

The Securities and Exchange Commission's Ban on Legal Services by Audit Firms: Amendments to Rule 2-01 of Regulation S-X Under the Securities Exchange Act of 1934

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IT IS THE DUTY of auditors¹ to present an unbiased financial portrait of a company and its assets. Every day millions of people are induced to invest their money based upon the reports of independent auditors and their firms.² These reports and financial statements have historically been accurate and reliable, thereby providing insight into the functioning of a company. As such, they often serve as a basis for deciding whether to invest money in a specific company. The public's reliance on the accounting profession stems from the fact that the accounting practices used in preparing these statements are standardized and highly regulated.³

Unlike the objective auditor, the traditional role of lawyers is to represent their clients, render advice on legal and non-legal issues, and occasionally litigate. When practicing in an accounting firm, a lawyer's practice area may include any of the following: tax, corporate, securities, employment, employee benefits, and other business-related fields.⁴ Additionally, attorneys practicing in accounting and auditing

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1. For the purpose of this Comment, the terms "auditor" and "accountant" will be used interchangeably. Generally, an accountant prepares the documents which the auditor then checks; but they are similar in that they communicate using the same lexicon.

2. See Proposed Rule: Revision of the Commission's Auditor Independence Requirements, Release No. 33,7870 (proposed June 27, 2000), available at <http://www.sec.gov/rules/proposed/34-42994.htm> [hereinafter Release No. 33,7870].

3. See 15 U.S.C. §§ 77aa(25)-(26) (1994); 17 CFR § 210.10-01(d) (1994).

4. See Peter C. Kostant, *Paradigm Regained: How Competition from Accounting Firms May Help Corporate Attorneys to Recapture the Ethical High Ground*, 20 PACE L. REV. 43, 48 (1999); see also Ward Bower, *The Case for MDPs: Should Multidisciplinary Practices Be Banned or Embraced?*,

firms may provide litigation support, case valuation, investigation, and alternative dispute resolution ("ADR").⁵ By attempting to convince both professions that they cannot work in the same firm and leaving them to defend the virtues of their respective careers, the Securities and Exchange Commission's ("SEC" or "the Commission") new rule proscribing legal services has strained the relationship between lawyers and auditors.

The Securities and Exchange Commission was created in 1934 in the wake of the Great Depression in order to enforce the Securities Act of 1933⁶ and the Securities Exchange Act of 1934.⁷ The two common sense principles on which the Acts are premised are: (1) companies offering securities must be truthful in the information they provide the public; and (2) sellers of securities, i.e., brokers, dealers, and exchanges, must also be truthful.⁸ The SEC's primary purposes are to promote disclosure of material financial information, enforce securities regulations, and protect investors.⁹ As a means of achieving these goals, the SEC requires that all companies with an excess of \$10 million in assets and securities held by more than 500 owners file annual and other periodic reports, such as yearly financial audits.¹⁰ These yearly financial audits are conducted by accounting firms that are expected to provide reasonable assurance that the client company's records are not materially misleading. Audits must be prepared in accordance with Generally Accepted Accounting Principles ("GAAP").¹¹ To ensure audits are reliable, the SEC also requires that

LAW PRAC. MGMT. MAG. (Jul./Aug. 1999), available at <http://www.abanet.org/lpm/magazine/mdp-bowe995.html>.

5. See Kostant, *supra* note 4, at 48.

6. See *The SEC: Who We Are, What We Do*, available at <http://www.sec.gov/asec/www-sec.htm> (last modified Aug. 8, 2000).

7. See 15 U.S.C. §§ 77a-78ll (1994). The Securities Act of 1933 is also known as the "truth in securities" act. See also *The SEC: Who We Are, What We Do*, *supra* note 6. The Act of 1934 gives broad authority to the SEC over all aspects of the securities industry. See *id.*

8. See *The SEC: Who We Are, What We Do*, *supra* note 6.

9. See *id.*

10. See *id.* An audit is the "verification or examination of financial accountants or records" to check their accuracy. WEBSTER'S THIRD NEW INTERNATIONAL 143 (1994).

11. The financial statements reviewed in audits are the client company's responsibility to prepare. In general, an auditor reviews the financial statements, examining both the balance sheet (showing assets, liabilities and equity) and the income statements (revealing revenues and expenses). See Release No. 33,7870, *supra* note 2, at *3. There are several methods for the auditor to examine the company's financial information, but it is usually done on a test basis or sample basis. See *id.* Then the auditor provides a written opinion on the company's financial statements and disclosures, determining if the records are materially misleading or comply with GAAP. See *id.*

the individuals who prepare the audits be independent of the company being audited.¹²

To ensure independence, auditors are subject to the authority of two governing bodies. The first is the American Institute of Certified Public Accountants ("AICPA"), which is concerned with preventing the dissemination of materially misleading financial statements and with proper application of GAAP and Generally Accepted Auditing Standards ("GAAS"). The other is the SEC, which governs the accurate disclosure of information. Although federal securities laws permit the SEC to define the term "independence,"¹³ the SEC has failed to give a definite meaning.¹⁴ Instead, the Commission instituted a two-prong approach to determine auditor independence: the auditor must remain independent in fact and in appearance.¹⁵

The accounting profession, overseen by the AICPA, also promulgates its own standards to which its members must adhere.¹⁶ Accountants must perform audits according to GAAS applying GAAP.¹⁷ In addition, in February of 1998, the SEC and AICPA created the Inde-

12. See 17 C.F.R. § 210.2-01 (1999); see also Release No. 33,7870, *supra* note 2; Final Rule: Revision of the Commission's Auditor Independence Requirements, Release No. 33,7919 (codified as amended at 17 C.F.R. §§ 210, 240 (2001)), available at <http://www.sec.gov/rules/final/33-7919.htm> [hereinafter Release No. 33,7919].

13. See 17 C.F.R. § 210.2-01(b) (1999) (last amended in 1983); see also Release No. 33,7870, *supra* note 2, at *1.

14. See 17 C.F.R. § 210.2-01(b) (1999); see also Release No. 33,7870, *supra* note 2, at *3. "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent." *Id.* The statute continues to give generalized examples illustrating when an auditor is not independent. See *id.* In the rule proposal, the Commission defined the role of the independent auditor as approaching "each audit with professional skepticism and [having] a willingness and freedom to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of an audit client." *Id.*

15. See Release No. 33,7919, *supra* note 12, at *3. The first prong, independence in fact, is "direct evidence of the auditor's mental state." *Id.* The second and more significant prong, independence in appearance, "recognizes that generally mental states can be assessed only through observation of external facts; it thus provides that an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment." Release No. 33,7870, *supra* note 2, at **3-4 (citing the AICPA Codification of Statements on Auditing Standards ("SAS") No. 1, AU § 220-01-02 (1988); PUBLIC OVERSIGHT BOARD, SCOPE OF SERVICES BY CPA FIRMS (1979); United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984) in support of this proposition).

16. See *About AICPA*, available at <http://www.aicpa.org/about/index.htm> (last modified June 22, 2001).

17. See PUBLIC OVERSIGHT BOARD, THE PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS (2000), at App. A [hereinafter PANEL ON AUDIT EFFECTIVENESS].

pendence Standards Board¹⁸ (“ISB”) to foster timely, thorough, and open debate regarding auditor independence and to suggest improvements.¹⁹ Because accountants play a crucial role in the SEC’s function of promoting accurate disclosure of financial information, their profession is strictly regulated.

In early November 2000, the SEC finalized its proposal for the new auditor independence rule.²⁰ Under this rule, audit firms are prohibited from providing almost all non-audit services because doing so allegedly threatens auditor independence.²¹ Most importantly, legal services were included in the group of proscribed services.²² The SEC’s inclusion of legal services in the rule is hurried and without support. The new rule is both over-inclusive and under-inclusive and does not provide for auditor independence as efficiently as possible. Part I of this Comment discusses the background of auditor independence and how the parties involved interact. Part II analyzes the new rule governing auditor independence which bans legal services from the repertoire of audit firms. Part III illustrates how, on four different levels, the SEC’s reactionary policy toward the legal services provided by audit firms is unfounded. This Comment concludes that the SEC prematurely wrote its new auditor independence rule without fully examining the issue and explains the consequences of the new rule.

