The Securities and Exchange Commission
and
An Auditor's Liability

An Honors Thesis (HONRS 499)

by

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Purpose of Thesis

This discussion of the Securities and Exchange Commission and the liability of accountants is to show how the two interrelate and the importance of the SEC in regards to the accounting profession. Along with a discussion of the history of the SEC, its purpose, and the important people associated with its development, there is an explanation of an accountants' liability as it relates to the Securities and Exchange Commission. This paper is an attempt to help explain and understand the relationship between the regulatory agency and the accounting profession.
In the early years of our nation, administrative law was virtually unknown. At this time, the United States had a relatively simple, non-industrial economic economy that required little regulation. However, as businesses grew, demands for regulation developed. In fact, the extent of regulation increased dramatically during the Great Depression of the 1930s as President Franklin D. Roosevelt strove to increase employment and escape the Depression. As a result, the Securities and Exchange Commission was created in 1934 to make the free market work better. Thus, securities laws and regulations were established to ensure that purchasers of stock would have sufficient information to make informed judgments about buying shares of a company.

The financial history of the United States during the decade preceding 1933 ultimately set the stage for the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, which establishes the Securities and Exchange Commission. In fact, the severity of the market "crash" and the size of the group of people who suffered losses, whether due to irresponsible security issuance and distribution or their own stupidity, inevitably led to demands for legislative reform. Thus, in 1933 the Securities Act was created as a conservative response to the economic crisis known as the Depression. This act provides for "full and fair disclosure of the character of securities sold in
interstate commerce and through the mails, and to prevent fraud in the sale thereof."² The basic policy underlying the act is that of informing the investor of the facts concerning securities and providing protection against fraud and misrepresentation. In fact, the objectives are "to prevent the exploitation of the public by the sale of securities through misrepresentation, to place adequate and true information before the investor, and to protect legitimate enterprises against the competition of fraudulent promoters in the sale of securities to the public."³ For this purpose, the act provides certain sanctions in the form of civil and criminal liability for violation of the law. For example, the act contains these three sanctions:

(1) The authority given the SEC to prevent by stop order or injunction the sale of securities because of false or untrue material statements or failure to furnish material information;
(2) The civil liability of those responsible for the flotation of the issue for false, untrue, or inadequate material representations;
(3) The criminal liability for the willful use of a fraudulent scheme or device, or the willful misstatement of a material fact or the willful omission of material facts.⁴

In essence, the broad purpose of the Securities Act of 1933 is to bring about a fair disclosure of the facts essential to the appraisal of a security. However, it is the Pecora Hearings, the Senate Banking and Currency Committee's 1932-34 investigation of stock exchange practices,⁵ that influences the character of the 1933 Securities Act and the SEC later created to enforce it. For instance, as with the Pecora investigation, the primary enduring mission of the SEC has been "to compel the disclosure of data by
firm's involved in the securities markets, indirectly inducing these firms to avoid illegal or embarrassing activities.\textsuperscript{6} Thus, after nearly fifty years of the Commission's "disclosure philosophy," this policy has become so well established that it is generally regarded as the appropriate method of regulating corporate finance. Ultimately, the Securities Act of 1933 gives the necessary administrative authority to the Securities and Exchange Commission. In essence, the SEC is an independent agency of the U.S. government\textsuperscript{7} which is empowered "to make, amend, and rescind such rules and regulations that may be necessary to carry out the provisions of the act, including rules governing registration statements and prospectuses for various classes of securities and issuers and regularly defining accounting, technical, and trade terms."\textsuperscript{8} Furthermore, neither Congress nor the Executive branch directs or controls its operations.\textsuperscript{9} However, SEC operations are overseen by both the executive and legislative branches\textsuperscript{10} which is a virtual necessity. According to William Cary:

Government regulatory agencies are often referred to as "independent" agencies, but this cannot be taken at face value by anyone who has ever had any experience in Washington. In fact, government regulatory agencies are step-children whose custody is contested by both Congress and the Executive, but without much affection for either one...without the cooperation of both Congress and the Executive, little construction can be achieved. [In other words], an agency is literally helpless if either branch is uninterested or unwilling to lend support.\textsuperscript{11} Furthermore, the SEC is composed of five commissioners, of which only three can be members of the same political party. Also, appointments to the Commission are made by the President, with the
advice and consent of the Senate, and the term of office is five years. In addition, the Commission maintains ten regional offices which conduct trading, accounting, and legal investigations and hearings to enforce the act. For instance, whenever it:

shall appear to the Commission, either upon complaint or otherwise, that the provisions...of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing under oath, or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts.

