public. Congress borrowed the disclosure philosophy so eloquently explained by Mr. Justice Brandeis: "publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman...." 2/ In adopting this basic regulatory device Congress recognized that it could work effectively only if accurate information and adequate financial statements are provided to the investing public.

Accountants

In the latter connection, Congress also recognized that issuers without assistance could not be relied upon to provide such financial statements. Although it was initially proposed that the government hire a corps of auditors to perform the auditing responsibility for financial statements filed with the Commission, it was decided that the financial statements filed with the Commission be audited by independent public accountants. This decision was based upon the accounting profession's

2/ Brandeis, Other Peoples' Money, 92 (1932 ed.).

representation that it was willing and able to assume this responsibility. In so doing, the Congress codified the basic concept expressed in the accountant's code of professional ethics; that is, the accountant must be independent in his relationship with his client. 3 / The concept of independence has always been considered by the Commission to be fundamental. As the Commission explained in 1936, the real function of certification "is the submission to an independent and impartial mind of the accounting practices and policies of registrants ... [so that] ... security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise .... [T]he certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements...." 4 / From the concept of independence, most of the accountant's professional obligations flow. An independent public accountant's paramount responsibility

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3 / See Rule 1.01 of the Code of Professional Ethics of the American Institute of Certified Public Accountants (1969).

4 / In the Matter of Cornucopia Gold Mines, 1 S.E.C. 364, 367 (1936).

is to the public, and that obligation cannot be subordinated to his client's private interests. As the Commission stated in its report in McKesson & Robbins, Inc.,

> "In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to managers or to owner-managers, he must now recognize fully his responsibility to public investors..." 5/

This was further explained by the Commission in Touche, Niven (1957), wherein it stated that:

> "The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client."(footnote omitted) 6/

And the Commission's first Chief Accountant once explained:

> "Technical accounting ability is essential for success in the field of public accountancy, but it is the quality of a certified public accountant's integrity and his independence more than his ability that determine the extent of his usefulness to society. No matter how highly skilled a

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5/ In the Matter of McKesson & Robbins, Inc., Acct. Ser. Rel. No. 19 (1940) p. 20 (1968 Compilation).

6/ In the Matter of Touche, Niven, Bailey & Smart, 37 SEC 629, 670-671 (1957).

> certified public accountant might be, if he could not be depended upon to see that the financial statements which he certifies are honestly presented, whether his client likes it or not, he would be not only valueless in the public accounting profession, he would be a business menace." 7 /

Unfortunately, recent Commission experiences have included a substantial failure on the part of some members of the accounting profession to report fairly on the financial statements of their clients. This failure has been reflected in what some describe as "creative accounting" or "form-over-substance accounting." The Commission's staff recently stated in the Penn Central report:

> "The problem of distinguishing form from substance is a significant and difficult one, yet successful discrimination is essential if financial statements are to be meaningful to investors and creditors .... Independent auditors bear a heavy burden of public responsibility in reviewing transactions with such a distinction in mind....
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> In addition to the analysis of various individual transactions, the overall impression left by the financial statements is part of the responsibility of the public accountants. Statements cannot simply be the accumulation of data relating to individual transactions viewed in isolation." 8 /

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7 / Blough, The Journal of Accountancy, December 1946, p. 453, quoted approvingly by the Commission in its Touche Niven decision, supra.

8 / SEC, Staff Report to the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Commerce: The Financial Collapse of the Penn Central Company (hereinafter referred to as "Penn Central Report") 77 (Subcomm. Print 1972).

Stated in other terms, this represents a subordination of the accountant's judgment to the desires of his client to engage in a questionable practice known as "income management."

It must be kept in mind that the accountant is certifying that the financial statements "fairly present" the issuer's financial condition or earnings. The public accountant simply cannot permit himself to be stampeded into an inadequate audit or misleading certification even if he can justify each one of the steps he has taken, when viewed in isolation. Compliance with generally accepted accounting principles is not necessarily sufficient for an accountant to discharge his public obligation. Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness, although it is said by some that "fair presentation" is the most fundamental accounting principle. This was recognized by the Court of Appeals for the Second Circuit in the Simon case 9 / and by the Commission over 30 years ago when it stated, accountants will be criticized when

> "the financial statements, looked at as a whole, were not truthfully informative and should never have been certified....