I. Background

A. The Impetus for Disclosure Requirements

The Great Depression of 1929 served as the major catalyst for the reform of accounting standards and securities law.²³ Before the stock market crash, companies were required to have their financial information prepared by independent accountants. However, companies

18. See Policy Statement: The Establishment and Improvement of Standards Related to Auditor Independence, Release No. 33,7507 (February 18, 1998), available at <http://www.sec.gov/rules/concept/33-7507.htm> [hereinafter Release No. 33,7507]. In July 2001, the SEC amended FRR-50 and decided that it would no longer look to the ISB for guidance on auditor independence issue. See *id.*; see also Commission Policy Statement on the Establishment and Improvement of Standards Related to Auditor Independence, Release No. 33,7993 (July 17, 2001), available at <http://www.sec.gov/rules/policy/33-7993.htm> [hereinafter Release No. 33,7993].

19. See *About the ISB*, available at <http://www.cpaindependence.org> (last visited Feb. 1, 2001).

20. See Release No. 33,7919, *supra* note 12.

21. See *id.* at *1.

22. See *id.* at **59–60.

23. See Susan B. Schwab, Note, *Bringing Down the Bar: Accountants Challenge Meaning of Unauthorized Practice*, 21 CARDOZO L. REV. 1425, 1438 n.70 (2000).

did not have to provide their entire financial positioning to the public.²⁴ The discrepancy in information created an opportunity to mislead investors since the financial statements only described a part of the financial stability of the company.²⁵ Although the economic condition of both the United States and the rest of the world significantly contributed to the 1929 Wall Street crash, the impact from the number of fraudulently floated securities²⁶ in the United States cannot be underestimated.²⁷

After the Depression, changes to financial reporting requirements focused on, among other things, increasing disclosure requirements, filing specified periodic reports, disclosing material facts in proxy statements, and restricting insider trading.²⁸ These changes were intended to make a company's financial position more transparent to the investor.²⁹ The new rules also mandated that public entities supply fuller disclosures of hard information,³⁰ but continued to prohibit the release of soft information.³¹ In this effort to protect investors from subjective opinions of auditors, the SEC allowed only objective information to reach the investor by regulating the auditor's reports.³²

In the late 1970s, the Commission realized the potential usefulness of soft information for investors.³³ The SEC determined that investors were unlikely to be misled by auditor opinions, and might, in fact, be aided by access to additional information. Thus, the SEC began to relax some of its strict disclosure requirements and allowed companies to describe their financial statements when filing reports.³⁴

Around the same time, Congress, the SEC, and several accounting associations became concerned with the erosion of auditor inde-

24. See *id.* at 1438.

25. See *id.* "[Financial statements] are but the skin of a living thought and subject to great misinterpretation as to their import for the future." *Id.* at 1438 n.69 (quoting Ted J. Fiflis, ACCOUNTING ISSUES FOR LAWYERS 519 (1991) (citations omitted)).

26. The term "float" means "issu[ing] [a security] for sale on the market." BLACK'S LAW DICTIONARY 653 (7th ed. 1999).

27. See ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS & LIMITED LIABILITY COMPANIES, at 331-32 (6th ed. 1998).

28. See Schwab, *supra* note 23, at 1438-39 n.70.

29. See *id.*

30. The term "hard information" refers to information based on past events or facts, e.g., prior financial position, etc. See *id.* at 1439 n.71.

31. The term "soft information" includes opinions, predictions, and subjective evaluations. See *id.* at 1439 n.72.

32. See *id.* at 1439.

33. See *id.*

34. See *id.* at 1439-40.

pendence and wanted to return to stricter audit standards.³⁵ As a result, from 1978 until 1982, the SEC required companies to disclose all non-audit services provided by their auditors in their proxy statements.³⁶ Companies were also required to state the percentage of the fees for *all* non-audit services compared to total audit fees; the percentage of the fee for *each* non-audit service compared to total audit fees; and include a statement as to whether each non-audit service was considered and approved by the audit committee of the board of directors or by the board itself.³⁷

The Public Oversight Board³⁸ ("POB") determined that providing audits and non-audit services, collectively called consulting,³⁹ were fundamentally incompatible.⁴⁰ This determination was based on the theory that an auditor had to be objective, i.e., not have a financial stake in the company which she was auditing, and that by providing consulting services, the collection of additional fees would engender bias and result in skewed financial reports.⁴¹ However, when the SEC determined that auditors and their firms were not providing the amount of non-audit services as previously believed, the proxy requirement was discontinued.⁴²

35. See Release No. 33,7870, *supra* note 2, at *5.

36. The SEC proxy requirement stated:

[S]hareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

SEC's Search Key Topics, available at <http://www.sec.gov/answers/proxy.htm>. See also Office of the Chief Accountant of the United States, SEC, STAFF REPORT ON AUDITOR INDEPENDENCE (1994).

37. See Release No. 33,7870, *supra* note 2, at *8.

38. The POB is an independent, private-sector body that monitors and reports on the self-regulatory programs and activities of the SEC Practice Section of CPA (Certified Public Accountant) Division of the AICPA. See PANEL ON AUDIT EFFECTIVENESS, *supra* note 17, at vii.

39. See Release No. 33,7870, *supra* note 2, at *5. Non-audit services include legal advice and human resources, which are collectively referred to as consulting. See *id.*

40. See *id.*

41. See *id.*

42. See *id.* at *8 n.7.

B. The Present Controversy over Auditor Independence

After this experimental period, accounting firms began a significant crossover into non-audit services and consulting.⁴³ In recent years, the extent to which audit firms have provided non-audit services has skyrocketed.⁴⁴ Accounting firms currently generate more revenue from the consulting branch of the firm than from the auditing branch, causing suspicion regarding the independence of auditors.⁴⁵ This development awakened the SEC, which was dormant on the issue, into increasing regulation of the auditing industry.⁴⁶

The SEC fears auditing firms will be unduly influenced by money.⁴⁷ That the bulk of their revenues are derived from consulting suggests auditing firms and auditors are less objective in auditing their clients' companies because they will try to sell consulting services to their clients, thereby generating more profit for the firm. Arguably, auditors will not objectively evaluate the company, but rather will make recommendations that financially benefit the auditing firm.⁴⁸

Concerns over auditor independence grew so strong that a number of organizations formed panels to objectively explore the issue.⁴⁹ In October 1998, the POB appointed the Panel on Audit Effectiveness ("the Panel") at the request of then SEC Chairman Arthur Levitt.⁵⁰ The impetus for the Panel's report was the increasing pressure on corporate management to achieve earnings or other performance targets.⁵¹ The SEC believed that in "succumbing to those pressures,

43. See Michael Schroeder, *SEC, Accounting Firms Reach Pact on Conflicts*, WALL ST. J., June 8, 2000, at A2.

44. See Release No. 33,7870, *supra* note 2, at *5 (noting the SEC found that in 1999, approximately half of the Big Five's revenue came from consulting). See also PANEL ON AUDIT EFFECTIVENESS, *supra* note 17, at 112.

45. See Release No. 33,7870, *supra* note 2, at *6.

46. See *id.* at *5.

47. See *id.* at **6-7.

48. See *id.* at *6.

49. See EARNSCLIFFE RESEARCH & COMMUNICATIONS, REPORT TO THE UNITED STATES INDEPENDENCE STANDARDS BOARD: RESEARCH INTO PERCEPTIONS OF AUDITOR INDEPENDENCE AND OBJECTIVITY—PHASE II (Jul. 2000) (exploring the perceptions of auditor independence by those involved with auditors and accounting firms). The report noted some concern about auditor independence, but overall the impression was positive. See *id.* at 6-7. See also INDEPENDENCE STANDARDS BOARD, DISCUSSION MEMORANDUM DM 99-4 (Dec. 1999) (discussing the advantages and disadvantages of banning legal services and recommending safeguards for auditor independence). The American Bar Association, the professional body which governs the legal field, had its own commission formed to investigate the topic. See discussion *infra* pp. 14-18.

