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SEC Accounting Series Release No. 150: A Critical Analysis

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Notes

SEC Accounting Series Release No. 150: A Critical Analysis

Without soliciting prior public comment, the Securities and Exchange Commission (SEC) publicly issued Accounting Series Release No. 150[1] (ASR 150) on December 20, 1973. In that release the Commission reaffirmed an earlier policy statement contained in Accounting Series Release No. 4[2] (ASR 4) that financial statements, prepared in accordance with accounting principles for which there is no substantial authoritative support, will be presumed misleading, and that footnotes or other disclosures will not avoid this presumption. ASR 150 states, for purposes of the policy contained in ASR 4, that pronouncements of the Financial Accounting Standards Board[3] (FASB) will be considered by the Commission as having substantial authoritative support. However, ASR 150 further states that accounting practices contrary to any FASB promulgations will be considered as not having substantial authoritative support and will consequently be *presumed* misleading.

On June 15, 1976, Arthur Andersen & Co. (Andersen)[4] filed a petition with the SEC requesting that ASR 150 and another release, ASR 177,[5] by

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[1]5 Fed. Sec. L. Rep. (CCH) ¶72,172 (Dec. 20, 1973). In 1972 the SEC amended Rule 1-01(a) of Regulation S-X to provide for the incorporation therein of all Accounting Series Releases which currently number over 247.

[2]5 Fed. Sec. L. Rep. (CCH) ¶72,005 (April 25, 1938).

[3]The Financial Accounting Standards Board was empowered by the American Institute of Certified Public Accounts (AICPA) effective July 1, 1973, to establish accounting principles to be known as Statements of Financial Accounting Standards. FASB succeeded two prior bodies of the AICPA which performed essentially the same functions. The Committee on Accounting Procedure (CAP) existed from 1939 to 1959 when it was succeeded by the Accounting Principles Board (APB), which continued to function up to the creation of FASB. The idea for FASB was the result of recommendations of the Study Group on Establishment of Accounting Principles (commonly known as the Wheat Committee), a committee appointed by the leaders of the accounting profession who were anxious to avoid government rule-making in accounting.

The advantages of FASB over its predecessors are that it is not directly answerable to the AICPA but to the Financial Accounting Foundation, a private organization, that its members are full time employees of the Board, and that the members are required to sever all private ties with firms and companies thus helping to assure its independence.

[4]Arthur Andersen & Co. is an accounting firm which is one of the eight largest accounting firms in the U.S. and has offices world-wide.

[5]In ASR 177, 40 Fed. Reg. 46107 (1975) 5 Fed. Sec. L. Rep. (CCH) ¶72,199, the SEC adopted a revision to Instruction H(f) for Form 10-Q reports which requires the independent accountants of an enterprise to indicate, when that enterprise has changed an accounting principle, "whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances." Andersen challenged the legality of ASR 177 on the procedural grounds that it was adopted and amended without compliance with the Administrative Procedure Act and the SEC's own rule-making regulations and on the

revoked and the term "substantial authoritative support," contained in ASR 4, be defined through the rule making procedures of the Administrative Procedure Act (APA), or alternatively, that ASR 4 be revoked also. The SEC issued ASR 193[6] in response to the petition, denying the request to revoke ASR 177 and deferring response to the other two requests until public comment had been received on three "basic issues."[7]

Two days after the SEC issued ASR 193, Andersen sought a temporary restraining order in federal district court to enjoin the enforcement of ASR 150 and ASR 177.[8] The court denied the temporary restraining order on August 13, 1976, as well as a petition for preliminary injunction on September 3, 1976.[9] In an oral opinion the court denied the preliminary injunction, concluding that ASR 150 should be characterized "as a method by which the SEC will evaluate accounting principles"[10] and not as a substantive rule. The court did not cite any legal principle or precedent to support its conclusion.

Andersen's suit for permanent injunction was dismissed on summary judgment in March of 1978 on the ground that Andersen lacked standing to sue.[11] The primary concern of the court was whether Andersen had suffered any economic injury as a result of ASR 150 or ASR 177;

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substantive grounds that it is arbitrary and capricious because of the burdens it places upon accountants and their clients. Andersen complained that ASR 177 shifted the responsibility to make the ultimate business decision of the advisability of an accounting change from a business standpoint, from the management of the enterprise to the independent accountant, which appears incompatible with the requirement that accountants be "independent". For a discussion of this issue see *Generally Accepted Accounting Principles Instruction H(f) and the Preferability Issue*, 11 VAL. U.L.J. 229 (1977).

[6] 5 Fed. Sec. L. Rep. (CCH) ¶72, 215 (July 27, 1976).

