

SEC Enforcement of Auditor Independence Violations: Recent Cases and Developments

By Russell G. Ryan*

In recent years, the SEC has filed a number of disciplinary and enforcement proceedings against major accounting firms for auditor independence violations. These cases demonstrate several alternative theories the Commission has developed to address such violations. The Sarbanes-Oxley Act of 2002 could also affect the nature and form of future cases in this important area.

Among many other current issues on the ambitious agenda of the Securities and Exchange Commission (the “SEC” or “Commission”), auditor independence has been a high priority. In November 2000 and again in January 2003, the Commission promulgated substantial changes to its rules and regulations setting forth the independence requirements for auditors of public companies.¹ Auditor independence has also been an area of significant interest to the SEC’s Division of Enforcement, as reflected by several high-profile disciplinary and enforcement cases against major accounting firms.² This article will discuss the SEC’s recent auditor independence cases in the context of providing an overview of several alternative ways in which the Commission has charged and remedied such violations. It will also highlight some of the provisions of the Sarbanes-Oxley Act of 2002 that are most likely to affect auditor independence enforcement, and conclude with a look at what recent cases and legislation portend for the future.

Rule 102(e) and Its Limitations

The SEC has brought most of its recent auditor independence cases as administrative proceedings, typically under Rule 102(e) of its Rules of Prac-

*Russell G. Ryan is a partner in the Washington, D.C. office of King & Spalding LLP. Before joining King & Spalding in January 2004, he served as Assistant Director in the SEC’s Division of Enforcement, where he participated in several of the investigations and cases discussed in this article. He is also an Adjunct Professor at George Mason University School of Law, where he teaches a course on securities enforcement issues.

tice.³ Rule 102(e), the relevant substance of which was codified by Sarbanes-Oxley as a new Section 4C of the Securities Exchange Act of 1934 (the “Exchange Act”),⁴ allows the Commission to censure accountants (and other professionals), and to suspend or bar them from the privilege of appearing or practicing before the Commission, if it finds that they engaged in “improper professional conduct.”⁵ For accountants, Rule 102(e) explicitly defines “improper professional conduct” to include – along with intentional, knowing, or reckless conduct – certain forms of negligent conduct. Specifically, the SEC can discipline accountants for either (i) a single act of “highly unreasonable conduct” in circumstances warranting “heightened scrutiny” or (ii) repeated instances of unreasonable conduct indicating a lack of competence.⁶ With regard to the first of these negligence standards, the Commission has made clear its view that questions regarding an auditor’s independence always warrant “heightened scrutiny.”⁷

In the context of Rule 102(e), the SEC deems it improper professional conduct for an accountant to conduct an audit, and issue an ostensibly independent audit report, if the accountant lacks independence from the client. Such conduct is deemed to violate the SEC’s requirements for the preparation of financial statements, which are set forth in Rules 2-01 and 2-02 of the Commission’s Regulation S-X⁸ and in Section 602 of the Commission’s Codification of Financial Reporting Policies.⁹ The Commission typically also cites to generally accepted auditing standards (“GAAS”), which include the following admonition regarding independence:

It is of utmost importance to the profession that the general public maintains confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence.... Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.¹⁰

In recent years, the SEC has filed an unprecedented number of Rule 102(e) proceedings charging auditor independence violations against major accounting firms. In January 1999, for example, the SEC settled a landmark case against PricewaterhouseCoopers LLP with a Rule 102(e) order. In its order, the Commission found that numerous partners and other profession-

als at the firm, and even one of the firm's retirement plans, had held investments in the securities of firm audit clients.¹¹

In 2002, the SEC announced several more Rule 102(e) settlements alleging independence violations against "big four" firms and their affiliates. In January 2002, the Commission settled an independence case with a Rule 102(e) order against KPMG LLP, finding that KPMG audited the financial statements of a mutual fund in which it contemporaneously held an investment.¹² Then, in June 2002, the Commission settled a case with a Rule 102(e) order against Moret Ernst & Young Accountants, the Dutch affiliate of Ernst & Young International, finding that the firm audited the financial statements of an audit client while it was simultaneously involved in numerous joint business relationships with the client that impaired the firm's independence.¹³ Finally, in July 2002, the Commission brought a second, settled Rule 102(e) proceeding against PricewaterhouseCoopers, this time charging the firm with having improper contingent fee arrangements with several audit clients, and with auditing accounts of other clients that included consulting fees those clients had paid to the firm for non-audit services.¹⁴

In each of these settlements, the SEC censured the audit firm for engaging in "improper professional conduct" within the meaning of Rule 102(e).¹⁵ At the same time, following a precedent established in a 1996 settlement with a smaller firm called Hein+Associates LLP,¹⁶ the Commission also ordered each firm to comply with a number of remedial undertakings specifically designed to prevent similar misconduct in the future.