50. See PANEL ON AUDIT EFFECTIVENESS, *supra* note 17, at 1.

51. See *id.* at vii.

management's behavior can become suspect."⁵² Furthermore, changes in technology were cited as increasing efficiency but decreasing effectiveness of audits, raising concerns about the relative financial importance of audits to auditing firms.⁵³ The SEC requested that the Panel conduct a thorough and objective examination of the auditing process, specifically exploring potential threats to auditor independence.⁵⁴ After almost two years of study, the Panel gave favorable reviews of the auditing profession, concluding that as long as independence standards were maintained, no drastic measures were needed with respect to non-audit services.⁵⁵ The Panel simply suggested that the SEC continue to monitor the effectiveness of the then-current ISB disclosures and audit committee disclosure requirements.⁵⁶

Despite the Panel's favorable reviews and conclusions, a few highly publicized scandals increased pressure on regulatory agencies to address the issue of non-audit services. One such fiasco involved PricewaterhouseCoopers, a Big Five firm,⁵⁷ in which the SEC reported 8,064 auditor independence violations.⁵⁸ The responsible parties included thirty-one top partners and six executives responsible for enforcing independence rules.⁵⁹ Ten of the employees were terminated as a result of the scandal.⁶⁰ Aside from the incident involving PricewaterhouseCoopers, no other major problems have surfaced at the other Big Five firms.⁶¹ Nevertheless, still suspecting undetected violations, on June 7, 2000, the SEC and the Big Five agreed to a "look back" audit, which allowed the SEC to investigate the firms for past violations, in exchange for immunity from prosecution for any violations found.⁶² However, in January 2001, the SEC rescinded its offer

52. *Id.*

53. *See id.* at viii.

54. *See id.* at vii.

55. *See id.* at ix.

56. *See id.* at 117.

57. *See id.* at 182 (explaining that the "Big Five" refers to the five largest accounting firms: Deloitte & Touche LLP, KPMG LLP, Arthur Anderson LLP, Ernst & Young LLP, and PricewaterhouseCoopers LLP).

58. *See* Elizabeth MacDonald, *Top Accounting Industry Group Sets Conflict-of-Interest Compliance Rules*, WALL ST. J., Feb. 2, 2000, at B2 (noting that the majority of these violations were auditors and their families improperly investing in audit clients).

59. *See id.*

60. *See id.*

61. *See id.*

62. *See Big Accounting Firms Agree to SEC 'Look Back' Audit*, N.Y. TIMES, June 8, 2000, at C15 (observing that most of the violations found were of the improper investment variety).

of amnesty to the auditing firms because it feared being forced into giving amnesty to those who refused to comply.⁶³

The American Bar Association (“ABA”) and many state bar associations have regulations, similar to the SEC’s, which prohibit lawyers from sharing profits with non-lawyers.⁶⁴ Since auditor independence affects lawyers as well, the ABA formed the Commission on Multidisciplinary Practice⁶⁵ in August 1998 to study the business phenomenon.⁶⁶ A year later, the commission recommended the ABA amend its ethical rules to allow firms to offer both legal and non-legal services, as long as lawyers had the control and authority necessary to assure lawyer independence.⁶⁷ After the presentation of the recommendation, the ABA’s House of Delegates declined to support any changes in the ethical standards.⁶⁸ In May 2000, the ABA’s Commission on Multidisciplinary Practice renewed its proposal and, again, it was rejected.⁶⁹ The tension between the two stances raises questions as to whether the legal profession is attempting to influence the SEC.⁷⁰

63. See *Independence*, PARTNER’S REPORT FOR CPA FIRM OWNERS, Jan. 2001, at 6, available at 2001 WL 17740271.

64. See Commission on Multidisciplinary Practice, *MDP Information* (Feb. 5, 2001), available at http://www.abanet.org/cpr/mdp_state_summ.html. The chart found on the website illustrates that approximately fifty percent of the state bar associations are studying the issue of allowing lawyers to work in conjunction with accounting firms. *Id.*

65. The ABA’s Commission on Multidisciplinary Practice defines multidisciplinary practice (“MDP”) as “[a] partnership, professional corporation, or other association or entity that includes lawyers and has as one, but not all, of its purposes the delivery of legal services to a client(s) other than the MDP itself or that holds itself out as providing nonlegal, as well as legal services.” ABA—Young Lawyers Division, *Commission on Multidisciplinary Practice: The FAQs on MDPs*, available at <http://www.abanet.org/yld/tyl/nov99/newtoyou.html> (Nov. 1999).

66. See *id.*; see also Bower, *supra* note 4, at 62.

67. See ABA News Release, *ABA Commission Renews Proposal for Multidisciplinary Practice*, available at <http://www.abanet.org/media/mar00/mdp.html> (last visited Mar. 22, 2000).

68. See John S. Dzienkowski & Robert J. Peroni, *Multidisciplinary Practice and the American Legal Profession: A Market Approach to Regulating the Delivery of Legal Services in the Twenty-First Century*, 69 *FORDHAM L. REV.* 83, 86–87.

69. See *id.* at 86–87; see also ABA Commission on Multidisciplinary Practice, *Report to the House of Delegates* (Jul. 2000).

70. Two other legal professional organizations spoke out on the issue. The National Lawyers Association strongly opposed Multidisciplinary Practices. See Nat’l Law. Ass’n, *Comments to MDPs* (Dec. 22, 1999), available at <http://www.abanet.org/cpr/farnan.html>. In contrast, the International Bar Association (“IBA”) expressed an interest in protecting client and public interest. See Bower, *supra* note 4, at 62. The IBA communicated its position to the World Trade Organization (“WTO”), which is strongly opposed to any sort of economic regulations. Thus, is it reasonable to conclude that MDPs are tacitly accepted on the global scale. See *id.*

Controversy has been brewing not only over the content of the new auditor independence rule, but also over the process by which it was created. Ernst & Young and PricewaterhouseCoopers initially invited scrutiny of and revisions to auditor independence rules, but then began to resent it. They argued that the proposed changes went too far, were too prohibitory and uncertain, and like the proxy disclosures of twenty years ago, will soon be unnecessary.⁷¹ Further suspicions arose when the SEC delegated all independence issues to the ISB, raising the question of whether the SEC had jurisdiction to promulgate new independence standards.⁷² These firms also complained that the public hearings on the proposed rule were not neutral and favored the SEC, which primarily invited proponents of the rule and offered a skewed discussion.⁷³

II. The Statute

On June 27, 2000, the Commission announced the proposed⁷⁴ regulations, which aimed at modernizing the rules for auditor inde-

71. See Floyd Norris, *A top accounting executive asks the S.E.C. to amend a new proposal on auditor independence*, N.Y. TIMES, Aug. 16, 2000, at C8. While Ernst & Young and PricewaterhouseCoopers initially supported the proposed rule, KPMG, Arthur Anderson and Deloitte & Touche opposed the changes from the start. *Id.*

72. See Hearing Testimony: Auditor Independence, Release No. 33,7870 (Sept. 13, 2000), available at <http://www.sec.gov/rules/extra/audmin2.htm> [hereinafter Hearing Testimony Day 2] (testimony of Robert K. Elliott, Chairman, AICPA) (asserting that the SEC's proposal to modify the rules circumvents the ISB and is contrary to Financial Reporting Release 50, which delegates authority on independence issues to the ISB). The ISB issue will not be addressed in this Comment.

73. See Tamara Loomis, *SEC Faces Stiff Opposition in Proposal for Guidelines*, N.Y. L.J., Sept. 14, 2000, at 5 (describing the resistance of the Big Five to the SEC's proposed auditor independence rule).