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> Before responding to Andersen's request, the Commission hereby solicits public comment on the following basic issues raised:
> 1. Should the Commission continue its policy of recognizing the pronouncements of the Financial Accounting Standards Board as providing a frame of reference for publicly held companies to satisfy their statutory disclosure obligations?
> 2. Should be Commission further define the phrase 'substantial authoritative support'?
> 3. Should the Commission further define the phrase accounting principles and practices used in Rule 2-02(c) of Regulation S-X [17 CFR 210.2-02(c)]?

Id. at ¶72,215.

[8] The district court in its opinion on the permanent injunction (See n. 11 *infra*) stated that they did not look upon Andersen's quick action with favor. They stated:

> An additional reason can be noted briefly that would support restraint in deciding the merits of the claim against ASR 150. . . . Plaintiff did not await the outcome of the SEC's deliberations, but filed this action on July 29, 1976. We look unfavorably on the fact that plaintiff bypassed the administrative procedures and sought to bring the question of validity of ASR 150 before the court prematurely.

Arthur Andersen & Co. v. SEC, 5 Fed. Sec. L. Rep. (CCH) ¶96,374 (N.D. Ill. March, 1978).

[9] The court summarily dismissed Andersen's challenge to ASR 150 in an oral opinion. Arthur Andersen v. SEC, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,720 (N.D. Ill., Sept. 3, 1976).

[10] *Id.*

[11] Arthur Andersen & Co. v. SEC. 5 Fed. Sec. L. Rep. (CCH) ¶96,374 (N.D. Ill. March, 1978).

however,the court also discussed the potential for civil or criminal sanctions because of either ASR 150 or ASR 177 but summarily dismissed that possibility in one paragraph.[12] In considering the risk of sanctions because of ASR 150, the court referred to its earlier determination in the preliminary injunction hearing that ASR 150 was not a substantive rule and stated that Andersen had not submitted anything subsequent to that decision to persuade the court to the contrary.

While Andersen failed to carry its burden of persuasion, the court's analysis is far from convincing that ASR 150 is merely a method by which the SEC will evaluate accounting principles. ASR 150 may in fact be a rule. This note explores that possibility, analyzes the scope and potential legal effect of ASR 150 on accountants and accounting within the context of SEC Rule 10b-5, and considers the impact of ASR 150 upon the concept of GAAP: "generally accepted accounting principles."

CHARACTERIZATION AND COMPLIANCE

The characterization of ASR 150 determines if there is a legal obligation upon accountants to comply with the release. If ASR 150 is a statement of policy as the SEC contended in the Andersen suit, accountants cannot be forced to comply with ASR 150 solely by ASR 150's own mandate. Some other rule or statute would have to be the source of the obligation.[13] However, if ASR 150 is a rule it would create an obligation to comply. Thus, the question is whether the mere labeling of a statement as policy is determinative of its effect.

Columbia Broadcasting System, Inc. v. United States,[14] directly addressed this issue. The Court held that the substance of what is done is controlling, not the label:

> The Commission argues that, since its Report *characterized the regulations as announcements of policy,* the order promulgating them is no more subject to review than a press release similarly announcing its policy. Undoubtedly, regulations adopted in the exercise of the administrative rule-making power, like laws enacted by legislatures, embody announcements of policy. But they may be something more. When, as here, the regulations are avowedly adopted in the exercise of that power, *couched in terms of command and accompanied by an announcement of the Commission* that the policy is one "which *we will follow in* exercising our licensing power," *they must be taken by those entitled to rely upon them as what they purport to be—an exercise of the delegated legislative power—which, until amended, are controlling alike upon the*

[12] *Id.* at p. 93,301.

[13] Pacific Gas Elec. Co. v. Federal Power Comm'n, 506 F.2d 33, 38-40, (D.C. Cir. 1974).

[14] 316 U.S. 407 (1942).

> *Commission and all others whose rights may be affected by the Commission's execution of them.*[15] (Emphasis added.)

ASR 150 is very similiar to the release in *CBS*. It states that FASB pronouncements "*will be considered* by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations *will be considered* to have no such support." The language is absolute and "couched in terms of [a] command." There are no words of discretion allowing SEC staff members to recognize deviations. Whatever the SEC's intent in promulgating ASR 150, they have created an absolute command which leaves accountants no choice but to comply.