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9 / United States v. Simon, 425 F.2d 796 (C.A. 2, 1969), certiorari denied, 398 U.S. 904 (1970).

> [T]oo much attention to the question whether the financial statements formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed their function of enlightenment, which is their only reason for existence." 10/

An additional problem which exists is what some of my colleagues have referred to as accounting "by the lowest common denominator." Stated in other terms, this means attempting to justify the use of an accounting practice or principle merely because it was followed in some other situation. There is too much emphasis being placed upon isolated examples of other situations accepted by the Commission or its staff. Whether or not the acceptance of a particular practice was appropriate in one case does not necessarily indicate that it would be appropriate in another situation. This practice should be compared to that of a lawyer preparing a brief on the basis of headnotes or dictum, without regard to the facts and the holding in the case. Similarly, an auditor may not borrow accounting principles blindly. If the application of accounting principles involved nothing more than a mechanical process, there would be no need for the existence of a profession of independent public accountants. I do not mean to over simplify the

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10/ Associated Gas and Electric Co., 11 S.E.C. 975, 1058-1059 (1942).

problem which accountants face or to suggest some easy solution. Nevertheless, if financial reporting is to continue as a viable and essential part of the federal securities laws, as it must, the accounting profession must do more in demonstrating that in reporting on financial statements it is doing so independently and with a view toward its public responsibility. This is no simple task. The fixation on income maintenance by some members of business management, combined with the pressure to create or accelerate income, accrue revenues and under-accrue expenses, losses and reserves will undoubtedly continue to cause considerable pressure to be brought to bear upon the accounting profession, a pressure that must be resisted.

The Commission over the years has attempted to strengthen the accounting profession and in this connection has recently taken certain specific steps in the interest of seeking greater objectivity and meaning in financial statements filed with the Commission and certified by independent public accountants. In 1971, the Commission amended its Form 8-K report to require reporting companies publicly to notify the Commission when it changed auditors. We have also required in this connection that the reporting company furnish the Commission with a separate letter stating whether in the 18-months preceding the engagement of new auditors, there were any disagreements with the former auditors or any matter of accounting principle or practice, the financial statement

disclosure, or accounting procedure, which disagreement, if not resolved to the satisfaction of the former accountants would have caused the auditor to refer to it in his opinion. Further, we have required the company to request the former auditors to furnish it with a letter addressed to the Commission stating whether they agree with the statements contained in the company's letter and, if not, stating the respects in which the auditors do not agree.11 /

It was our hope that in adopting this requirement we would be strengthening the independent role which is expected and demanded of public accountants. From the results to date, it would appear at least in part, that this measure has met with a fair degree of success. Further, the Commission has strongly endorsed the establishment of audit committees composed of outside or non-management directors in order to increase the reliability of financial statements of publicly-held companies. 12/ In addition, the Commission has proposed that periodic reports disclose large and unusual charges or credits to income in greater detail and that such reports be reviewed by the company's auditor. 13/ When one reads about large

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11 / See Securities Exchange Act Release No. 9344 (1971).

12 / See Securities Act Release No. 5237 (March 23, 1972).

13 / See Securities Act Release No. 5313 (October 2, 1972).

write-offs, sometimes running into the hundreds of millions, one must ask whether such write-offs shouldn't have been reflected in earlier periods than those being reported on. Perhaps some of these "extraordinary" charges should have been recognized earlier.

In a number of situations a company's independent accountant may frequently feel a need to obtain legal advice. There are many routine situations where reliance upon the company's own counsel may be appropriate, but there exist a number of areas where reliance upon such counsel may not be a safe harbor. Under conditions where legal matters are highly material to the validity of financial statements, it would seem that more prudent practice might call for consultation with the accountant's own counsel because counsel for the issuer cannot really be expected to be "independent" in the same sense that is expected of the accountant. Indeed under the Investment Company Act regular counsel for the investment adviser or principal underwriter (who usually manage investment companies) are considered "interested persons" for purposes of evaluating whether, among other things, they may serve as independent directors.14/

14/ See Section 2(a)(19) and 10(a) of the Investment Company Act of 1940.