74. Rulemaking is the process where federal administrative agencies implement legislation passed by Congress. See *How the SEC Rulemaking Process Works*, available at <http://www.sec.gov/asec/wwwsec.htm> (last modified Aug. 8, 2000). Specifically, the authority of the SEC, as an administrative agency, to enact new regulations is granted by the Securities Acts of 1933 and 1934. See *id.* The Acts serve as a general framework for the securities markets allowing for evolution of those markets and of rules used to regulate them. See *id.* In rulemaking, there are three major steps: concept release, rule proposal, and rule adoption. See *id.* A concept release simply describes the issue in general terms and often involves public comment. The concept release is not a necessary step and is often omitted if the subject is fairly straightforward. See *id.* The release then evolves into the rule proposal, a formal detailed document, which is then presented to the full Commission. See *id.* Following an approval by the Commission, the rule is presented to the public for comment during a specified period of time, usually between thirty and sixty days. Finally, after hearing public comment, the final rule is drafted and presented to the Commission for its consideration. See *id.* If the Commission adopts it, the rule becomes part of the official body of regulations that govern the securities industry. See *id.* If the new rule is controversial, it may be subject to congressional review and veto prior to becoming effective. See *id.*

pendence in three general areas:⁷⁵ “(1) investments by auditors or their family members in audit clients; (2) employment relationships between auditors or their family members and audit clients; and (3) the scope of the services provided by the audit firms to their audit clients.”⁷⁶

A. The New Rule Regulating Auditor Independence

The SEC listed several developments in the accounting profession which, in its opinion, compromise auditor independence, and thus, necessitated the reforms.⁷⁷ Primarily, the SEC was concerned that the percentage of revenue derived from audits was dwindling and being replaced by consulting revenues.⁷⁸ The SEC also questioned whether the previous independence standards were appropriate given the financial market’s new emphasis on strategic alliances, mergers, and advances in technology.⁷⁹ The SEC noted that economic and business environments changed so drastically that the old auditor independence provisions were no longer effective.⁸⁰

75. See Floyd Norris, *SEC Proposes Stricter Accounting Rules*, N.Y. TIMES, June 28, 2000, at C1.

76. *The Commission’s Proposal To Modernize the Rules Governing the Independence of the Accounting Profession*, available at <http://www.sec.gov/news/extra/audfact.htm> (last modified June 27, 2000).

77. See PANEL ON AUDIT EFFECTIVENESS, *supra* note 17, at 112.

78. See Release No. 33,7870, *supra* note 2, at *2.

79. Specifically, the SEC stated:

[F]irms are becoming primarily business advisory service firms as they increase the number, revenues from, and types of non-audit services provided to audit clients[;] firms and their audit clients are entering into an increasing number of business relationships, such as strategic alliances, co-marketing arrangements, and joint ventures[;] firms are divesting significant portions of their consulting practices or restructuring their organizations[;] firms are offering ownership of part of their practices to the public, including audit clients[;] firms are in need of increased capital to finance the growth of consulting practices, new technology, training, and large unfunded pension obligations[;] firms have merged, resulting in increased firm size, both domestically and internationally[;] firms have expanded into international networks, affiliating and marketing under a common name[;] non-CPA financial service firms have acquired accounting firms, and the acquirors previously have not been subject to the profession’s independence, auditing, or quality control standards[;] firms’ professional staffs have become more mobile, and geographical location has become less important due to advances in telecommunications and internet services[;] and audit clients are hiring an increasing number of firm partners, professional staff, and their spouses for high level management positions.

Release No. 33,7870, *supra* note 2, at *2.

80. See *id.* at *4.

The amended regulations were based on four general scenarios in which the Commission believed an accountant could not be independent.⁸¹ These circumstances occur when the auditor “(i) has a mutual or conflicting interest with the audit client,^[82] (ii) audits the accountant’s own work,^[83] (iii) functions as management or an employee of the audit client,^[84] or (iv) acts as an advocate^[85] for the audit client.”⁸⁶ These broad definitions essentially allowed the Commission to ban non-audit services.

The SEC expected to prevent future problems by eliminating the ability of audit firms to provide non-audit services—most importantly legal services.⁸⁷ Among the other services proscribed⁸⁸ were: bookkeeping,⁸⁹ financial information systems design,⁹⁰ appraisal or valuation services,⁹¹ actuarial services,⁹² internal audit outsourcing,⁹³

81. *See id.* at *2.

82. An example of such mutual interest is an auditor investing in the company which he or she was auditing.

83. An example of this is bookkeeping, where the accountant would prepare and maintain financial records and the auditor of the same firm would verify those records.

84. Here, the auditor becomes in effect part of the decisional force of the client company and has an opportunity to affect the fate of the client company rather than simply being an inspector of financial records.

85. *See* Hearing Testimony Day 2, *supra* note 72, at *31 (Sept. 13, 2000) (testimony of Nancy LaMata, N.Y. Society of CPAs). The intent was to ban legal services from accounting firms’ consulting services. *See* Hearing Testimony: Auditor Independence, Release No. 33,7870 (July 26, 2000), *available at* <http://www.sec.gov/rules/extra/audmin.htm> at *9 [hereinafter Hearing Testimony Day 1] (testimony of J. Michael Cook, former Chairman of Deloitte & Touche) (arguing that many opponents of the ban believe that “advocacy” had too far-reaching effects and that a more narrow definition should be used). *See also* Hearing Testimony: Auditor Independence, Release No. 33,7870, *79 (Sept. 20, 2000), *available at* <http://www.sec.gov/rules/extra/audmin3.htm> [hereinafter Hearing Testimony Day 3] (testimony of Ronald Nielsen, Iowa Accountancy Examiners Board).

86. Release No. 33,7870, *supra* note 2, at *45. These four ideals are listed in paragraph (b) of the proposed rule.

87. *See id.* at *6.

88. *See* Release No. 33,7919, *supra* note 12, at **112–16.

89. Bookkeeping is defined as any service involving maintaining or preparing a company’s financial records. *See id.* at *112. Thus, the auditor would be essentially checking his or her own work.

90. Financial information systems design involves designing or implementing a hardware or software system which is significant to the client company’s financial statements as a whole. *See id.*

91. Appraisal or valuation services involve any service requiring a fairness opinion where the results are likely to be audited by an accountant. *See id.* at *113.

92. Actuarial service is any advisory service involving the determination of policy reserves and related accounts. *See id.* at 113–14.

93. Internal audit outsourcing consists of the accounting firms conducting audits of client company’s internal operations and systems. *See id.* at **114–15.

management functions,⁹⁴ human resources,⁹⁵ broker-dealer or investment banking services,⁹⁶ and expert services.⁹⁷

The proposed rule, which is more detailed than the previous auditor independence rule, lists each banned non-audit service.⁹⁸ The prior introductory sentence was largely retained but the statute was then broken down into many specific subparts. The ban on legal services reads, in pertinent part:

(c) [a]n accountant is not independent under the standard of paragraph (b)^[99] of this section if, during the audit and professional engagement period, the accountant has any of the financial, employment or business relationships with, provides any of the non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5) of this section, or otherwise does not comply with the standard of paragraph (b) of this section(4)(I) Legal services. Providing any service to an audit client or an affiliate of an audit client that, in the jurisdiction in which the service is provided, could be provided only by someone licensed to practice law.¹⁰⁰

The SEC considered a blanket ban on all non-audit services, but eventually rejected the idea.¹⁰¹ Instead the SEC's proposed rule on auditor independence evolved into broad and generalized categories of non-audit services to be proscribed.

94. Management functions occur when an employee of the accounting firm temporarily acts as a director, officer, or employee of the client company and performs any decision-making or supervisory role. *See id.* at *115.

95. Human resources includes recruiting, hiring, or designing compensation packages or tests for directors, officers, or managers of an audit client. *See id.*

96. Broker-dealer or investment banking services consist of acting as a securities professional and analyzing an audit client's securities and investments. *See id.*

97. Expert services are defined as rendering or supporting any expert opinion for an audit client in administrative or regulatory filings or proceedings. *See* Release No. 33,7870, *supra* note 2, at *48.

98. *See id.*

99. Paragraph (b) of the proposed rule stated:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Under this standard, an accountant is not independent whenever, during the audit and professional engagement period, the accountant: (1) [h]as a mutual or conflicting interest with the audit client; (2) [a]udit's the accountant's own work; (3) [f]unctions as management or an employee of the audit client; or (4) [a]cts as an advocate for the audit client.

Release No. 33,7870, *supra* note 2, *45.

100. *Id.* at **45, 48; *see also* 17 CFR § 210.2-01(c)(4)(i)(I) (1999).

101. *See* Release No. 33,7870, *supra* note 2, at *7.