CBS shows that the label attached to a pronouncement by the issuing agency does not control the duties imposed upon those within its reach. However, even if duties flow from a pronouncement, the question arises whether the rule is law. Professor Davis offers a framework for analyzing interpretive and legislative rules:[16]

> The law about the distinction ... is quite troublesome, but at the two extremes the law is quite clear. *One very solid proposition is this:* Whenever a legislative body has delegated power to an agency to make rules having force of law (whether or not the delegation is explicit) *the rules* the agency makes pursuant to the granted power *have the same force as a statute* if they are valid, and they are valid if they are constitutional, within the granted power, and issued pursuant to proper procedure; a court may no more substitute its judgment as to the content of a legislative rule than it may substitute its judgment as to the content of a statute.[17]

Thus ASR 150 would have the force of law if it is "constitutional, within the granted power, and issued pursuant to proper procedure." There appear to be no serious constitutional challenges to ASR 150.[18] The power

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[15]*Id.* at 422.

[16]The terms "interpretative rules" and "legislative rules" are not defined in the Administrative Procedure Act. A definition for "interpretative rules" can be found in the Attorney General's Manual on the Administrative Procedure Act (Manual 30, 1977). Reliance on this manual is well founded as the Attorney General's Office was integrally involved in the creation of the Administrative Procedure Act. In a footnote the Manual states that "the following definitions are offered: . . . INTERPRETATIVE RULES - rules or statements issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." On page 126 of ADMINISTRATIVE LAW, Davis states that "the term 'legislative' is now the one in general usuage to designate rules that are not interpretative."

[17]K. DAVIS, ADMINISTRATIVE LAW 126 (3rd ed. 1972) (emphasis added). Davis further states that "Four Supreme Court cases will show that the law in support of the proposition thus stated in quite clear." Those cases are: Public Utilities Comm'n. of Calif. v. United States, 355 U.S. 534, 542 (1958); Free v. Bland, 369 U.S. 663, 668 (1962); Abbott Laboratories v. Gardner, 387 U.S. 136, 151-52 (1967); FCC v. Schreiber, 381 U.S. 279, 289 (1965).

[18]Andersen did launch a constitutional challenge to the so-called "delegation of power to FASB." In its opening brief to support its motion for summary judgment it stated on pages 23-24 that:

> The delegation made in ASR 150 is contrary to the due process clause of the

of the SEC to promulgate ASR 150 and accounting rules generally is plenary.[19] That leaves only the question of whether ASR 150 was issued pursuant to proper procedure, one of the two grounds Andersen relied upon in challenging ASR 150. Even if ASR 150 is held to have been improperly issued in another proceeding, the SEC would probably reissue ASR 150 in accordance with APA requirements.[20]

This authority, together with *CBS*, leads to the conclusion that when an administrative agency properly issues a pronouncement that is absolute and certain in its language in an area that is both constitutional and within the agency's granted power, those subject to the pronouncement are compelled by law to comply with it. The SEC undoubtedly wants compliance with ASR 150; their only apparent reason for labeling it a statment of policy was to avoid the public notice and rule-making procedures of the Administrative Procedure Act. Accordingly, ASR 150 should be characterized as a rule and not a method.

Assuming that ASR 150 has the force of law and correspondingly compels accountants to comply with its terms, what is the standard for compliance? The FASB participated with the SEC on an informal basis in drafting ASR 150.[21] The FASB suggested a rule that would have given accountants assurance that accounting principles used when following FASB pronouncements would have substantial authoritative support and not be presumed misleading under ASR 4. That rule, had it been adopted, would merely have stated the obvious. However, the SEC modified the rule so that accounting principles contrary to FASB pronouncements would not have substantial authoritative support and be presumed misleading. The final language of the rule reads:

> For purpose of this policy [ASR 4], principles, standards and practices promulgated by the FASB in its Statements and In-

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Fifth Amendment to the Constitution. The broad, unreviewed power of the Financial Accounting Standards Board to make rules legally binding upon registrants and accountants is broader than any delegation ever sustained by the federal courts. The line of cases represented by *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936), has established a firm principle that a governmental agency cannot delegate rule-making power to a private group. . . . It is the failure to have review of the group's action by an agency prior to its effectiveness that has caused the Supreme Court to find a constitutional infirmity in the delegation. [Citations omitted.] Such failure is present in the instant case. Each new accounting pronouncement of the Financial Accounting Standards Board becomes automatically enforceable by the staff of the SEC upon its issuance.

[19]"The Commission may prescribe, in regard to reports made pursuant to this chapter, . . . the methods to be followed in the preparation of the reports. . ." 15 U.S.C. 78m(b) (1970). *See also* 15 U.S.C. 77s(a), 78c(b) (1970).