Also in 2002, the SEC's Division of Enforcement and Office of the Chief Accountant brought a contested administrative proceeding against Ernst & Young LLP that was based, in part, on Rule 102(e) and new Exchange Act Section 4C.¹⁷ In that proceeding, which featured an 11-day hearing on the merits, Ernst & Young was charged with violating independence requirements by engaging in a series of business and marketing relationships with its audit client PeopleSoft Inc. from 1994 through 1999. On April 16, 2004, while this article was in production, the Commission's chief administrative law judge issued a significant decision against Ernst & Young in which she, among other things, suspended Ernst & Young pursuant to Rule 102(e) from accepting audit engagements from new SEC registrant audit clients for a period of six months.¹⁸

Rule 102(e) has inherent limitations, however, that could cause the Commission to rely on other types of proceedings in the future. These limitations relate to the relatively narrow range of remedies available in Rule 102(e) proceedings. Independence cases – in contrast with cases involving audit

failures or even auditor complicity in a client's wrongdoing – frequently involve firm-wide inadequacies of policies and procedures, collective conduct by individuals in more than one part of the firm (such as auditors, consultants, and even the firm's national office), or other factors suggesting that the firm itself, more than any one or more particular individuals, may be culpable.¹⁹ Where the respondent is the firm itself, however, the most severe sanctions explicitly authorized by Rule 102(e) – a bar or suspension from appearing or practicing before the Commission – are usually not practical or appropriate, because such remedies can effectively prevent the firm from auditing public companies, resulting in potentially devastating consequences to the firm, its publicly-traded audit clients, and the market generally.²⁰

Where a bar or suspension against the firm is impractical, the SEC's only remaining option under Rule 102(e) is a censure. Until recently, even a censure under Rule 102(e), regardless of the type of underlying conduct, was widely considered a severe sanction against an audit firm, particularly a firm with a large number of public company audit clients.²¹ In the post-Enron era, however, with the Commission having issued Rule 102(e) orders against several of the biggest audit firms and sued two of them in federal court for fraud,²² and with Arthur Andersen having been put out of business after a criminal conviction,²³ the SEC and its staff no longer appear to consider a Rule 102(e) censure to be a harsh enough sanction.

The narrow range of express remedies in Rule 102(e) reveals a related limitation on the utility of Rule 102(e) in auditor independence cases: the rule does not expressly provide for any financial remedies against a respondent. Thus, unless an accountant or firm agrees to a pay money as part of a settlement, the SEC cannot order such relief under Rule 102(e) even for willful violations of auditor independence requirements. The Commission overcame this limitation in its recent settlements with PricewaterhouseCoopers and Moret Ernst & Young Accountants, because in each case the settling firm agreed to pay a substantial sum of money pursuant to undertakings that were reflected in the respective Rule 102(e) orders. In PricewaterhouseCoopers' 1999 settlement with the Commission, the firm undertook to establish a \$2.5 million fund for programs to further awareness and education relating to auditor independence requirements,²⁴ while in its 2002 settlement the firm undertook to pay \$2.75 million directly to the United States Treasury.²⁵ Moret Ernst & Young Accountants, in its June 2002 settlement with the Commission, undertook to pay a \$400,000 civil penalty.²⁶ Nit-pickers and purists might question the appropriateness of the SEC obtaining in settlement a remedy it cannot lawfully order in a contested administrative

proceeding, but the Commission itself has not publicly expressed any misgivings.

The Cease-and-Desist Alternative

In addition to disciplining auditors for independence violations in Rule 102(e) proceedings, and often in conjunction with such proceedings, the SEC has charged independence violations in administrative cease-and-desist proceedings. Under its statutory cease-and-desist authority, the Commission can order any person who violates the securities laws, or any other person who is a “cause” of a violation, to cease and desist from doing so.²⁷ For the Commission, the cease-and-desist alternative offers at least two distinct advantages over proceeding solely under Rule 102(e). First, a cease-and-desist order can be predicated on a finding of simple negligence,²⁸ in contrast with the heightened level of negligence required to discipline an accountant under Rule 102(e).²⁹ Second, in cease-and-desist proceedings, the Commission is expressly empowered to require a respondent to account for and disgorge unlawful gains.³⁰

In several auditor independence cases, the Commission has used its cease-and-desist authority to find auditors liable as direct violators of the securities laws and as “causes” of securities law violations by their audit clients.³¹ Most commonly, the Commission has found a direct violation by the auditor of Rule 2-02 of Regulation S-X.³² Regulation S-X generally governs the form and content of financial statements that are filed with the Commission, and Rule 2-02(b)(1) specifically requires an auditor’s report to state whether the audit was conducted in accordance with GAAS. The Commission takes the position that a false certification of GAAS compliance violates this requirement.³³ In the Commission’s view, when an auditor is not independent, the audit is not in compliance with GAAS, and a certification of such compliance therefore violates Rule 2-02.³⁴

In cease-and-desist proceedings involving auditor independence, a non-independent auditor is typically found also to be a “cause” of the audit client’s violation of applicable filing and reporting obligations under the federal securities laws.³⁵ Such obligations generally require the client to file financial statements that have been audited by an independent auditor,³⁶ and thus are not satisfied where the auditor lacks independence from the client. Whether or not the Commission also takes enforcement action or other remedial measures against the audit client,³⁷ the auditor may be held responsible as a cause of its client’s violation.