After four rounds of public hearings, the Commission revised the proposed rule and gained some support from the Big Five firms as a result of several compromises—compromises which included providing legal services.¹⁰² The SEC adopted “the broader [phrase] ‘admitted to practice before the courts of a United States jurisdiction’”¹⁰³ instead of the more restrictive “someone licensed to practice the law.”¹⁰⁴ The new rule states:

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement (c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section (4) An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client: . . . (ix) Legal services. Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.¹⁰⁵

The effect of this change in language is to prevent easy evasion through advocating with permission of the court and to maintain significant hurdles for accounting firms. This “phrase [also] appears to loosen restrictions on the Big Five’s international endeavors.”¹⁰⁶ The agreement on legal services has been met with mixed reactions. Supporters of the rule say that it will allow accounting firms to expand their law-related services, especially in an international context.¹⁰⁷ They claim that the SEC declined to adopt restrictive definitions of the terms “legal services” and “affiliate”—the former to allow expansion of domestic activities, and the latter to allow for joint ventures in legal services abroad.¹⁰⁸ On the other hand, critics of the rule perceive it as providing broader prohibitions.¹⁰⁹

Other minor adjustments included the decisions not to ban expert services under the non-audit services category and to mandate

102. See generally William R. McLucas & Paul R. Eckert, *The Securities and Exchange Commission’s Revised Auditor Independence Rules*, 56 Bus. Law. 877 (2001).

103. *Id.*

104. *Id.*

105. Release No. 33,7919, *supra* note 12, at **107–15.

106. Geanne Rosenberg, *SEC’s new rules will likely allow Big Five to expand legal services*, NAT’L L.J., at B7 (Dec. 4, 2000).

107. See *id.*

108. *Id.*

109. See McLucas & Eckert, *supra* note 102, at 909.

the use of proxy statements to disclose consulting information.¹¹⁰ The Commission unanimously adopted the proposed rule on November 15, 2000.¹¹¹

B. The SEC's Arguments in Support of the Final Rule

In the text accompanying both the proposed and final rules, the SEC bolsters its position with two general arguments. The first argument is that the auditor becomes vulnerable to economic pressure from audit clients in certain situations.¹¹² The SEC believes accountant objectivity is nearly impossible to achieve when there is a commitment to many large, non-audit engagements.¹¹³ It contends that American capital markets are vibrant because the public is confident the information they receive is whole, unbiased, and accurate.¹¹⁴ This confidence begets a willingness to invest because the public is certain it is making a fully informed decision to invest in a solid company. In the economy's current climate of risky ventures and start-ups, the Commission feels the need for full disclosure is greater than ever.¹¹⁵ The SEC presumes that there must be a rule to guard the professionalism of accountants who may be unduly influenced by fluctuations of the market.¹¹⁶

Weaved into this first argument is the Commission's concern about the change in sources of revenue for accounting firms. It estimates that only thirty percent of revenue is derived from auditing services.¹¹⁷ The Commission and its proponents fear that accounting firms have been using auditing services as part of a "loss leader" scheme, in which the client is pulled in with audit services, a process required by SEC regulations, and then sold superfluous and costlier non-audit services.¹¹⁸ The SEC fears that in order for the accounting

110. See *id.*

111. See McLucas & Eckert, *supra* note 102, at 877.

112. See Release No. 33,7870, *supra* note 2, at **6-7; Release No. 33,7919, *supra* note 12, at **9-12.

113. See Release No. 33,7919, *supra* note 12, at **9-12.

114. See Gretchen Morgenson, *S.E.C. Seeks Increased Scrutiny and New Rules for Accountants*, N.Y. TIMES, May 11, 2000, at C1.

115. See Release No. 33,7919, *supra* note 12, at **2-3.

116. See Laurie Hatten-Boyd, *Ebbs and Tides and Water Rise—What's the Real Concern with MDPs?*, 53 TAX LAW. 489, 492 (2000).

117. See Morgenson, *supra* note 114, at 11.

118. See Dave Dasgupta, Editorial, *Don't Let Big Five End Run the SEC*, WALL ST. J., July 6, 2000, at A27 (stating the issue of audit services being used as a loss leader was also thoroughly discussed at the Public Hearings before the Commission). The view on the loss leader concept with respect to accounting firms is somewhat disjointed. Recently, SEC Chief Accountant Turner stated that audits as loss leaders is a myth, speculating that ac-

firm to obtain consulting fees, the auditors may not conduct themselves as rigorously as they would otherwise.¹¹⁹ Thus, the so-called “mutuality of interest” interferes with the accuracy and unbiased perspective of the auditor.¹²⁰

The second general argument the SEC proffers is that there are independence issues inherent in the nature of certain non-audit services.¹²¹ The Commission and the proponents of the Rule claim that a ban on non-audit services is necessary to protect investors.¹²² The basic duty of an auditor is to present a neutral financial picture, while the duty of a lawyer is to advocate for his or her client. Supporters of the Rule claim the idea of auditors and lawyers working under one roof presents fundamental inconsistencies that cannot be reconciled.¹²³ They argue that lawyers employed by accounting firms cannot be trusted to provide competent and conflict-free representation, thereby adversely affecting the objective accuracy of the audits.¹²⁴

Supporters of the Rule also view confidentiality as another area where lawyers and auditors cannot work together.¹²⁵ They argue that tension arises from the differences between the “core values” of a lawyer, such as privilege, professional standards, and ethical requirements, and those of an auditor.¹²⁶ For example, while discussions between a lawyer and her client are protected,¹²⁷ the same information given to an auditor must be disclosed.¹²⁸

As an example of compromised auditor independence, the Commission cites a company hiring its audit firm to perform valuations of

counting firms use this perception to leverage prices for higher-margin business. See *CPA Fees Source: Accounting Office Management & Administration Report*, CFO, CONTROLLER'S REPORT, Feb. 2001, at 6, available at 2001 WL 18273729. However, it is claimed that the Chief Accountant had little or no support to back this allegation. See *id.* Again, auditing firms are quick to reject the loss leader theory, admitting that they make money on audits. See *id.*

119. See *id.*

120. Michael Schroeder & Judith Burns, *Levitt Seeks Rules to Curb Audit Firms' Conflicts*, WALL ST. J., May 10, 2000, at A2 (noting that SEC Chief Accountant Lynn Turner, concerned about accounting firms mixing consulting and auditing, stated, “[a]udit firms should not be part of a web of business relationships that gives them a mutuality of financial interest with an audit client.”).

121. See Release No. 33,7919, *supra* note 12, at *12.

122. See Bruce A. Green, *The Disciplinary Restrictions on Multidisciplinary Practice: Their Deviation, Their Development, and Some Implications for the Core Values Debate*, 84 MINN. L. REV. 1115, 1144–45 (2000); see also Release No. 33,7919, *supra* note 12, at *4.

123. See Release No. 33,7870, *supra* note 2, at *24.

124. See *id.*

125. See Green, *supra* note 122, at 1144–45; Kostant, *supra* note 4, at 50–51.

126. See Green, *supra* note 122, at 1144–48.

127. See Kostant, *supra* note 4, at 50–51.

128. See *id.*

in-process research and development.¹²⁹ The SEC claims that in this situation, the audit firm is responsible not to the public, but to the company's management.¹³⁰ It can be assumed that the decisions are being made to please management, which jeopardizes the auditor's independence and his duties to the public. The SEC attempts to avoid this tension through the amendment of the auditor independence regulations.

III. Analysis and Criticism

This Comment focuses on the SEC position that an auditor cannot be independent when he provides legal services for his client.¹³¹ This assumption has the potential to do far more harm than good, and the SEC should consider less intrusive regulations. The SEC is wrong to compare the independence-threatening characteristics of other prohibited non-audit services with those of legal services. This position views the lawyer one-dimensionally, solely capable of acting as an advocate; however, in contemporary commercial settings, lawyers play many roles. Further, legal services do not share the same qualities as the other non-audit services. For example, in non-audit services such as bookkeeping or management functions, the auditor becomes involved in the functioning of the client company. The lawyer, on the other hand, offers advice but cannot make final decisions for the client. Given the differences between the two types of non-audit services, legal services and other non-audit services should be treated differently by the SEC.

In addition, the auditor independence rule will likely touch every accounting firm or partnership in the country, since many state accounting boards have indicated that they will adopt the amended SEC regulations.¹³² This is not an issue which promises to affect solely the Big Five accounting firms.¹³³ The smaller auditing and accounting firms believe they will be significantly impacted by the SEC's new rule,

129. See Release No. 33,7870, *supra* note 2, at *2.

130. See *id.*

131. Some observers have commented that the legal field's proscription of fee sharing and the like, are an attempt to preserve lawyers' monopoly of the field. See Green, *supra* note 122, at 1129; see also Gary A. Munneke, *A Nightmare on Main Street (Part MXL): Freddie Joins an Accounting Firm*, 20 PACE L. REV. 1, 15-16 (1999); Schwab, *supra* note 23, at 1432 n.37.