[20]This is what occurred when Andersen successfully challenged the SEC for not complying with the Administrative Procedure Act when issuing ASR 146. Arthur Andersen & Co. v. SEC [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94, 147 (D.D.C. Sept. 11, 1973) (summary of complaint). The complaint was voluntarily dismissed after the issuance of ASR 146A. Fed. Sec. L. Rep. (CCH) ¶66,123.14. It should be noted that ASR 146A, which was issued after the proper public proceedings, merely reaffirmed ASR 146.

[21]Brief for Plaintiff, Arthur Andersen & Co. v. SEC, *supra* note 11.

> terpretations will be considered by the Commission as having subtantial authoritative support, and those contrary to such FASB promulgations will be considered* to have no such support.
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> *It should be noted that Rule 203 of the Rules of Conduct of the Code of Ethics of the AICPA provides that it is necessary to depart from accounting principles promulgated by the body designated by the Council of the AICPA if, due to unusual *circumstances,* failure to do so would result in misleading financial statements. *In such a case, the use of other principles may be accepted or required by the Commission.*[22] (Emphasis added.)

The footnote creates uncertainty by requiring that one of two sets of accounting principles be used where "circumstances": (1) require the use of FASB principles, (2) allow the use of non-FASB principles, or (3) require the use of non-FASB principles.[23] This raises the question of when each accounting principle should be used.

The rule announced in the text of ASR 150 is absolute, while the footnote carves out an exception to the rule. The rule appears to be favored over the exception because it is preferentially positioned in the text and contains the words "will be considered" rather than "may be accepted or required." The key to the exception turns on the word "misleading". However, that one word does not provide sufficient guidance for interpretation. "Misleading" has several possible meanings: its everyday meaning, a meaning given it by courts in Rule 10b-5 suits, a new meaning for SEC purposes in accepting finanical reports, or the meaning as it appears in Rule 203 of the Rules of Conduct of the Code of Ethics of the AICPA. The latter meaning seems to be preferred since the footnote directly refers to the standard in Rule 203. However, it seems unlikely that a court would limit itself to the AICPA meaning. Thus accountants have a problem of choosing between FASB and non-FASB principles. Viewed in this context, ASR 150 is not an informative guide, but rather a rule raising the stakes for an accountant's wrong choice of accounting principles. If the SEC intended to provide a "safe harbor" for accountants, they failed to achieve their purpose.

RELATIONSHIP BETWEEN ASR 4 AND ASR 150

Any suit by an injured party relying wholly or partially upon ASR 150 will necessarily involve ASR 4 since the former is an extension of the latter. Thus,

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[22] 5 Fed. Sec. L. Rep. (CCH) ¶72,172 (Dec. 20, 1973).

[23] The term "non-FASB principles" is somewhat inaccurate in that the principles referred to not only lack connection with FASB they are at least in part contrary to an existing FASB pronouncement. However, due to convenience the term will be used to refer to these principles. It should also be noted that FASB pronouncements include the unsuperseded pronouncements of its predecessor boards.

an analysis of their relationship is warranted. The legal considerations applicable to ASR 150 seems equally applicable to ASR 4 which states:

> In cases where financial statements filed with this Commission pursuant to its rules and regulations . . . are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material . . . .

There is little textual difference between ASR 150 and ASR 4. They are both absolute in their language and limit the range of acceptable accounting procedures. Furthermore, ASR 4 not only restricts accounting principles, but also restricts disclosure formerly allowed in the certificate of the accountant and in the footnotes of the statement. Even if there is some legal reason not to consider ASR 4 as having the force of law itself, the same result may be achieved through ASR 150. ASR 150 restates ASR 4 almost verbatim and expressly reaffirms it with the words "For the purpose of this policy [ASR 4], principles, standards, and practices promulgated by the FASB . . . will be considered . . . as having substantial authoritative support . . . ." Thus ASR 4 may be considered as having the force of law either by itself or through incorporation into ASR 150.

This raises the novel question of whether an accountant could be deemed to have certified a financial statement that is misleading as a matter of law. It might be argued that using accounting principles contrary to an FASB pronouncement without proof that unusual circumstances require the exception to the rule in ASR 150 creates a financial statement presumed to be misleading. Since the issue of whether a financial statement is misleading is factually difficult to resolve, such a presumption could be important. If the presumption could not be overcome, the financial statement could be labeled misleading as a matter of law. This would be an absurd result and hopefully would not be accepted by any court.[24] However, even if a court did not accept "misleading as a matter of law," the violation of the duty owed under ASR 150 and the presumed misleading nature would probably have persuasive impact and increase the likelihood of civil liability.

CIVIL LIABILITY

If an accountant were sued for an impermissible deviation from ASR 150, the most likely basis for the suit would be a violation of Rule 10b-5.[25] ASR 150 would be a valuable tool in establishing the misleading nature of the financial statement. However, there would be two obstacles to a successful suit. One

[24]The trouble with the argument is not obvious at first glance. The standard which triggers the exception is not the unusual circumstances but the misleading nature of the financial statement if other principles were not used. Thus the trigger of the exception is the same as the presumption.