The Commission's litigated case against KPMG Peat Marwick is illustrative. In December 1997, the Commission instituted contested proceedings in which its Division of Enforcement and Office of Chief Accountant accused KPMG of lacking independence from an audit client, Porta Systems, Inc., due to certain financial and business relationships beyond the auditor-client relationship.³⁸ The Division of Enforcement and Office of Chief Accountant sought remedies under both Rule 102(e) and the cease-and-desist provisions of the Exchange Act.³⁹ After a hearing on the merits, an administrative law judge ("ALJ") found that KPMG was not independent from Porta Systems, and thus that the firm violated Rule 2-02 of Regulation S-X and caused Porta Systems to violate its reporting obligations under Exchange Act Section 13(a) and Rule 13a-1.⁴⁰ The ALJ nevertheless concluded that KPMG did not act with the state of mind required for a finding of "improper professional conduct" under Rule 102(e) as written at the time of the conduct in question, and that the isolated nature of the violations and absence of an audit failure rendered a cease-and-desist order inappropriate as well.⁴¹

On appeal from the ALJ's decision, the Commission agreed with the ALJ's conclusions that KPMG lacked independence and that the firm therefore violated Rule 2-02 of Regulation S-X and caused Porta Systems to violate Exchange Act Section 13(a) and Rule 13a-1.⁴² The Commission also affirmed the ALJ's determination that KPMG's state of mind was not reckless or intentional, and thus did not constitute "improper professional conduct" under the prior version of Rule 102(e) that had been applied by the ALJ in the case.⁴³ However, the Commission disagreed with the ALJ's decision not to impose a cease-and-desist order, holding that negligence was a sufficient predicate for such an order and finding sufficient risk of future violations to warrant such relief.⁴⁴ After the Commission denied KPMG's request for rehearing, the U.S. Court of Appeals for the D.C. Circuit denied KPMG's petition for review of the Commission's decision.⁴⁵

In the case against KPMG, the remedy of disgorgement was neither sought nor ordered. However, the SEC has ordered such relief in several other recent auditor independence proceedings brought under its cease-and-desist authority. In these cases, which typically involved audit failures beyond the lack of independence, the auditor's unlawful gains were roughly quantified as the audit fees received for the tainted audit.⁴⁶ In a recent contested proceeding against Ernst & Young LLP involving only independence violations, the SEC's chief administrative law judge similarly ordered the firm, among other things, to disgorge nearly \$1.7 million in audit fees (plus

interest), as well as to retain an independent consultant to ensure future compliance with independence requirements.⁴⁷

The SEC justifies such disgorgement of audit fees on the theory that it deprives the auditor of revenue received from an engagement that was improperly accepted, but that rationale raises difficult issues in many circumstances. For example, where an independence violation does not occur in the context of a failed audit, or does not require the issuer's financial statements to be re-audited, disgorgement of audit fees may be inappropriate because the audit firm provided the issuer and its shareholders with the service for which they bargained. Similarly, even where the independence impairment forces an issuer to have its financial statements re-audited, reputable audit firms will often pay for the re-audit, which could make any subsequent disgorgement order appear redundant and punitive.⁴⁸

Independence Cases in Federal Court

Although most of the SEC's recent auditor independence cases have been brought as administrative proceedings, that was not always the case. During the 1980s and 1990s, the Commission brought at least a half-dozen independence cases in federal court – many of which involved auditor misconduct going well beyond a lack of independence, and all of which were ultimately settled as to the auditors.⁴⁹ In federal court, the Commission can obtain injunctions, disgorgement, civil penalties, and other relief.⁵⁰ Where the case involves an auditor independence violation, at least three alternative theories might be pled against the auditor.

First, as discussed above in connection with cease-and-desist proceedings, the SEC has taken the position that an auditor who lacks independence directly violates Rule 2-02 of SEC Regulation S-X. Although the Commission has approved and sustained this direct liability theory in administrative proceedings,⁵¹ the theory has not yet been squarely tested in court, where accounting firms may find a more receptive audience.⁵²

In addition to being charged with a direct violation of Regulation S-X, a non-independent auditor might be charged in federal court with aiding and abetting its audit client's failure to file financial statements with the SEC that are certified by an independent auditor. The theory would be similar to the above-discussed "causing" theory that the SEC has used in cease-and-desist proceedings, but would require proof of at least recklessness,⁵³ whereas negligence has been held sufficient for a cease-and-desist order.⁵⁴ The SEC relied on such an aiding and abetting theory in a complaint against Ernst & Young in 1991, the only time the Commission has sued a major ac-

counting firm in federal court solely for independence violations.⁵⁵ In that case, the Commission charged Ernst & Young, as successor to Arthur Young & Co., with failing to maintain independence from two different audit clients and thereby causing and aiding and abetting the clients' failures to include independently audited financial statements in various public filings. The case was settled in 1995 with Ernst & Young agreeing to a final order requiring it to comply with an undertaking to abide by the Commission's auditor independence requirements.⁵⁶

A third possible charge the SEC might assert in court against a non-independent auditor would be a direct violation of the antifraud provisions of the federal securities laws. Under such a theory, the Commission presumably would have to allege and prove, among other things, that there was a material impairment of the auditor's independence and that the auditor acted with scienter. Although the Commission has not brought many such fraud cases recently, and has never charged a major firm with fraud based solely on an independence violation, the theory has been successful in a number of settled cases involving individual accountants.⁵⁷

One illustrative case arose from the SEC's investigation of financial fraud and other wrongdoing at E.S.M. Group, Inc. in the late 1970s and early 1980s. In addition to suing the company, its broker-dealer subsidiaries, and several affiliated individuals,⁵⁸ the Commission filed a separate complaint charging E.S.M.'s auditor, Jose L. Gomez, a partner of Alexander Grant & Company, with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5.⁵⁹ The primary basis for the fraud charges was Gomez's lack of independence from E.S.M., which was caused by his receipt of payments from several E.S.M. principals, and his knowledge that his firm's audit opinions were therefore false in stating that the audits were conducted in accordance with GAAS. In settling the matter, Gomez agreed not only to an injunction against future fraud violations, but also to an injunction against providing audit services to public companies and securities firms.⁶⁰ Gomez further agreed to accept a follow-on Rule 102(e) order barring him from appearing or practicing before the Commission as an accountant.⁶¹ In a related criminal proceeding, Gomez pled guilty to conspiracy and mail fraud and was sentenced to 12 years in prison.⁶²