132. See *Partner's Report for CPA Firm Owners*, at <http://www.accountingweb.com> (last modified Nov. 9, 2000).

133. See *id.*

even though they do not serve any SEC registered clients.¹³⁴ They are also concerned that the comment period is too short to sufficiently delve into the potential consequences of the Rule and are troubled by the lack of empirical evidence supporting the SEC's position.¹³⁵ Small accounting firms estimate that profits will decrease for both them and their small business clients, and thus they will be forced to cut up to fifty percent of their workforce; they are also concerned that the Rule will adversely impact their ability to recruit new talent.¹³⁶

Unfortunately, the SEC is not willing to fully consider the ramifications of the new Rule. In fact, it has dismissed the concerns of smaller accounting firms as being "so hypothetical that it's irrelevant to our decision at this point."¹³⁷ The SEC's obvious indifference lends truth to allegations that the Commission is not being objective. Its two main arguments are flimsy and are not truly faithful to its pledged purpose of protecting the public.

A. A Rebuttal to the SEC's Claim That Economics Should Not Be a Motivating Factor

The SEC's primary argument is that mixing the two professions—auditing and legal services—creates an economic motive.¹³⁸ However, this is an unfair proposition in the modern economy which is, and traditionally has been, driven by profit margin. When the law mandates a particular economic activity such as an audit, the reasons for performing the audit are not profit driven.¹³⁹ In economic terms, the price of a service (or its value) is a representation of the service's utility or how much an individual wants or demands it. Once a particular good or service is mandated, its value is no longer accurately reflected in its cost because the want or demand of the individual becomes irrelevant. Thus, by requiring audits, the SEC has broken the economic link between utility and cost.¹⁴⁰ It is also imprecise to compare the

134. See Hearing Testimony Day 2, *supra* note 72, at **72-74 (Sept. 13, 2000) (testimony of Gary Shamis).

135. See *id.*

136. See *id.* at **73-74.

137. *Id.* at *74 (testimony of Arthur Levitt) (responding to the concerns of Gary Shamis, who was representing the fiftieth largest accounting firm in the United States and believed that the state of Ohio would use the SEC regulations as a benchmark for its own independence standards).

138. See Release No. 33,7870, *supra* note 2, at *6.

139. See Hearing Testimony Day 2, *supra* note 72, at **108-09 (testimony of Rajib Doogar).

140. See *id.* at *108.

revenues brought in by audits with those brought in by fees for consulting—where cost more precisely reflects the service's value.

Furthermore, there is a disincentive to be honest and unbiased when the party to be critiqued is also the party who is paying for the service. Specifically, the fact that the paying client-company wants a positive audit recommendation creates pressure on the auditor to deliver.¹⁴¹ Since the audit has the potential to recur every year, versus consulting or legal services which are no longer needed after the project or case has been completed, this pressure is magnified.¹⁴² So, even without providing non-audit services, there is a tendency for the accounting firm to attempt to please the company it audits because of the potential for repeat business.¹⁴³ “[A]s long as auditing firms are hired by their clients who can hire and fire and negotiate with them at will, the possibility of true independence no longer exists because a negative report has negative implications for the auditing firm as well.”¹⁴⁴ Regardless of whether non-audit services are performed, true independence is elusive. The only way to avoid this would be to have audits performed by public or governmental auditing firms, an idea which has been rejected by Congress.¹⁴⁵

B. Legal Services and Audits Necessarily Conflict—A Four Part Rebuttal

The SEC's second argument in support of the new auditor independence rules asserts that, in certain non-audit services such as legal services, there are inherent and irreconcilable independence conflicts.¹⁴⁶ This rationale can be discredited by four distinct points. First,

141. See generally Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597 (2000) (claiming the self-serving bias affects auditors as much as attorneys, but that the effect would be greater with the presence of non-auditing services).

142. See *id.* at 1631–33.

143. See Hearing Testimony Day 3, *supra* note 85, at *27 (testimony of Robert K. Elliott) (noting that auditing is quite profitable for accounting firms, and at the gross profit level is the most profitable). Thus, auditors would strive to keep this lucrative relationship regardless of non-audit services.

144. Hearing Testimony Day 1, *supra* note 85, at *68 (testimony of Max H. Bazerman, Professor, Kellogg Graduate School of Management, Northwestern University); see also Hearing Testimony Day 3, *supra* note 85, at *59 (testimony of Don N. Kleinmuntz, Professor of Business Administration, University of Illinois at Urbana-Champaign) (stating that “[l]imiting or restricting non-audit services will not eliminate the economic relationship”).

145. See Hearing Testimony Day 3, *supra* note 85, at *43 (testimony of Stephen G. Butler, Chairman of KPMG).

146. See Release No. 33,7870, *supra* note 2, at *7; Release No. 33,7919, *supra* note 12, at *12.

the current structure of accounting firms providing legal services is a result of market forces and should be left alone. Second, the core values of attorneys and accountants can be reconciled. Third, the SEC rule as it presently defines "advocacy" is far too broad and will be difficult to enforce. Finally, other accounting models have demonstrated that providing both auditing and legal services are not inconsistent tasks.

1. The Current Market Structure Is Beneficial to Consumers

Among its concerns, the SEC cited the fact that the marketplace has changed dramatically in recent years due to technical advances and that it was unsure if auditor independence standards were still being met.¹⁴⁷ However, this concern is unfounded because market demand is moving toward an area where lawyers and accountants can work side by side for the benefit of clients.¹⁴⁸ Additionally, "[t]he global economy and the Internet communication system place demands on professionals that can be met only in a teaming approach."¹⁴⁹

The SEC's concerns ignore the fact that the current market was not created by the Big Five firms, but is a result of the changing consumer demand for legal services.¹⁵⁰ Business practices have become so complex in the modern economy that several different genres of services, especially legal services, are required to fully comprehend the ramifications of a single transaction.¹⁵¹

There are several consumer benefits to having accounting and auditing firms provide non-audit services, especially legal services. First, the client receives the advantage of an integrated team approach.¹⁵² From the auditor's perspective, the more the auditor knows about the company he audits, such as knowledge gained through providing non-audit services, the more effective the audit.¹⁵³ Conversely, the more a lawyer knows about his client, the better the advice rendered, thereby benefiting the client through the coordination of collective knowledge.¹⁵⁴

147. See Release No. 33,7870, *supra* note 2, at *2.

148. See Kostant, *supra* note 4, at 43.

149. Dzienkowski & Peroni, *supra* note 68, at 123.

150. See Hatten-Boyd, *supra* note 116, at 507.

151. See Kostant, *supra* note 4, at 50.

152. See Dzienkowski & Peroni, *supra* note 68, at 117-18.

153. See *id.*

154. See *id.*

Second, the pairing of lawyers and accountants results in an efficiency of time and money, as well as an increase in the quality of service.¹⁵⁵ The client-company will save time by dealing with only one service provider rather than several.¹⁵⁶ It will save money through the economies of scale, where the average cost of producing a service decreases with increased production of that service.¹⁵⁷ The increase in the quality of services results from the variety of specialized skills the accounting firms can offer clients.¹⁵⁸

Since the “establishment of MDPs will not decrease the number of professional services firms competing for client business, but instead will expand product offerings, the introduction of multidisciplinary services is more likely to increase rather than decrease competition in the market for professional services.”¹⁵⁹ Such a laissez-faire situation would allow for the genesis of innovative services benefiting the public by providing additional services, such as assisted negotiation.¹⁶⁰ Experts are confident that the market, if left alone, will self regulate and work itself out.¹⁶¹

2. Similarities in the Core Values of Lawyers and Accountants

Supporters of the proposed Rule argue there are inherent and incompatible differences between the core values of a lawyer and those of an accountant. The two areas of dispute are client privilege and confidentiality, and ethical standards. Supporters of the proposed Rule claim that accountants, unlike lawyers, have no privilege of confidentiality to the client—since their duty is to the public, they must disseminate any information they find to the general public.¹⁶²

155. *See id.* at 118–19.