Attorneys

The accounting profession has not been alone in receiving criticism in its performance concerning public companies. The legal profession has also been sharply criticized. This was particularly true for its part in some of the events which preceded the enactment of the federal securities laws and which, unfortunately, have, at least in part, continued to date. Much can be found in the legislative history of these statutes which reflects unfavorably upon the bar and two articles which appeared in the 1934 issues of the Harvard Law Review provide illustrations of the problem presented. I refer to Mr. Justice Stone's article on The Public Influence of the Bar 15/ and former Chairman, now Justice Douglas', article on Directors Who Do Not Direct. 16/

Justice Douglas observed that lawyers must share equally the responsibility for many of the events which precede the enactment of the federal securities laws. Quoting a popular columinist of the day, Justice Douglas noted: 17/

15/ Stone, The Public Influence of the Bar, 48 Harv. L. Rev. 1, (1934).

16/ Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305 (1934).

17/ Id. at 1329, n. 65.

> "But just as a fine, natural football player needs coaching in the fundamentals and schooling in the wiles of the sport, so, too, it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of their play."

> "Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns they would soon be caught offside and penalized, and some of the noted financiers who are now immortalized as all-time all-American larcenists never would have risen beyond the level of the petty thief or short-change man."

Providing some additional insight into the problem, Mr. Justice Stone observed that in the events which preceded these statutes, much was attributable to the failure to observe the fiduciary principle that "a man cannot serve two masters" and that in the separation of ownership from management, there exists an inherent conflict; a conflict which often has resulted in those who nominally serve as trustees ignoring their responsibilities. Unfortunately he also felt compelled to observe that the departure from the fiduciary principle did not "usually occur without the active assistance of some member of our profession..." Part of any analysis of an attorney's responsibility under the federal securities laws lies in the fact that in representing a public corporation, he is representing a "multiplicity of clients" with all of the conflicts inherent in any such situation. The recently issued Code of Professional Responsibility, while recognizing such multiple representation does not provide any real guidance. It merely states that a lawyer's allegiance is to the "entity",

"not to a stockholder, director, officer, employee, representative, or other person connected with the entity" and that in advising the "entity" the lawyer "should keep paramount its interest and his professional judgment should not be influenced by the personal desires of any person or organization." 18/ Unfortunately, these simple statements raise more questions than they answer. For instance, when the attorney-client privilege is asserted, is it for the benefit of the public corporation or its management?

Even if it be assumed that the attorney representing a public corporation will maintain his allegiance to the so-called "entity", that is not the end of the problem. What of the allegiance of the attorney who has an interest in the registrant or who will acquire such an interest in a registered offering. We have required that any counsel named in the prospectus as having passed on legal matters in connection with the offering, disclose any material interest in the issuer that they have or will acquire in connection with the offering. 19/

A variation of this problem is occurring in a number of registered offerings for tax shelter programs where public funds are raised with no specific use of proceeds, such as in a "blind pool", and where there exists

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18 / ABA, Code of Professional Responsibility, Ethical Consideration 5-18.

19 / See Securities Act Release No. 5094 (1970).

numerous real and potential conflicts of interest, not only with respect to the management but for the attorneys as well. We have considered these business conflicts to be sufficiently important to require special disclosure. Further, we have specifically requested that counsel for the issuer (usually a limited partnership) advise us what they would do when faced with such conflicting interests; who would they represent and how would the public or limited partners be represented. Counsel have almost universally stated that they would always seek separate counsel to represent the public investor as soon as the conflict becomes apparent. Notwithstanding these assurances one must question whether, at least in some situations, there may not exist a need to have separate counsel at the outset. If, as the ethical considerations appear to indicate, counsel's allegiance must be to the "entity," it does not seem unreasonable to demand continued allegiance to the entity as such and not permit shifting allegiance. At least one court considered a failure to disclose what it found to be a conflict of interest by a law firm to be an omission of a material fact in a proxy statement involving a merger. While on appeal, the court of appeals found it unnecessary to reach this question, I believe it represents good law. 20/

20/ Kohn v. American Metal Climax, 322 F. Supp. 1331 (E.D. Pa. 1971) affirmed on other grounds, 458 F.2d 255 (C.A. 3, 1972).