Another relevant case arose a decade later from the SEC's financial fraud investigation of PNF Industries, Inc. In 1994, the Commission sued PNF and several of its officers and affiliates for a wide range of securities violations.⁶³ In the same case, the Commission also charged PNF's auditor, Louis

Fox, with fraud in violation of Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. The essence of the fraud charges against Fox was that he and his firm, Goldstein & Halper, lacked independence as PNF's auditor because Fox had agreed to accept 1,000 shares of PNF convertible preferred stock. The Commission alleged that Fox committed fraud by failing to cause his firm to disclose this independence impairment in its audit report, which PNF had included in its annual report on Form 10-K for its 1991 fiscal year. In settling the case, Fox agreed to a fraud injunction and a \$25,000 civil penalty.

Impact of Sarbanes-Oxley Act on Auditor Independence Enforcement

Several provisions of the Sarbanes-Oxley Act of 2002 are likely to affect future enforcement of auditor independence. As previously noted, Sarbanes-Oxley codified the relevant substance of Rule 102(e) as a new Section 4C of the Exchange Act.⁶⁴ More prominently, Sarbanes-Oxley established a five-member Public Company Accounting Oversight Board (PCAOB) with authority – subject to SEC oversight and review – to set standards for public company audits, including auditor independence standards, and to investigate and discipline audit firms and their “associated persons” for violations of applicable standards, rules, and provisions of the federal securities laws.⁶⁵

Although Sarbanes-Oxley explicitly preserves the SEC's own jurisdiction to set auditor independence standards and to enforce and remedy independence violations,⁶⁶ it provides the PCAOB with powerful enforcement weapons that go beyond the administrative remedies available to the SEC. For example, subject to SEC review, the PCAOB can effectively suspend or bar an audit firm or its associated persons from auditing public companies not only if it finds that the firm or associated person has violated the securities laws or applicable independence standards, but even if the firm or associated person fails to cooperate with a PCAOB investigation.⁶⁷ In addition, the PCAOB was given explicit statutory authority to impose substantial civil money penalties against audit firms and associated persons – ranging as high as \$15 million per violation – for violations of auditing standards including independence requirements.⁶⁸

Beyond codifying Rule 102(e), creating the PCAOB, and providing the PCAOB with broad authority to establish and enforce auditing standards, Sarbanes-Oxley also addressed auditor independence on a substantive level. Title II of the Act amended Exchange Act Section 10A to prohibit audit firms from performing a number of non-audit services for audit clients, including bookkeeping and related services; financial information systems design and implementation; appraisal or valuation services; fairness opinions;

actuarial services; internal audit outsourcing services; management functions or human resources; brokerage or investment services; legal and expert services unrelated to the audit; and any other services the PCAOB determines, by regulation, to be impermissible.⁶⁹ For most other non-audit services, the Act requires prior approval by the client's audit committee and public disclosure of that approval.⁷⁰

Sarbanes-Oxley also requires firms to rotate the partners assigned to particular audit engagements at least once every five years,⁷¹ and prohibits firms from auditing any public company whose chief executive, or any top accounting executive, previously worked for the audit firm and participated in any audit of the company within a year prior to the start of the audit.⁷² In January 2003, the SEC adopted final rules to implement the auditor independence provisions of Sarbanes-Oxley.⁷³ These rules became effective on May 6, 2003.

Conclusion

It is likely to take some time to evaluate the full impact of Sarbanes-Oxley on the future of auditor independence enforcement. In the meantime, in both its rulemaking and enforcement initiatives, the SEC has made clear its intent to continue playing a leading role in this area. Since 1999, the Commission has brought an unprecedented number of auditor independence cases against major accounting firms, which, along with earlier precedents, reveal certain unmistakable trends. For example, when filed as settled cases, the most common resolution of these cases has been a Rule 102(e) order censuring the firm and requiring it to comply with remedial undertakings, which often include some form of financial payment. However, as suggested by recently litigated independence cases, absent a settlement the SEC typically will institute proceedings under both Rule 102(e) and the Commission's cease-and-desist authority. By doing so, the Commission gives its ALJs the flexibility to consider a wider range of potential remedies – including disgorgement of audit fees – and to order relief even upon a finding of simple negligence. Finally, although it has not often done so in recent years, the Commission could pursue egregious independence violations in federal court, where it can seek injunctions, disgorgement, civil penalties, and ancillary relief.

NOTES:

¹. Final Rule: *Revision of the Commission's Auditor Independence Requirements*, SEC Rel. Nos. 33-7919, 34-43602, 35-27279, IC-24744, IA-1911, FR-56 (Nov. 21, 2000); Final Rule:

Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Rel. Nos. 33-8183, 34-47265, 35-27642, IC-25915, and IA-2103 (Jan. 28, 2003).