156. *See id.*

157. *See id.* at 119.

158. *See id.*

159. *Id.* at 121.

160. *See* Elijah D. Farrell, *Accounting Firms and the Unauthorized Practice of Law: Who Is the Bar Really Trying to Protect?*, 33 IND. L. REV. 599, 622 (2000); *see also* Ann L. MacNaughton, *Law Practice in the 21st Century: Assisted Negotiations and Multidisciplinary Problem-Solving* (1999), available at <http://www.abanet.org/lpm2/mdp/macnaug1.html> (last visited Mar. 30, 2001); Ann L. MacNaughton, *Multidisciplinary Practice: Strategic Response to Transformation of Global Business Realty* (1999), available at <http://www.abanet.org/lmp2/mdp/macnaug2.html> (standing for the proposition that the new global structure impacts lawyers in two ways: (1) an increase in demand for assisted negotiation in business dispute resolution, and; (2) an expanded use of multidisciplinary cost-shared problem-solving and dispute resolution models); John Gibeaut, *Cash Boughs*, A.B.A. J., Feb. 2001, at 50.

161. *See* Dzienkowski & Peroni, *supra* note 68, at 205.

162. *See* Kostant, *supra* note 4, at 50–51.

However, this argument is flawed. First, AICPA Rule 301 prohibits accountants from disclosing confidential information or attesting to financial statements without consent.¹⁶³ Thus, accountants do not have an absolute duty to disclose all information.¹⁶⁴ General counsel for a Big Five firm stated that there is “‘little real conflict’ between protecting client confidences and making full disclosure in audits.”¹⁶⁵ Even though legal counsel receives confidential information, the privilege is not always absolute—such counsel should always advise their client to fully disclose information to its auditors.¹⁶⁶ There is “an independent duty to disclose all material information to their auditors regardless of the attorney-client privilege.”¹⁶⁷ The attorney-client privilege also does not protect communications in furtherance of a crime or fraud because these are not within the proper function of a lawyer providing legal assistance.¹⁶⁸

Further weakening the supporters’ argument, Congress enacted an amendment to Internal Revenue Code section 7525 in 1998, which creates a tax practitioner-client privilege.¹⁶⁹ Under this provision, the same standard of confidentiality applies to certain communications between a federally authorized tax practitioner and the client, as between attorneys and their clients.¹⁷⁰ “Nevertheless, the creation of this privilege represents congressional recognition of the key role that accountants and other non-lawyers who are admitted to practice before the IRS play in tax return preparation, tax planning, and tax controversy work.”¹⁷¹

Allegations of superior ethical standards for lawyers are based on inaccurate assumptions.¹⁷² The traditional roles of lawyers and ac-

163. See Hatten-Boyd, *supra* note 116, at 498–99.

164. See Kostant, *supra* note 4, at 60.

165. *Id.* at 52.

166. *See id.*

167. *Id.*

168. *See id.* at 64.

169. *See* I.R.C. § 7525 (2001).

170. *See* Dzienkowski & Peroni, *supra* note 68, at 110.

171. *Id.*

172. *See* Green, *supra* note 122, at 1144–48 (stating that a lawyer’s core values are based on five premises: (1) lawyers are better; (2) lawyers’ rules are better; (3) non-lawyers are corrupt; (4) non-lawyers corrupt lawyers; and (5) lawyers’ norms are non-negotiable); *see also* Hearing Testimony Day 3, *supra* note 85, at *3 (testimony of Robert Elliott).

You start with a presumption or a statement that audit failures and restatements are up and that there’s something wrong with accounting. You then assume, perhaps, that one of the reasons this might be happening is impaired independence of accountants. And you go from there to looking at why that impairment might exist, and you see these non-audit services which are growing and perhaps believe

countants are quite different. The lawyer acts as both a confidential advisor and advocate, while the accountant's "public responsibility transcends any employment relationship with the client."¹⁷³ However, this paradigm is becoming less and less true, especially in the context of transactional lawyers dealing with corporate clients, since the main objective of the transactional lawyer is to advise, not to advocate.¹⁷⁴ Although the concept of independence may not be identical for both professions, there is no reason why lawyers in consulting or accounting firms cannot be held to the same standard as those employed by traditional law firms.¹⁷⁵ In fact, lawyers—especially transactional lawyers—and accountants share more similarities than many people believe. Among the parallels between the two occupations are the governance by autonomous, self-regulating authorities,¹⁷⁶ the same professional standards in SEC proceedings,¹⁷⁷ and relatively little need for the attorney-client privilege in securities cases.¹⁷⁸

3. Difficulty in Enforcement of "Advocacy"

If the SEC adopts a proscription of legal services, such a proscription will be difficult to enforce. As written, the definition of the term

that some of those services are impairing independence, and therefore, the proposing release would, essentially, cut them off.

Id.

173. Kostant, *supra* note 4, at 59.

174. See generally Peter C. Kostant, *Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice*, 84 MINN. L. REV. 1213 (2000) (claiming the market for legal services is changing and that corporate lawyers will play an important role in facilitating the transition).

175. See Kostant, *supra* note 4, at 62.

176. See *id.* at 62. The self-regulation requirements are set forth by the AICPA for accountants and the ABA for lawyers.

177. See *id.* At SEC proceedings, both lawyers and accountants have been found liable for negligently failing to protect corporate clients from the misconduct of client managers. *Id.*

178. "Commissioner Randolph, in a recent opinion, reiterated that 'neither Rule 2(e), nor the court's recognition of it, have ever drawn distinctions between accountants and attorneys (footnote omitted).'" Kostant, *supra* note 4, at 61 (arguing that corporate lawyers practicing transactional work are "advisors" and not "advocates" and as such, are akin to accountants. He also asserts that since SEC proceedings are non-adversarial, there is little need for the attorney-client privilege, thus, severely weakening a key argument of the SEC.).

“advocacy” is entirely too broad¹⁷⁹ and will be open to differing interpretations.¹⁸⁰

The definition of “advocacy” should be clarified . . . to exclude customary auditor/client relationships which do not threaten independence . . . the normal by-products of good audit recommendations from an auditor to the client to enhance their controls, improve the efficiency of their business, [and] lawfully minimize the taxes they pay.¹⁸¹

The prohibition assumes an organization cannot be independent in providing legal services. In order to avoid lawyers and accountants finding loopholes in the proposed rule, the SEC should consider adopting a flexible principle rather than a strict ban, similar to the prohibition on insider trading.¹⁸² A rule based upon flexible principles will allow those charged with enforcing the auditor independence rule to better adhere to the intent of the SEC, while avoiding being both under-inclusive and over-inclusive.

4. Existing and Theoretical Models

There are several existing and theoretical models which have demonstrated that providing legal services is not necessarily inconsistent with auditor independence. The existing models include tax services, the Bar Association of the District of Columbia plan, and the Canadian and British models.¹⁸³ The six theoretical models are: (1) the cooperative model; (2) the command and control model; (3) the ancillary business model; (4) the contract model; (5) the joint venture model; and (6) the fully integrated model.¹⁸⁴ The fully integrated

179. See Honorable Charles L. Briant, *Is It the End of the Legal World As We Know It?* 20 *PAGE L. REV.* 21, 25 (1999).

180. See Hearing Testimony Day 2, *supra* note 72, at *39 (testimony of Nancy Newman LaMata, N.Y. Society of CPAs) (stating that there may be situations where an accountant may need to become an advocate).

181. Hearing Testimony Day 1, *supra* note 85, at *9 (testimony of J. Michael Cook, former Chairman and CEO of Deloitte & Touche); see also Hearing Testimony Day 3, *supra* note 85, at *79 (testimony of Ronald Nielsen, Iowa Accountancy Examining Board).

182. See DAVID L. RATNER & THOMAS LEE HAZEN, *SECURITIES REGULATION* 616 (5th ed. 1996) (stating that Rule 10b-5, employed most often for insider trading violations, does not specifically refer to or define the term “insider trading.”).