Disclosure of both actual and potential conflicting interests has long been required under the federal securities laws of broker-dealers and investment advisers. 21/ Attorneys must make similar disclosure. 22/

Another variation of this problem occasionally occurs when a lawyer or law firm represents a number of witnesses in an investigation or a number of defendants in some other form of proceeding. This is not a problem peculiar to the securities laws, but is one which I think too little attention has been paid. The problem appears in a number of forms. It sometimes occurs when both a public corporation and some of its officers or directors are under investigation. Although their interests may be the same, they also may not be and in some situations there may exist sharp conflicts. While the lawyer who is asked to represent potentially divergent interests may obtain the consent of the individuals, as is required by his professional obligations, one must question whether meaningful consent is possible by the public corporation when in many cases there does not exist a truly disinterested management

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21/ See Chasins v. Smith, Barney & Co. 438 F.2d 1169 (C.A. 2, 1970) and SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

22/ See e.g. ABA Code DR 5-105(c) and EC 5-16.

or board of directors capable of giving such consent. 23/ Better practice would appear to suggest that it would be advisable to have the corporation separately represented, as is frequently done in shareholder derivative suits. Of course, counsel for the corporation in such circumstances often has some very difficult decisions to make as how best to protect his "client's" interests, particularly since his allegiance apparently is to the "entity" and not to any stockholder, officer or director. Still another variation of this problem occurs when a lawyer represents several defendants in, for example, a Commission enforcement proceeding but has one client who is, shall we say, his "primary" client such as a corporate or professional institution of sorts. Can he "zealously" represent his individual clients 24/ when the so-called primary client is probably paying his fee to represent all the defendants and it may often be expeditious for the institution to compromise the litigation on a different basis than that available to the individuals and perhaps at their expense or "sacrifice." Such potential conflicts become particularly pronounced whenever settlement becomes a possibility. 25/ It would seem that at the very least the lawyer should

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23/ Cf. Garner v. Wolfinbarger, CCH Fed. Sec. L. Rep. ¶93,600, (D. Ala., Aug. 16, 1972). See also ABA Code DR 5-105(c).

24/ Canon 7 of ABA Code.

25/ Cf. ABA Code DR 5-106(a).

discuss such potential conflicts with his individual clients and explore the various ramifications of such conflicts with them. In fact, in some cases the lawyer should probably urge the individual to obtain separate counsel.

While the Commission's rules of investigation authorize the sequestration of witnesses and counsel, 26/ counsel should not look to Commission counsel to protect his own professional integrity.

While it is simpler to evaluate the independent accountant's responsibility in light of his express statutory role, an evaluation of the attorney's role requires us to probe deeper. The two professionals' respective roles provide an interesting contrast. For example, an auditor is charged with independently examining the representations of management. Generally the lawyer is not. Nevertheless as the Commission explained a number of years ago, 27/

> "an attorney's opinion based upon hypothetical facts is worthless if the facts are not as specified, or if unspecified but vital facts are not considered.

26/ Rule 7(b) of the Commission's Rules Relating to Investigations.

27/ Securities Exchange Act Rel. No. 6721 (1962).

> Because of this, it is the practice of responsible counsel not to furnish an opinion concerning, [for example], the availability of an exemption from registration ..., unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution."

This does not mean the attorney must investigate the truth of all his client's statements under risk of liability. He may not, however, deliberately close his eyes to the obvious risk that he is engaging in unlawful conduct. Responsible counsel do not participate in the filing of a registration statement without a thorough investigation, even though technically their opinion may be very limited in connection with that offering. Some counsel have actually described the preparation of a registration statement as involving an adversary relationship between themselves and the issuer, even if they represent the issuer. This, it seems to me is a healthy attitude which ought to be encouraged. Similarily, counsel should exercise care in the preparation of requests for no-action letters from the staff.