² See, e.g., *KPMG Peat Marwick L.L.P.*, Admin. Proc. File No. 3-9500, 1997 SEC LEXIS 2529 (Dec. 4, 1997) (order instituting contested proceeding); *PricewaterhouseCoopers, LLP*, SEC Rel. Nos. 34-40945, AAER-1098 (Jan. 14, 1999) (settled administrative proceeding); *KPMG LLP*, Admin. Proc. File No. 3-10676, Rel. Nos. 34-45272, IC-25360, and AAER-1491 (Jan. 14, 2002) (settled administrative proceeding); *Moret Ernst & Young Accountants*, Admin. Proc. File No. 3-10815, SEC Rel. Nos. 34-46130, AAER-1584 (June 27, 2002) (settled administrative proceeding); *PricewaterhouseCoopers LLP*, et al., Admin. Proc. File No. 3-10835, SEC Rel. Nos. 34-46216 and AAER-1596 (July 17, 2002) (settled administrative proceeding); *Ernst & Young LLP*, Admin. Proc. File No. 3-10933, SEC Rel. Nos. 33-8146, 34-46821, and AAER-1661, 2002 SEC LEXIS 2872 (Nov. 13, 2002) (order instituting contested proceeding).

³ 17 C.F.R. § 201.102(e).

⁴ 15 U.S.C. § 78d-3.

⁵ 17 C.F.R. § 201.102(e)(ii).

⁶ 17 C.F.R. § 201.102(e)(iv)(A). The Commission added these negligence provisions to Rule 102(e) in October 1998, and expressly stated that it would apply them retroactively if appropriate. See Final Rule: *Amendment to Rule 102(e) of the Commission's Rules of Practice*, SEC Rel. Nos. 33-7593, 34-40567, 35-26929, 39-2369; IA-1771, and IC-23489 (Oct. 19, 1998). It applied the standards retroactively in *Swart, Baumruk & Co., LLP*, Admin. Proc. File No. 3-10410, SEC Rel. Nos. 34-43883 and AAER-1361 (Jan. 25, 2001).

⁷ See Final Rule: *Amendment to Rule 102(e) of the Commission's Rules of Practice*, SEC Rel. Nos. 33-7593, 34-40567, 35-26929, 39-2369; IA-1771, and IC-23489 (Oct. 19, 1998) (quoted in *Swart, Baumruk & Co., LLP*, Admin. Proc. File No. 3-10410, SEC Rel. Nos. 34-43883 and AAER-1361 (Jan. 25, 2001)).

⁸ 17 C.F.R. §§ 210.2-01 and 210.2-02.

⁹ Codification of Financial Reporting Policies, § 602, *reprinted in* Vol. 3 Fed. Sec. L. Rep (CCH) ¶ 38,335.

¹⁰ Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 1, AU § 220.03.

¹¹ *PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-9809, SEC Rel. Nos. 34-40945 and AAER-1098 (Jan. 14, 1999).

¹² *KPMG LLP*, Admin. Proc. File No. 3-10676, Rel. Nos. 34-45272, IC-25360, and AAER-1491 (Jan. 14, 2002).

¹³ *Moret Ernst & Young Accountants*, Admin. Proc. File No. 3-10815, SEC Rel. Nos. 34-46130 and AAER-1584 (June 27, 2002).

¹⁴ *PricewaterhouseCoopers LLP*, et al., Admin. Proc. File No. 3-10835, SEC Rel. Nos. 34-46216 and AAER-1596 (July 17, 2002). This most recent case against PricewaterhouseCoopers was also brought as a cease-and-desist proceeding under Section 21C of the Securities Exchange Act of 1934, which is discussed later in this article.

¹⁵ In another recent case that was litigated before an administrative law judge, the ALJ suspended an audit firm (and its principal) from appearing or practicing before the Commission for a period of 1 year. *Horton & Co., et al.*, Admin. Proc. File No. 10355, Initial Dec. Rel. No. 208 (July 2, 2002).

¹⁶ *Hein + Associates LLP, et al.*, Admin. Proc. File No. 3-9035, SEC Rel. Nos. 34-37396 and AAER-798 (July 2, 1996).

¹⁷. *Ernst & Young LLP*, Admin. Proc. File No. 3-10933, SEC Rel. Nos. 33-8146, 34-46821, and AAER-1661, 2002 SEC LEXIS 2872 (Nov. 13, 2002).

¹⁸. *Ernst & Young LLP*, Admin. Proc. File No. 3-10933, SEC Initial Decision Release No. 249 (Apr. 16, 2004). The decision also imposed other relief noted elsewhere in this article.

¹⁹. Outside of the auditor independence context, although the SEC has brought numerous enforcement proceedings against *individual* auditors, it has brought relatively few against major audit firms. This historical disparity is likely to change, however. In a widely reported speech last December, the SEC's Director of Enforcement announced that it was "time to adopt a new enforcement model – a new paradigm: one that holds an accounting firm responsible for the actions of its partners; one that *reverses* the current presumption *against* suing firms for an audit failure...." Stephen M. Cutler, Remarks Before the American Institute of Certified Public Accountants (Dec. 12, 2002), available at <http://www.sec.gov/news/speech/spch121202smc.htm>.

²⁰. See generally *Report of the Task Force On Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants*, 52 Bus. Law. 965, 969-71 (May 1997).

²¹. See generally *Report of the Task Force On Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants*, 52 Bus. Law. 965, 969-71 (May 1997).