[25]17 C.F.R. §240.10b-5 (1978).

obstacle would be establishing the theoretical connection between ASR 150 and Rule 10b-5 so that a violation of ASR 150 would create more than just an inference that the statement was misleading. The second obstacle would be overcoming the 10b-5 scienter requirement established by *Ernst & Ernst v. Hochfelder.*[26]

The theoretical question can be more generally stated as: What analytical framework should be used in a 10b-5 suit to determine the effect of a violation of an SEC rule in an area that the SEC clearly has power to regulate? Four approaches are potentially applicable, by analogy, to a 10b-5 suit. They are:

1) *Colonial Realty*[27] doctrine of implying a cause of action for violation of an exchange or dealer association rule.
2) *Cort*[28] doctrine of implying a federal right of action.
3) Tort doctrine that violation of a statute constitutes prima facie evidence.
4) Sui generis approach.

The implied causes of action are the easiest to dismiss. The *Colonial Realty* doctrine is only applicable in the limited situations that almost always involve fraud.[29] It is obvious that ASR 150 violations do not fit that categorization. *Cort* requires that four factors be met before a federal right of action may be implied.[30] Because a person injured by a misleading financial statement would be in the special class to be protected and the cause of action is not one traditionally relegated to state law, two of the factors would be met. But a problem arises because ASR 150 is promulgated under the authority of plenary grant of power from which no legislative intent to create such remedy is indicated except by inference. The *Cort* doctrine comes closer than *Colonial Realty* but still is too troublesome to be useful.

The tort doctrine that violation of a statute, ordinance, administrative rule, or traffic regulation constitutes prima facie evidence has several requirments. They are:

1) Injury to a member of the class to be protected.
2) Injury must be due to the hazard the statute or rule intended to prevent.

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[26]425 U.S. 185 (1976).

[27]Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2nd Cir. 1966), *cert. denied*, 385 U.S. 817.

[28]Cort v. Ash, 422 U.S. 66 (1975).

[29]Sanders v. John Nuveen & Co., 554 F.2d 790, 797 (1977).

[30]The four factors are as follows:

(1) Is the plaintiff one of the class for whose especial benefit the statute was enacted?
(2) Is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one?
(3) Is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff?
(4) Is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

3) Violation must be the proximate cause of the injury.
4) The statute or rule is intended to set a standard of conduct for the defendant.[31]

ASR 150 would clearly meet all the requirements except number 3 which would have to be established in the materiality determination of each suit. However, one major problem with this doctrine is that the violation of the statute generally only establishes negligence which is not sufficient for finding liability under Rule 10b-5.[32] A more pervasive problem is establishing the nature of a Rule 10b-5 action since the strength of the analogy is a function of the relationship between tort law and a Rule 10b-5 action.

> Courts have considered whether 10b-5 is closer to tort or contract claim and if it should be treated as an equitable or legal cause of action. These distinctions assume importance when state law must be employed as an aid to federal jurisdiction, but otherwise 10b-5 should be treated as sui generis.
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> Courts placed great reliance on tort law when they first interpreted 10b-5. Although federal law controls, state law was used as an analogy or was incorporated into 10b-5 because it was consistent with the aims of the federal securities legislation. More recently, however, judges have not blindly adopted common law tort doctrines; instead they have ascertained whether l0b-5's purposes would be furthered by their assimilation into the Rule.[33]

Thus, the trend seems to be to consider Rule 10b-5 actions as essentially sui generis and to rely upon its purposes to establish its parameters. This injury forms the fourth type of approach.

Rule 10b-5(2) makes it unlawful to "make any untrue statement of a material fact. . . ."[34] This rule plays an important role for investors since financial statements are heavily relied upon by investors in making investment decisions. The main purpose of ASR 150 is to prevent the use of accounting principles which could produce misleading financial statements. Given this close similarity of purpose, the consideration of an ASR 150 violation would probably weight heavy in a court's determination of the misleading nature of the report. However, it would be difficult to establish that a violation of ASR 150 should be determinative of the misleading element of a Rule 10b-5 action.

But even if a violation of ASR 150 supplied the misleading element of a

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[31] M. BENDER, NEGLIGENCE, *§1.02[2]. Note that requirement 4 is optional.*
[32] See notes 34-36 *infra* and accompanying text.
[33] 1 A. JACOBS, THE IMPACT OF RULE 10B-5 § 14 (1977).
[34] 17 CFR §240.10b-5(2).