183. See Mary C. Daly, *Choosing Wise Men Wisely: The Risks and Rewards of Purchasing Legal Services from Lawyers in a Multidisciplinary Partnership*, 13 *GEO. J. LEGAL ETHICS* 217, 243 (2000); Hatten-Boyd, *supra* note 116, at 500–01 (discussing the parallel between providing tax services and providing other legal services); see also Charles C. Wolfram, *LEGAL ETHICS: In-house MDPs?* *NAT'L L. J.*, Mar. 6, 2000, at B6 (suggesting the Canadian model as a solution for the United States).

184. See Dzienkowski & Peroni, *supra* note 68, at 153.

model does away with the freestanding law firm.¹⁸⁵ The benefits of this model are the seamless provision of services and the promotion of teamwork and cooperation.¹⁸⁶ However, it is this model the supporters of the SEC's new Rule oppose.¹⁸⁷

In the context of tax services, the preparer of a tax return, whether accountant, auditor, or lawyer, is given protection equivalent to the attorney-client privilege afforded to lawyers.¹⁸⁸ In a tax setting, courts recently recognized that the practice of law overlaps with the practice of accounting, and have rejected the use of a rigid approach.¹⁸⁹ However, if Congress has concluded that a tax preparer merits privilege, then other legal services should not be barred as inconsistent with accounting and consulting.

The Bar Association of the District of Columbia has allowed lawyers in a partnership to share legal fees with non-lawyers; however, it does not permit the same freedom of services offered by accounting and auditing firms outside of the United States.¹⁹⁰ Additionally, Model Rule of Professional Conduct Rule 5.4 requires that the sole purpose of the partnership be to provide legal services and that non-lawyers must adhere to the same standards of professional conduct as lawyers.¹⁹¹ However, the regulation does not define or limit the vocation of the non-lawyer partner.¹⁹² The comments to the Rule refer to several types of partnerships, including "public accountants working in conjunction with tax lawyers or others who use accountants' services in performing legal services."¹⁹³

Although it was expected that Washington, D.C., would become the center for auditing and accounting firms in the United States, this did not happen.¹⁹⁴ Few accounting firms have taken advantage of the rule because the requirement that providing legal services be the sole function of the enterprise has proved troublesome.¹⁹⁵ Furthermore, firms with offices throughout the United States have found it hard to

185. See Daly, *supra* note 183, at 226.

186. See Dzienkowski & Peroni, *supra* note 68, at 171.

187. See Daly, *supra* note 183, at 226.

188. See Hatten-Boyd, *supra* note 116, at 500-01; see also Kostant, *supra* note 174, at 1264-65 (arguing that patent lawyers have successfully maintained high ethical standards in a non-litigation context where both lawyers and non-lawyers can act as agents).

189. See Farrell, *supra* note 160, at 606-08.

190. See Daly, *supra* note 183, at 243.

191. See *id.*

192. See *id.*

193. *Id.* at 244.

194. See *id.*

195. See *id.*

balance the Washington, D.C., rule with the total ban on non-audit services in other states.¹⁹⁶

The international landscape is rapidly changing while the United States is standing still—resisting change and the unknowns of multidisciplinary practices.¹⁹⁷ The United Kingdom was the first to take steps toward approving multidisciplinary practices, allowing lawyers and non-lawyers to work together.¹⁹⁸ England's solution applies the same standard of confidentiality to international accounting firms as to lawyers in the same position.¹⁹⁹ Although current rules do not allow for fee-sharing, they do allow for close relationships between solicitors and non-lawyers.²⁰⁰ Thus, firms are able to provide a broader range of services, although total cooperation between the two professions is not yet possible.²⁰¹ Presently, there is a movement toward permitting solicitors to join with non-lawyers and toward permitting still stronger alliances.²⁰²

Both Canada and Australia have followed suit.²⁰³ Canada allows ownership and fee-sharing between lawyers and non-lawyers and encourages the adoption of rules which aid auditing and accounting firms in providing a full range of services.²⁰⁴ Australia is considering whether to allow law firms to incorporate, to share legal fees with non-lawyers, and to participate in passive investment on the Australian Stock Exchange.²⁰⁵

The initiative of Washington, D.C.'s Bar Association has suggested that the sole motivation for opposing lawyers and accountants working together is not compromised independence, but preservation

196. *See id.*

197. *See Commission on Multidisciplinary Practice Updated Background and Informational Report and Request for Comments*, at **3–4, available at http://www.abanet.org/lpm/mdparticle12210_front.shtml (1999).

198. *See id.*; *see also* Michael Simmons, *The Accountants Are Coming A Practical Lawyer's Survival Kit* (1998), available at <http://www.abanet.org/lpm2/mdp/simmons1.html> (last visited Mar. 30, 2001). For a European perspective, *see* Michael Simmons, *Multidisciplinary Partnerships: Who's Afraid of The Big Bad Wolf?* (1998), available at <http://www.abanet.org/lpm2/mdp/simmons2.html> (last visited Feb. 7, 2001).

199. *See* Anthony E. Davis, *Multijurisdictional Practice by Transactional Lawyers—Why the Sky Really Is Falling*, *PROF. LAW.*, Winter 2000, at 23; *see also* Hearing Testimony Day 2, *supra* note 72, at **96–97 (testimony of Graham Ward, President of Institute of Chartered Accountants in England and Wales) (suggesting that the new regulations would be in conflict with European law).

200. *See* Dzienkowski & Peroni, *supra* note 68, at 116–17.

201. *See id.*

202. *See id.*

203. *See* Daly, *supra* note 183, at 116.

204. *See* Dzienkowski & Peroni, *supra* note 68, at 116.

205. *See id.*

of monopoly.²⁰⁶ Prohibitions on lawyers and non-lawyers working together have significant anti-competitive effects on how demands for legal services in the workplace are satisfied.²⁰⁷ Further, if the birthplace of American jurisprudence finds it acceptable to allow the two professionals to work together, the SEC must have a motive other than auditor independence. To truly benefit the public, the Commission should have postponed its decision regarding auditor independence until it had evidence of violations or a better understanding of the effects. The Commission should now retract its restrictive new Rule, just as it did with the proxy statements in 1982.

C. What the SEC Should Have Done

Accounting firms providing more than just auditing services are a recent phenomenon; however, they had been providing additional services without reprimand prior to the SEC's new Rule.²⁰⁸ The firms experienced only a few compromises of auditor independence during the period prior to the SEC's new Rule.²⁰⁹ This makes the SEC's reaction not one based on observation, but one of assumption, and thus is without support.

The SEC outlined two major areas of concern regarding auditor independence: economic motivation and threatened core values. However, the SEC's fears were misplaced. Instead of reacting to change, the SEC should have allowed more time to consider the full ramifications of its new Rule. The SEC should have selected a fully integrated model complemented by a transition period. The downfall of all other models is that, without full cooperation, the benefits of lowered costs and increases in quality of services are not realized, as seen in the Washington, D.C., model.

Further, our economy is driven by a laissez-faire spirit. When their entrepreneurial spark is stifled, businesses will undoubtedly

206. See Briant, *supra* note 179, at 26–27, Judge Briant discusses Judge Richard A. Posner's view of the legal profession as being like:

other medieval guilds, . . . built on selfish, anti-competitive restrictions on entry and on the conduct and pricing of the work. This view of the legal profession is as some hulking monopoly with its feet in the Middle Ages, milking clients for the cost of unnecessary, duplicative, and occasionally inefficient services . . . and at the same time hiding behind ethical rules that do nothing but curtail good old-fashioned competition.

Id. (footnotes omitted).

207. See Dzienkowski & Peroni, *supra* note 68, at 93.

208. See Kostant, *supra* note 4, at 4–5.

209. See *id.*

move elsewhere.²¹⁰ The SEC should take the initiative to foster, rather than discourage, a market which includes fully integrated accounting firms.

Conclusion

In conclusion, the SEC prematurely banned legal services from auditing and accounting firms. The fundamental assumption made by the SEC is wrong—that acting as a lawyer for an audit client necessitates bias. In the text preceding the proposed rule, the SEC states regarding the ability to quantify the impairments to independence, “[s]tudies cannot always confirm what common sense makes clear.”²¹¹ In the long run, the Commission’s decision will likely do more harm than good.

210. See *Dzienkowski & Peroni*, *supra* note 68, at 205–06.

211. Release No. 33,7870, *supra* note 2, at *7.