²². In June 2001, the Commission issued a settled Rule 102(e) order against Arthur Andersen LLP and simultaneously filed a settled civil lawsuit in federal court charging the firm with fraud in connection with its failed audits of Waste Management, Inc. See *Arthur Andersen LLP*, Admin Proc. File No. 3-10513, SEC Rel. Nos. 34-44444 and AAER-1405 (June 19, 2001); *SEC v. Arthur Andersen LLP*, et al., Civil Action No. 1:01CV01348 (D.D.C. filed June 19, 2001), SEC Lit. Rel. No. 17039 and AAER No. 1410 (June 19, 2001). In January 2003, the Commission filed a contested civil action in federal court charging KPMG LLP and four of its partners with fraud in connection with that firm's audits of Xerox Corporation. See *SEC v. KPMG LLP*, No. 03CV0671 (S.D.N.Y.), SEC Lit. Rel. No. 17954 and AAER No. 1709 (Jan. 29, 2003).

²³. On June 15, 2002, Arthur Andersen was criminally convicted of obstruction of justice in connection with the SEC's investigation into accounting irregularities at Enron Corp. *U.S. v. Arthur Andersen, LLP*, No. CR-H-02-121 (S.D. Tex.).

²⁴. *PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-9809, SEC Rel. Nos. 34-40945 and AAER-1098 (Jan. 14, 1999);

²⁵. *PricewaterhouseCoopers LLP*, et al., Admin. Proc. File No. 3-10835, SEC Rel. Nos. 34-46216 and AAER-1596 (July 17, 2002).

²⁶. *Moret Ernst & Young Accountants*, Admin. Proc. File No. 3-10815, SEC Rel. Nos. 34-46130 and AAER-1584 (June 27, 2002).

²⁷. See, e.g., Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1; Securities Exchange Act of 1934 § 21C, 15 U.S.C. § 78u-3; Investment Company Act of 1940 § 9(f), 15 U.S.C. § 80a-9(f); Investment Advisers Act of 1940 § 203(k), 15 U.S.C. § 80b-3(k).

²⁸. The plain language of the cease-and-desist provisions (i.e., "knew or should have known") invokes a classic negligence standard, at least in cases where the respondent is charged with "causing" another person's violation. E.g., Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1; Securities Exchange Act of 1934 § 21C, 15 U.S.C. § 78u-3; Investment Company Act of 1940 § 9(f), 15 U.S.C. § 80a-9(f); Investment Advisers Act of 1940 § 203(k), 15 U.S.C. § 80b-3(k); see also *KPMG, LLP v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002) (language of statute "virtually compel[s]" the Commission to apply a negligence standard) *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

²⁹. See *supra* notes 6 and 7 and accompanying text. See also *Ernst & Young LLP*, Admin Proc. File No. 3-10933, SEC Initial Decision Rel. No. 249 (April 16, 2004) (ALJ Decision in contested proceeding).

^{30.} See, e.g., Securities Act of 1933 § 8A(e), 15 U.S.C. § 77h-1(e); Securities Exchange Act of 1934 § 21C(e), 15 U.S.C. § 78u-3(e); Investment Company Act of 1940 § 9(f)(5), 15 U.S.C. § 80a-9(f)(5); Investment Advisers Act of 1940 § 203(k)(5), 15 U.S.C. § 80b-3(k)(5).

^{31.} E.g., *PricewaterhouseCoopers LLP*, et al., Admin. Proc. File No. 3-10835, SEC Rel. Nos. 34-46216 and AAER-1596 (July 17, 2002); *KPMG Peat Marwick LLP*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002); *J. Allen Seymour, CPA*, Admin. Proc. File No. 10521, SEC Rel. Nos. 34-44461 and AAER-1413 (June 21, 2001); *Swart, Baumruk & Co., LLP*, Admin. Proc. File No. 3-10410, SEC Rel. Nos. 34-43883 and AAER-1361 (Jan. 25, 2001); *Moore Stephens, P.C., et al.*, Admin. Proc. File No. 3-9903, SEC Rel. Nos. 34-41425 and AAER-1135 (May 19, 1999); *Charles E. Falk, CPA*, Admin. Proc. File No. 3-9902, SEC Rel. Nos. 34-41424 and AAER-1134 (May 19, 1999); *Dennis M. Gaito, CPA*, Admin. Proc. File No. 3-9904, SEC Rel. Nos. 34-41426 and AAER-1136 (May 19, 1999 institution of proceedings) and SEC Rel. Nos. 34-45941 and AAER-1556 (May 16, 2002 settled order).

^{32.} 17 C.F.R. § 210.2-02.

^{33.} *KPMG Peat Marwick LLP*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002). Federal courts have analogously held that other materially false representations in required filings made pursuant to Exchange Act Section 13(a) and the Commission rules thereunder violate those provisions. See, e.g., *SEC v. McNulty*, 137 F.3d 732-740-41 (2d Cir. 1998) (inaccurate information in Form 8-K filing); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978) (inaccurate information in Form 10-K and Form 10-Q filings).

^{34.} *KPMG Peat Marwick LLP*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{35.} See cases cited in note 31, *supra*.

^{36.} See, e.g., Securities Act of 1933 §§ 5(b), 7(a) and Schedule A, Items 25 and 26, 15 U.S.C. §§ 77e(b), 77(g)(a), 77aa (25) and (26); Securities Exchange Act of 1934 §§ 12(b)(1), 13(a)(2), 14(a), and 17(e)(1), 15 U.S.C. §§ 77l(b)(1), 78m(a)(2) 78n(a), and 78q(e)(1); Regulation S-X, Article 3, 17 C.F.R. § 210.3-01 *et seq.*

^{37.} The Commission, for example, could require the audit client to obtain a reaudit of its financial statements, see, e.g., *Dennis M. Gaito, CPA*, Admin. Proc. File No. 3-9904, SEC Rel. No. 34-41426 and AAER-1136, Order Instituting Proceedings at ¶ 3 (filed May 19, 1999), or in appropriate circumstances could take enforcement action against the client, see, e.g., *Am-Pac International, Inc.*, Admin. Proc. File No. 3-10503, SEC Rel. Nos. 34-44389 and AAER-1401 (June 5, 2001). In a recent appeal, KPMG argued that a cease-and-desist order cannot be issued for causing a violation unless the primary violator is also charged, but the court did not resolve the issue because KPMG had waived the argument by failing to raise it in the proceedings before the Commission. *KPMG, LLP v. SEC*, 289 F.3d 109, *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{38.} *KPMG Peat Marwick L.L.P.*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-39400 and AAER-994 (December 4, 1997 order instituting proceedings).