10b-5 action, there is another obstacle to a successful 10b-5 suit: *Ernst & Ernst v. Hochfelder.*[35] Although at least three circuit courts had held that negligence alone was sufficient for liability under 10b-5,[36] *Hochfelder* established the requirement of "scienter" for such violations and accordingly held that an action will not lie for negligence alone. *Hochfelder* the plaintiffs were suing auditors for not discovering the unusual mail rule of the president of the company, whereby he was able to fradulently obtain money from the plaintiffs. Since the complaint alleged that the auditors were merely negligent, the Court held for the auditors. It seems that *Hochfelder* would bar a 10b-5 action brought primarily on a ASR 150 violation. However, cases since *Hochfelder* cloud the issue considerably.

Hochfelder expressly left open the question whether recklessness would meet the scienter requirement.[37] The Court stated:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5.[38]

But cases decided since *Hochfelder* have overwhelmingly held that recklessness will suffice. The court in *Steinberg v. Carey*[39] noted, "Moreover, the Court notes the virtual unanimity of the cases considering the question since *Hochfelder,* that reckless conduct meets the scienter standard in a Rule 10b-5 claim."[40]

The effectiveness of *Hochfelder* as a bar to accountant's liability has been eroded by cases holding that recklessness will suffice and more importantly by their definitions of recklessness. In *McLean v. Alexander,*[41] the plaintiff was a highly sophisticated investor interested in buying all the stock of a small company involved with laser beam technology. The

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[35]Ernst & Ernst v. Hochfelder, *supra* note 26.

[36]*Id.*

[37]The Court also left open the question whether scienter was a necessary element in an action for injunctive relief under 10b-5.

[38]Ernst & Ernst v. Hochfelder, *supra* note 25, at n. 12.

[39]439 F. Supp. 1233 (1977).

[40]Some of the cases which hold that reckless conduct will meet the scienter requirement in Rule 10b-5 are: Nelson v. Serwold, Fed. Sec. L. Rep. (CCH) ¶96,399 (9th Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., Fed. Sec. L. Rep. (CCH) ¶96,275 (2d Cir. 1978); Wright v. Heizen Corp., 560 F.2d 236 (7th Cir. 1977); Sanders v. John Nuveen Co., 554 F.2d 790 (7th Cir. 1977); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977); Bailey v. Meister Bran, Inc., 535 F.2d 982 (7th Cir. 1977); Herzfeld v. Lavanthol, Krekstein, Horwath and Horwath, 540 F.2d 27 (2d Cir. 1976); Valente v. Pepsico, Inc., Fed. Sec. L. Rep. (CCH) ¶96,496 (D.C. Del., 1978); Weinberger v. Kendrich, 432 F. Supp. 316 (S.D.N.Y. 1977); Stein v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977); Frenke v. Midwestern Okl. Div. Auth., 428 F. Supp. 719 (D. Okl. 1976); Coleco Industries, Inc. v. Berman, 423 F. Supp. 275 (E.D. Penn., 1976); McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976); Miller v. Schwiekert 413 F. Supp. 1062 (S.D.N.Y. 1976); Adams v. Standard Knitting Mills, Inc, Fed. Sec. L. Rep. (CCH) ¶95,683 (95,713) (E.D. Tenn. 1976).

[41]420 F. Supp. 1057 (D. Del. 1976).

company had developed a laser tool to be used in the construction industry, but had developed capital problems attempting to market the product. Prior to sale of the stock the defendants prepared a financial statement showing sales to the tool to several distributors as accounts receivable of the corporation. After purchasing the corporation, plaintiff learned that some of the sales had merely been consignment arrangements with distributors. The plaintiff then sued the defendant's accountants for knowingly or recklessly misrepresenting, in the financial statement, the number of sales.

The court characterized the issue and facts of the case by saying:

> The issue which must be determined is whether on the facts presented in this record, Schiavi's conduct in the preparation of the financial statement constituted such *reckless and/or knowing misbehavior* as to warrant imposition of liability under section 10(b) and Rule 10b-5. For reasons articulated more fully in a subsequent portion of this opinion, Schiavi's conduct *constitutes far more than mere negligence, but falls short of a preconceived actual intent to defraud.* His behavior embraces both *actual knowledge of material facts not revealed and reckless disregard for the truth.*[42]

The court then declared *Hochfelder* inapplicable to the case, but discussed it as a basis for analysis,[43] concluding that good faith is not a defense for reckless behavior,[44] and the Circuit Court's definition of scienter was controlling rather than *Hochfelder's*.[45] Relying on that analysis the court looked to Third Circuit cases and extended current holdings by analogy.[46] The court concluded:

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[42] *Id.* at 1080 (emphasis added).