An example of this attitude is illustrated in the staff's study on Penn Central. 28/ Management of Penn Central had asked that one of the underwriters' counsel be removed because of his instant questioning

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28/ Penn Central Report p. 108-120.

of management's representations. The senior partner in the law firm refused. He explained among other things that there were certain duties imposed by a case known as BarChris. 29/ Fortunately, in part as a result of counsel's efforts, the public did not add additional millions to Penn Central's imminent collapse. As the partner concluded:

> "someday this whole thing would blow up, and I wanted to make sure that ... [the underwriter - his client] was focusing on it...." 29(a)/

The senior partner was referring of course to Judge McLean's opinion in BarChris where in discussing the liability of a lawyer-director who had drafted the registration statement he stated:

> "It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check on matters easily verifiable is not unreasonable. Even honest clients make mistakes. The statute [at least under Section 11] imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record."30 /

At attorney's responsibilities can be analyzed on the basis of his relationship with his client. It can also be approached in a number of

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29 / Penn Central Report p. 114.

29(a)/ Ibid.

30 / Escott v. BarChris Construction Corp. 283 F. Supp. 643, 690 (S.D.N.Y., 1968).

other ways. As a lawyer, of course, he is required to represent his client within the bounds of the law. 31/ Further, an attorney acting in his professional capacity may not provide that degree of "assistance or encouragement" to his client which would make him liable as an aider and abettor for violations of the federal securities laws committed by his client. 32/

A very pressing problem is the question of the extent to which a professional can become a participant in an illegal securities transaction or can otherwise be charged with aiding and abetting such a securities transaction. In view of some recent cases one might ask: What is the minimum level of conduct that a professional must engage in before he can be subjected to liability. This question is illustrated by a recent opinion of a federal district court in Oregon in which it was stated that a lawyer:

31/ Canon 7 of the ABA Code of Prof. Resp. (1969).

32/ See Securities and Exchange Commission v. Century Investment Transfer Corp., CCH Fed. Sec. L. Rep. ¶93,232 (S.D.N.Y., Oct. 5, 1971). See also United States v. Sarantos, 455 F.2d 877 (C.A. 2, 1972); Securities and Exchange Commission v. First Securities Co. of Chicago, CCH Fed. Sec. L. Rep. ¶93,430 (C.A. 7, 1972); Brennan v. Mid-Western United Life Insurance Co., 417 F.2d 147 (C.A. 7, 1969); Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (C.A. 7, 1969).

"need not have actual knowledge of an illegal securities transaction in order to become a 'participant' in such sale. The fact that a defendant did not know, and could not have known, of the illegal quality of a securities transaction, while relevant to the issue of his liability is not relevant to the issue of his participation."33 /

While the Court was construing an Oregon securities statute and applying it to the question of whether service of process had been properly effected, the implications of the Court's opinion appear to be rather broad. The meaning of the opinion remains obscure in terms of the extent to which "participation" may give rise to liability. The Court defines participant in a number of ways. For example, the Court states that "[e]ven if ... [the lawyer] did not know and could not have known of [the issuer's] failure to register the securities, he was a participant in the sale because, without his assistance, the sale would not have been accomplished." The Court also holds that even as to the other partners in the law firm who did not have a hand in the preparation of the documents, the law firm's authorized designation on the corporation's published reports as "corporate counsel" was enough "to make the firm's partners 'participants' in any unlawful securities transactions in which the annual reports were used for promotional purposes." 34/

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33 / Black & Company v. Nova-Tech, Inc., 333 F. Supp. 468, 472 (D. Ore., 1971).

34 / Ibid.