^{39.} *KPMG Peat Marwick L.L.P.*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-39400 and AAER-994 (December 4, 1997 order instituting proceedings).

^{40.} *KPMG Peat Marwick L.L.P.*, Admin. Proc. File No. 3-9500, Initial Decision Rel. No. 157 (Jan. 21, 2000).

^{41.} *KPMG Peat Marwick L.L.P.*, Admin. Proc. File No. 3-9500, Initial Decision Rel. No. 157 (Jan. 21, 2000).

^{42.} *KPMG Peat Marwick, L.L.P.*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{43.} *KPMG Peat Marwick, L.L.P.*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{44.} *KPMG Peat Marwick, L.L.P.*, Admin. Proc. File No. 3-9500, SEC Rel. Nos. 34-43862 and AAER-1360 (Jan. 19, 2001), *reconsideration denied*, SEC Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109, and *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{45.} *KPMG, LLP v. SEC*, 289 F.3d 109, *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{46.} *See, e.g., J. Allen Seymour, CPA*, Admin. Proc. File No. 10521, SEC Rel. Nos. 34-44461 and AAER-1413 (June 21, 2001) (disgorgement of \$16,141.49 in audit fees and interest); *Swart, Baumruk & Co., LLP*, Admin. Proc. File No. 3-10410, SEC Rel. Nos. 34-43883 and AAER-1361 (Jan. 25, 2001) (disgorgement of \$41,981 in audit fees and interest).

^{47.} *Ernst & Young LLP*, Admin. Proc. File No. 3-10933, SEC Initial Decision Rel. No. 249 (April 16, 2004).

^{48.} In one recent settlement in which disgorgement was not ordered, the Commission explicitly noted that the audit firm had already paid for a re-audit and related expenses. *KPMG LLP*, Admin. Proc. File No. 3-10676, Rel. Nos. 34-45272, IC-25360, and AAER-1491, at footnote 6 (Jan. 14, 2002).

^{49.} *See, e.g., SEC v. Greenway Environmental Services, Inc.*, Civil Action No. 1:97CV01041 (D.D.C., filed May 13, 1997), SEC Lit. Rel. No. 15365 and AAER No. 914 (May 13, 1997); *SEC v. PNF Industries, Inc., et al.*, Civil Action No. 94-4691 (D.N.J., filed Sep. 27, 1994), SEC Lit. Rel. No. 14257A and AAER No. 602A (Oct. 3, 1994); *SEC v. Ernst & Young*, Civil Action No. 91-1443 (D.D.C., filed June 13, 1991), SEC Lit. Rel. No. 12885 (June 13, 1991) (filing of case) and SEC Lit. Rel. No. 14442 and AAER No. 655 (March 15, 1995) (settlement of case); *SEC v. TRX Industries, Inc.*, Civil Action No. 89-1899 (D.D.C., July 5, 1989), SEC Lit. Rel. No. 12150 and AAER No. 234 (July 5, 1989); *SEC v. Gomez*, Civil Action No. 85-6227 (S.D. Fla., filed Mar. 20, 1985), SEC Lit. Rel. No. 10705 (Mar. 20, 1985) (filing of case) and SEC Lit. Rel. No. 10747 and AAER No. 57 (May 8, 1985) (settlement of case); *SEC v. Drown, et al.*, Civil Action No. 82-6361 (C.D. Cal., filed Dec. 15, 1982), SEC Lit. Rel. No. 9836 and AAER No. 3 (Dec. 15, 1982).

^{50.} The Commission's authority to obtain injunctions and penalties is statutory and explicit. *See, e.g., Securities Act of 1933* § 20(b) and (d), 15 U.S.C. § 77t(b) and (d); *Securities Exchange Act of 1934* § 21(d), 15 U.S.C. § 78u(d). Its authority to obtain disgorgement and other ancillary relief is a product of caselaw. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307-08 (2d Cir. 1971); John H. Sturc & Russell T. Goin, *Disgorgement: A Primer*, 32 Rev. Sec. & Comm. Reg. 153 (Aug. 1999).

^{51.} *See supra* notes 32-34 and accompanying text.

^{52.} In a recent appeal before the U.S. Court of Appeals for the D.C. Circuit, KPMG argued that Regulation S-X applies only to companies that issue securities, and not to their auditors. However, the court declined to rule on the issue because KPMG had failed to press the argument in the proceedings below before the Commission. *See KPMG, LLP v. SEC*, 289 F.3d 109, *reh'g and reh'g en banc denied*, 2002 U.S. App. LEXIS 14543 and 14544 (D.C. Cir. 2002).