[43] Having limited its decision to the necessity for scienter and having expressly noted it was leaving open the question of whether recklessness constituted intentional conduct arising to the requisite degree of scienter for purposes of imposing civil liability under section 10(b) and Rule 10b-5, it is concluded *Hochfelder* should not be treated as being in any way dispositive of the issue before this Court.

However, *Hochfelder* does serve as a starting point for analysis.

Id. at 1080.

[44] While section 10(b) "should be interpreted no more broadly," there is not need or justification for construing it more narrowly. Since a good faith defense is appropriate only in negligence actions, one may conclude that Congress intended 10(b) to govern reckless, knowing, or deliberate conduct, none of which are negatived by the defense of good faith.

Id. at 1081.

[45] "Finally, the Supreme Court having explicitly left undefined the perimeters of scienter, the law of the Circuit Courts controls." *Id.* at 1081.

[46] The Third Circuit position on scienter is developing cautiously. Thus far, it has not required an actual intent to defraud but rather has acknowledged that "there is considerable authority against interpreting a scienter requirement as equivalent to a showing of intent to defraud." *Rochez Bros., Inc.* v. *Rhoades,* 491 F.2d 402, 407 (3d Cir. 1974). Specifically, the Third Circuit has held in non-disclosure cases that "[d]efendant was under a duty to disclose all material facts to plaintiff, and his failure to do so when he had actual knowledge of those facts satisfies any scienter requirement." *Id.* at 407-08.

> I find no rational reason why actual knowledge of omitted material facts, sufficient to establish scienter in non-disclosure cases, is not equally sufficient in this case of misrepresentation where defendant has knowledge of either the actual misrepresentation or the material omissions. Accordingly, I find the requisite scienter essential to liability under 10(b) and Rule 10b-5 is present in the form of knowing misconduct, in that Schiavi had actual knowledge of material facts which he failed to disclose in his opinion audit.[47]

Accordingly, if the defendant accountant has knowledge that the facts constitute misrepresentation, the scienter requirement is met.[48] This is exactly the situation presented by an ASR 150 violation. A typical scenario might run as follows: an accountant becomes aware of a fact that might need disclosure, questions whether ASR 150 requires the use of FASB or non-FASB principles, consciously decides that FASB principles apply (which require no disclosure), and later is found to have made an incorrect choice of principles.

In holding the defendant accountant liable, the court in *McLean* expressly correlated knowing misbehavior with reckless misbehavior.[49] "There is little reason to distinguish between knowing misbehavior and reckless misbehavior under Section 10(b) and Rule 10b-5. In practice, one who recklessly makes a statement inherently possesses some knowledge of its falsity."[50]

> *Accord, Thomas* v. *Duralite Co., Inc.* 524 F.2d 577, 584 (3d Cir. 1975); *Fenstermacher* v. *Philadelphia National Bank,* 493 F.2d 333, 340 (3d Cir. 1974).

Id. at 1082. (Footnotes in quote omitted).

[47]*Id.* (Footnote in quote omitted).

[48]Valente v. Pepsico, Inc., Fed. Sec. L. Rep. (CCH) ¶96,496, n.45 (1978). There the court states:

> Defendants argue that an "actual knowledge" or "knowing conduct" standard requires not only knowledge of the omitted information, but also knowledge that the information will mislead investors. There is no indication in *Rochez, supra* that the latter type of knowledge is required. Most securities cases which apply a standard of knowing conduct refer only to knowledge of the omitted information.

[49] The failure to disclose the material information in this case was neither inadvertent, compare *SEC v. Bausch & Lomb, Inc.,* 420 F. Supp. at 1242, nor the product of simple forgetfulness, see *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d at 1045 n. 20, but instead the result of a conscious decision made by the defendants. In view of the obviousness of the danger that investors would be misled by their failure to disclose the material information, such conduct must be considered reckless.

SEC v. Nat. Student Marketing Corp., Fed. Sec. L. Rep. (CCH) ¶96,540, p. 94, 198 (1978).

> The difference, therefore, between the factual situation before the Supreme Court in *Hochfelder* . . . and the case before us involving affirmative acts by Laventhol which were materially misleading, is clear. The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their actual participation in the preparation and issuance of false and materially misleading accounting reports upon which Herzfeld relied to his damage.

Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 37 (2nd Cir. 1976).

[50]420 F. Supp. at 1084.