It has long been recognized that a lawyer or accountant has no provilege to circulate a statement which he knows to be false simply because his client has furnished it to him. 35/ Nor, may a lawyer or an accountant escape liability for fraud by closing his eyes to that which he can readily see and understand. 36/ This does not mean, however, that a lawyer who is putting his client's description of a chemical process into understandable English may be held liable simply because of his failure to detect discrepancies between the description and other technical reports available to him which are beyond his ability to understand. 37/ Nevertheless, he cannot counsel others to make statements in the face of obvious indications of which he is aware that those statements are not true. 38/ Further, he may not, consistent with his professional obligations, remain silent once he receives information "which clearly establishes that his client has,

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35/ Securities and Exchange Commission v. Frank 388 F.2d 486, 489 (C.A. 2, 1968). See also Statement of Auditing Procedure No. 38 of the Committee on Auditing Standards of the American Institute of Certified Public Accountants.

36/ Securities and Exchange Commission v. Frank, supra, 388 F.2d at 489. Cf. United States v. Sarantos, supra, 455 F.2d 877.

37/ Securities and Exchange Commission v. Frank, supra.

38/ United States v. Sarantos, supra, 455 F.2d 877.

in the course of the representation," perpetrated a crime or fraud upon a person or tribunal if his client refuses to rectify the situation. 39/ This so-called crime-fraud exception to the attorney-client privilege is one which has long been recognized. What is a professional's obligation to insist that statements with which he is associated be corrected when he learns they are untrue even though he may have believed them to be correct at the time they were either filed with the Commission or issued to the public? In this regard, the professional's duty, at least initially, is not very different from his client's. Thus, courts have recognized that when there exists reason to believe that people are continuing to rely on a representation which is not true, the individual responsible for the representation must see that it is corrected. 40/ Certainly, no one would suggest that securities should continue to be sold or traded on the basis of a registration statement discovered to be false and no longer accurate merely because it was declared effective by the Commission before its falsity was discovered. The issuer's responsibility, having learned of the falsity, is clear. 41/ The professional's responsibility is equally clear. 42/ Indeed, if the

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39/ ABA, Code of Prof. Res. DR4-101(c)(3) and DR7-102(B).

40/ Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A. 2, 1972).

41/ Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra.

42/ Ibid. See also Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y., 1967).

client refuses to take steps to correct a material falsity consistent with the advice of his lawyer or accountant, I believe they must cease representing the client. Another question is, having withdrawn or ceased representing the client, may the lawyer or accountant stop at that point or must he go further. Under some circumstances, they are required to do more. Certainly, where a crime or fraud is involved, that is what the rules of the American Institute of Certified Public Accountants and the American Bar Association's Code of Professional Responsibilities require. This is not to suggest that such action is required in every case or indeed in most. Rather, what is required is an evaluation of all of the facts and circumstances, including the materiality of the false statement and the extent to which the public and the Commission may be relying upon the professional in determining whether his client has acted properly or within the bounds of the law. The fact that the lawyer or accountant may have publicly associated himself with the client or represented that he, the lawyer, or accountant, will perform certain acts in connection with consummation of a particular transaction, is relevant to an evaluation of his responsibilites. The fact that they have publicly held themselves out as being involved in a transaction or situation or otherwise become participants often requires them I believe, to take more steps to correct any misrepresentations. Such a

situation is obviously quite different from that where public reliance is not involved. This was implicitly recognized recently by the Court of Appeals for the Ninth Circuit when it held that an accountant had no duty to disclose irregularities in his client's affairs when the accountant was in no way professionally associated with the prospectus in issue.43 /

This raises the problem of when is a professional publicly "associated" with his client.

The accountant is obviously "associated" with financial statements which he certifies. A lawyer, I believe is similarly associated when he is named as having expressed certain types of opinions.

The American Institute of Certified Public Accountants has taken the position that a certified public accountant:

> "is associated with unaudited financial statements when he has consented to the use of his name in a report, document or written communication setting forth or containing the statements. Further, when ... [he] submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements." (emphasis added)44 /

43/ Wessel v. Buhler, 437 F.2d 279 (C.A. 9, 1971).

44/ Statement of Auditing Procedures No. 38, ¶3. Committee on Auditing Procedures of the American Institute of Certified Public Accountants (1967).