^{53.} Exchange Act Section 20(e) establishes liability for any person who “knowingly provides substantial assistance to another person” who violates the securities laws, 15 U.S.C. § 78t(e), and at least one court has held that recklessness is sufficient for such purposes, at least where the defendant owed investors a fiduciary duty, *see SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS 16204, at *27-28 (S.D.N.Y. 2000).

^{54.} *See supra* note 28 and accompanying text.

^{55.} *SEC v. Ernst & Young*, Civil Action No. 91-1443 (D.D.C. filed June 13, 1991), SEC Lit. Rel. No. 12885 (June 13, 1991).

^{56.} *SEC v. Ernst & Young*, Civil Action No. 91-2267-X (N.D.Tex.), SEC Lit. Rel. No.14442 and AAER No. 655 (March 15, 1995).

^{57.} *See, e.g., SEC v. Smyth, et al.*, No. 01-CV-1344 (N.D. Ga. 2001), SEC Lit. Rel. Nos. 17044 (June 21, 2001) and 17566 (June 17, 2002). *SEC v. Greenway Environmental Services, Inc.*, Civil Action No. 1:97CV01041 (D.D.C., filed May 13, 1997), SEC Lit. Rel. No. 15365 and AAER No. 914 (May 13, 1997); *SEC v. PNF Industries, Inc.*, et al., Civil Action No. 94-4691 (D.N.J., filed Sep. 27, 1994), SEC Lit. Rel. No. 14257A and AAER No. 602A (Oct. 3, 1994); *SEC v. TRX Industries, Inc.*, Civil Action No. 89-1899 (D.D.C., July 5, 1989), SEC Lit. Rel. No. 12150 and AAER No. 234 (July 5, 1989); *SEC v. Gomez*, Civil Action No. 85-6227 (S.D. Fla., filed Mar. 20, 1985), SEC Lit. Rel. No. 10705 (Mar. 20, 1985) (filing of case) and SEC Lit. Rel. No. 10747 and AAER No. 57 (May 8, 1985) (settlement of case); *SEC v. Drown, et al.*, Civil Action No. 82-6361 (C.D. Cal., filed Dec. 15, 1982), SEC Lit. Rel. No. 9836 and AAER No. 3 (Dec. 15, 1982). The Commission also recently settled a previously-filed administrative proceeding in which it found an auditor independence violation to constitute fraud under Exchange Act Section 10(b) and Rule 10b-5. *Dennis M. Gaito, CPA*, Admin Proc. File No. 3-9904, SEC Rel. Nos. 34-45941 and AAER-1556 (May 16, 2002 settled order).

^{58.} *SEC v. E.S.M. Group, Inc. et al.*, Civil Action No. 85-6190 (S.D. Fla., filed Mar. 4, 1985), SEC Lit. Rel. No. 10681 (Mar. 11, 1985).

^{59.} *SEC v. Gomez*, Civil Action No. 85-6227 (S.D. Fla., filed Mar. 20, 1985), SEC Lit. Rel. No. 10705 (Mar. 20, 1985). Subsequently, the Commission filed a settled complaint against Grant Thornton, the successor firm to Alexander Grant & Company, and several of its other partners, charging them with fraud and related violations based primarily on repeated audit failures in connection with the firm’s engagement by E.S.M. *See SEC v. Grant Thornton, et al.*, Civil Action No. 86-6832 (S.D. Fla., filed Oct. 16, 1986), SEC Lit. Rel. No. 11263 and AAER No. 532 (Oct. 16, 1986).

^{60.} *SEC v. Gomez*, SEC Lit. Rel. No. 10747, AAER No. 57 (May 8, 1985).

^{61.} *Jose L. Gomez, C.P.A.*, Admin. Proc. File No. 3-6547, SEC Rel. Nos. 34-22293 and AAER-68 (Aug. 6, 1985).

^{62.} *U.S. v. Ewton, et al.*, Indictment No. 86-6076 (S.D. Fla.), SEC Lit. Rel. No. 11353 (Feb. 10, 1987).

^{63.} *SEC v. PNF Industries, Inc.*, et al., Civil Action No. 94-4691 (D.N.J., filed Sep. 27, 1994), SEC Lit. Rel. No. 14257A and AAER No. 602A (Oct. 3, 1994).

^{64.} Sarbanes-Oxley Act of 2002 § 602 (codified as Exchange Act § 4C, 15 U.S.C. § 78d-3).

^{65.} Sarbanes-Oxley Act of 2002 §§ 101-109.

^{66.} Sarbanes-Oxley Act of 2002 § 3.

^{67.} Sarbanes-Oxley Act of 2002 § 105.

^{68.} Sarbanes-Oxley Act of 2002 § 105(c)(4).

^{69.} Sarbanes-Oxley Act of 2002 § 201(a) (codified as Exchange Act § 10A(g), 15 U.S.C. § 78j-1(g)).

^{70.} Sarbanes-Oxley Act of 2002 §§ 201(a) and 202 (codified as Exchange Act §§ 10A(h) and (i), 15 U.S.C. 78j-1(h) and (i)).

- ^{71.} Sarbanes-Oxley Act of 2002 § 203 (codified as Exchange Act § 10A(j), 15 U.S.C. 78j-1(j)).
- ^{72.} Sarbanes-Oxley Act of 2002 § 206 (codified as Exchange Act § 10A(l), 15 U.S.C. 78j-1(l)).
- ^{73.} Final Rule: *Strengthening the Commission's Requirements Regarding Auditor Independence*, SEC Rel. Nos. 33-8183, 34-47265, 35-27642, IC-25915, and IA-2103 (Jan. 28, 2003).