A possible explanation for equating knowing misbehavior with reckless behavior is offered by *Rolf v. Blyth, Eastman Dillon & Co., Inc.*:

> A final basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. Proof of a defendant's knowledge or intent will often be inferential . . . and cases thus of necessity cast in terms of recklessness. To require in all types of 10b-5 case that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under Section 10(b).[51]

Bloomenthal carries this explanation one step further by stating:

> Scienter even in its strictest form can be alleged and in some instances proven, at least to the satisfaction of the fact finder. Such intent, typically, must necessarily be proven by drawing inferences, and the fact that false and misleading statements have been made, along with other circumstances established by the evidence, may be sufficient to lead to the inference that such representations were made with an intent to deceive.[52]

This practice of permitting inferences, if not properly confined, could lead to liability for accountants for conduct that is merely negligent, but called by a different name. In fact, this may have already happened in cases like *McLean*.

With respect to 10b-5 liability, accountants currently appear to be in worse shape than before the *Hochfelder* decision. Even though accountants could be held liable for negligence prior to *Hochfelder*, the defense of good faith was available to them. Cases since *Hochfelder* have eroded its protection by blurring the distinction between negligence and the various forms of reckless behavior, and more importantly by holding that the defense of good faith is no longer available. With this erosion, scienter appears to provide little protection for accountants in the type of situation in which ASR 150 would be involved.

CONFUSION OVER GAAP

A separate question raised by the issuance of ASR 150 is its impact upon the concept of "generally accepted accounting principles" (GAAP). GAAP is a phrase commonly used to identify the consensus at a particular time of the proper accounting principles and practices. Although there is reference to the term in eight different SEC regulations,[53] neither the SEC or federal courts have defined it. In 1970 the AICPA attempted to define GAAP in Accounting Principles Board Statement No. 4 (APB

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[51] [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,275, p. 92,774 (2nd Cir. 1978).

[52] 3 A.H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW §9.21[4][f] at 9-13 (rev. 1977).

[53] 17 C.F.R. §§240.17a-5(c)(2)(i) (1977), 240.11a1-1(t)(e) (1976), 210.7A-02(a), -06(c) (1974), 230.434a (a)(2) (1973), 230.610a (1968).

4). It seems that the SEC would have defined GAAP itself had it been dissatisfied with the AICPA definition.[54] This is especially true since every regulation but one, which mentions GAAP, has either been promulgated or amended since APB 4 was issued by the AICPA.

Nowhere in the AICPA definition does it state that AICPA pronouncements[55] are the exclusive source of GAAP in areas covered by AICPA pronouncements, only that they are GAAP per se. Rule 203 of the Rules of Conduct of the Code of Professional Ethics does require general compliance with AICPA pronouncements, currently stated as FASB pronouncements, but that applies only to members of the AICPA. Since Rule 203 is a rule of conduct it would not affect the definition of GAAP in APB 4. Thus, it may be assumed that prior to the issuance of ASR 150, GAAP was defined by the AICPA, for SEC purposes, and included principles other than FASB principles which could have been in fact contrary to FASB principles.

Footnote 1 of APB 4 enumerates the relationship between GAAP and substantial authoritative support:

> Inasmuch as generally accepted accounting principles embody a concensus, they depend on notions such as general acceptance and substantial authoritative support, which are not precisely defined. The Securities and Exchange Commission indicated in Accounting Series Release No. 4 that when financial statements are "prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate . . . ." The AICPA Special Committee on Opinions of the Accounting Principles Board defines generally accepted accounting principles as those "having substantial authoritative support."

Thus, at least implicit in the definition of GAAP is the requirement that the principle have substantial authoritative support. This is where ASR 150 is significant. It states in absolute terms that principles contrary to FASB pronouncements are deemed not to have substantial authoritative support. The exception for deviation from FASB principles contained in the footnote of ASR 150 would not affect this statement. Thus, for SEC purposes, ASR 150 has reduced the number of accounting principles that qualify as GAAP. Admittedly, this reduction is achieved directly by the force of ASR 150 alone. However, this analysis shows that the meanings of the eight regulations that reference the term GAAP have been changed indirectly without any showing of intent to do so.

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[54] This assumption is based upon the fact that the AICPA definition is the only formal definition.

[55] FASB was not created until 1973, *supra* note 2.

CONCLUSION

The apparent purpose of ASR 150 was to recognize pronouncements of FASB as a source of accounting principles acceptable to the SEC. Had the SEC promulgated a rule to accomplish that and no more, the rule would have been well received. However, the SEC has promulgated a rule which establishes an ambiguous standard of compliance, potentially increases accountants' civil liability, and alters the definition of GAAP. If the SEC desired to achieve either of the latter two results, they should have done so directly. Acceptable accounting principles for SEC purposes should be formulated with greater care to prevent such unnecessary consequences.

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