While the AICPA has set forth standards concerning the methods to be employed by the accountant in making clear that he has not audited and is not in any way certifying to the unaudited financial statements, it has nevertheless been recognized that a certified public accountant may not even be associated with unaudited financial statements which he knows are not in conformity with generally accepted accounting principles unless his reservations concerning the unaudited statements are clearly set forth. His report is required to refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements. 45/

It has been also recognized that if the client:

> "will not agree to the appropriate reservations or will not accept the accountant's ... [report] with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement. Further, a certified public accountant should refuse to provide typing or reproduction services or to be, associated in any way with the unaudited financial statements which, on the basis of the facts known to him, he concludes are false or intended to mislead." 46/

While the bar associations have not been quite as explicit, it seems clear that the lawyer too may not permit himself to be "associated"

45/ *Id.* at para 6.

46/ *Id.* at para 7.

with or circulate statements of his client which he knows or has reason to believe are materially false. Both the accountant and the lawyer will naturally be held liable if they issue unwarranted opinions. What of situations, however, where they have not expressed opinions but are otherwise publicly "associated" with the client or some of the client's representations. Quite obviously, they are not responsible for every statement which appears in the report or prospectus. They are, however, liable for material statements they know or have reason to believe are false. Further, in many situations, where they issue opinions, their exposure may be fairly broad. For example, frequently counsel for the issuer, pursuant to the underwriting agreement, which is a public document filed as an exhibit to the registration statement, is required to render an opinion that they have no reason to believe that the registration statement and prospectus contain any untrue statements of material fact or omit to state any material fact. Apart from the financial statements, as to which the accountants are to require to opine, one must ask whether there are many statements of material fact contained in the registration statement and prospectus for which counsel rendering that kind of opinion does not have some responsibility.

At this point I would like to describe for you some of the Commission's more recent experiences with professionals which I hope will help illustrate the problems. Part of our concern stems from the

fact, as indicated above, that the federal securities laws cannot function effectively without continued reliance upon the professional integrity of those attorneys and accountants who practice before the Commission. As a result of that concern, the Commission adopted as one of its Rules of Practice, Rule 2(e). This rule authorizes the Commission generally to deny, temporarily or permanently, to any professional, including attorneys and accountants, the privilege of appearing or practicing before it "in any way." This may occur if an individual has been found not to possess the requisite qualifications to represent others; found to be lacking in character or integrity; found to have engaged in unethical or improper professional conduct; or, found to have willfully violated or willfully aided or abetted a violation of the federal securities law. In addition, the rule provides for the automatic disqualification of professionals whose license to practice has been revoked or suspended in any state, territory or district or if the professional has been convicted of a felony or misdemeanor involving moral turpitude. Further, the rule provides for the prompt, temporary suspension of any professional from appearing or practicing before the Commission once that professional has been by name:

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

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

The effect of being suspended from practice before the Commission means that the professional may not transact any business with the Commission and may not prepare any statement, opinion, or other paper as an attorney or accountant which is filed with the Commission. Further, the Commission has taken the position that, with respect to a lawyer, practicing and appearing before the Commission includes representing or advising any entity or person in connection with the preparation or filing of any document which may be required to be filed with the Commission under the federal securities laws.47/ This is obviously a very broad prohibition. Needless to say, it is entirely possible for an entire firm of accountants or lawyers to be suspended from practice before the Commission.

We have attempted to tailor sanctions in 2(e) proceedings to fit particular situations with emphasis on corrective action. For example, we are considering prohibiting firms from taking on any new SEC business for some period of time while corrective measures are instituted.

47/ Securities and Exchange Commission v. Ezrine, CCH Fed. Sec. L. Rep. ¶93,594 (August 2, 1972).

We are also considering the possibility of requiring outside professional surveillance of the auditing procedures and standards of an entire accounting firm. For example, a third party such as the AICPA could review the practice of disciplined accounting firms for some period of time and render a written report to the Commission for its evaluation. In this connection, in areas short of an injunctive action or a 2(e) proceeding we are considering making referrals to the Institute's Ethics Division of substandard work by accountants encountered by the Commission's staff. This is similar to the practice we have long followed in cooperating with and referring certain matters to State Bar and licensing authorities when we have encountered problems with lawyers or accountants. Such referrals have not, however, been a satisfactory substitute for initial action by the Commission against those involved.

The Commission has not hesitated in the past to insist that professionals fulfill their responsibilities or otherwise comply with the securities laws. But somehow the message seems to have been lost on some people.

The Commission's experience with some professionals has, on occasion, required us to take drastic steps, including the obtaining of unusual forms of injunctive relief. In one case, a court required the defendant, who was an accountant, to serve copies of the Court's opinion, findings and judgment, upon all existing and prospective clients for the next three years, and, within three days thereafter, file an affidavit with the Court and the Commission certifying in effect that he had compiled with the order. 48/ In another case, a court required a lawyer to forward to the Commission copies of all opinion letters he issued on securities transactions and required him to report all his securities transactions to the Commission. 49/ In still another case it was necessary for the Commission to obtain an injunction preventing an attorney from appearing or practicing before it, after he had already been suspended pursuant to Rule 2(e). 50/ In the latter connection, the Court directed that this attorney "advise all persons who hereafter seek to or in fact do retain the defendant's legal services in connection with matters arising under the federal securities laws, that the defendant cannot and will not practice before the Commission...." 51/

48/ Securities and Exchange Commission v. Raffer, S.D.N.Y., 70 Civ. 547 (SEC Litigation Release No. 4581, April 3, 1970).

49/ Securities and Exchange Commission v. Fields, S.D.N.Y., 71 Civ. 5416 (SEC Litigation Release No. 5332, Feb. 25, 1972).

50/ Securities and Exchange Commission v. Ezrine, S.D.N.Y., 72 Civ. 3161, BNA Sec. Reg. and L. Rep. No. 164, A-12 (Aug. 9, 1972).

51/ Ibid.

While some of these cases reflected situations where some of the professionals have had a financial stake in the enterprise, that has not always been so. Indeed in a number of cases the professionals involved have had no financial stake other than their fees; nevertheless, courts have found them liable, both civilly and criminally. The best illustration of this is the Simon case which I discussed earlier. 52 / Simon involved the conviction of auditors who certified financial statements which were found not to present fairly the company's financial condition. Similarly, in the litigation that followed the collapse of Yale Express System, Inc., the Court emphasized that a person may be held liable for misrepresentations, "regardless of his interest in the transaction." 53 / A similar rule can also be found in situations involving certain kinds of "non-disclosure." This is not a result that has just recently developed under the federal securities laws, rather it is a recognition of traditional principles of common law. As the Court in Fischer v. Kletz stated;

> "The common law has long required that a person that has made a representation must correct that representation if it becomes

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52 / United States v. Simon, supra, 425 F.2d 796.

53 / Fischer v. Kletz, 266 F. Supp. 180, 187 (S.D.N.Y., 1967).

> false and if he knows people are relying on it. This duty to disclose is imposed regardless of the interest of defendant in the representation and subsequent nondisclosure." 54/

Indeed, as was observed almost 30 years ago:

> "[D]erelictions by accountants are for the most part not a result of greed to share in the loot produced by fraud. On the contrary, accountants, have been led astray by their desire to help their clients out of a particular embarrassment by stretching a point of auditing or accounting principle. Unless the affairs of the client improve, the accountants subsequently find themselves committed to the same intentional errors but to a greater degree, until a day of reckoning, when third parties, usually creditors, stockholders, or the government, delve into the affairs of the client and discover the fraud ... almost invariably the facts show that except for the retention of a particular client of doubtful value accountants have not profited by the scheme...." 55/

The same could also be said for many situations involving attorneys.

In concluding my remarks and to highlight the importance of the professional's responsibilities under the federal securities laws, all professionals should be mindful of Judge Friendly's famous statement in the Benjamin decision: "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." 56/

54/ Id. at 188.

55/ Kostelanetz, "Accountants Responsibilities and the Criminal Law," The New York Certified Public Accountant (July 1943), p. 401, quoted approvingly by the Commission in Touche, Niven.

56/ United States v. Benjamin, 329 F.2d 854, 863 (C.A. 2) certiorari denied, 377 U.S. 953 (1964).