Furthermore, each regional office serves the residents within the zone over which it has jurisdiction and enforces restraints on accounting, legal, and investment firms by explaining the requirements of the statute and ultimately the rules and regulations of the Commission itself.

As provided in the Securities Exchange Act of 1934, the responsibilities of the SEC are "quasi-legislative in nature in that the agency has far-reaching authority to impose rules and regulation in order to administer the Securities Acts." In fact, the SEC ultimately has the power to "enforce the laws it administers and to interpret its own rules and regulations." Ironically, rather than providing the Commission with a clear mandate, the legislators have granted the agency the authority to study the controversy or issue its own set of rules. In effect, Congress has broadly defined the Commission's areas of expertise and invited it to forge its own mandate to maintain "the public interest and for the protection of investors."
In essence, the SEC administers the Securities Act of 1933 and the Securities Exchange Act of 1934. Some of the SEC's major responsibilities include:

1. Requiring disclosure of facts concerning offerings of securities listed in national securities exchanges and of certain securities traded over-the-counter;
2. Regulating the trade in securities on the thirteen national and regional securities exchanges and in over-the-counter markets;
3. Investigating securities fraud;
4. Regulating the activities of securities brokers, dealers, and investment advisors and requiring their registration;
5. Supervising the activities of mutual funds;
6. Recommending administrative sanctions, injunctive remedies, and criminal prosecution against those who violate securities laws.  

The SEC also undertakes specific assignments at the request of Congress. For instance, the SEC may advise Congress on proposed and existing legislation, investigate conditions in the securities markets, and analyze data regarding the financial community obtained from filings made with the agency itself. In addition, the Commission has the authority to proscribe the required form(s) which includes the items or details to be shown in the balance sheet and earnings statement, and the methods to be used in the preparation of accounts and on the valuation of assets. In fact, the Commission examines the registration statements to make sure they are accurate and complete. If at any time, either before or after the effective date, the Commission finds that a registration statement contains an untrue or misleading statement of a material fact, it may suspend the registration statement and thus stop further distribution of the questionable securities. However,
much of the success of this legislation depends upon the alertness, aggressiveness, and ability of the administrative personnel.

Consequently, it is very important who is a member on the Commission and who is appointed chairman. Therefore, at the onset of the Securities and Exchange Commission, President Roosevelt was faced with the difficult task of appointing a chairman. In fact, it was widely assumed that James Landis, the leader of the Federal Trade Commission's Securities Division, would be the first chairman of the SEC. However, Roosevelt had other plans because he felt that James Landis was "better as a member than as a chairman because he is essentially a representative of strict control and operates best when defending that position against opposition from contrary view." Thus, Roosevelt recommended Joseph Kennedy for chairman of the SEC "because of his executive ability, knowledge of habits and customs of business to be regulated, and the ability to moderate different points of view on the Commission." However, many people felt that the choice of Kennedy to be the SEC's first chairman was incredible. Not only was Kennedy a pool operator and a bear raider, but he also periodically collaborated with Charles Wright and other market manipulators whom the SEC would soon indict. However, Kennedy would later become the SEC's first chairman despite his past affiliations. Under his leadership, the SEC played a conciliatory role, achieving prominence for its stimulation of private investment. With the enactment of the Holding Company Act, the agency's emphasis would shift to business reform; its character inevitably would become more
confrontational. Thus, Kennedy realized that it was his time to step down and soon resigned. His last act as chairman was to participate in the "unanimous election of James Landis as his successor." It was assumed that Landis as chairman would be cautious, undogmatic, a mediator between the conflicting claims of such parties as investors and securities issuers, the New York Stock Exchange and the smaller, regional exchanges, Exchange floor members and Commission house members. However, Landis was not a radical, but an articulate advocate of an expanded role for the federal regulatory agencies. In fact, Landis was doubtful that unregulated firms in industries like banking, insurance, utilities, shipping, or communications could function adequately to meet public needs, therefore Landis viewed the primary purpose of an administrative agency to be "the guidance and supervision of the industry as a whole" rather than simply play the role of policeman. In essence, during his tenure as SEC chairman, Landis helped to draft the 1933 and 1934 Securities Acts and the "regulations, opinions, and reports issued during the SEC's first three years." After Landis' resignation, the next chairman of the SEC became William Orville Douglas. In essence, Douglas led the SEC in a crusade that attempts to complete the Commission's "logical mandate by consolidating SEC enforcement of the over-the-counter markets, commencing enforcement of the geographic integration and corporate simplification provisions of the Public Utility Holding Company Act, and replacing state standards of corporate finance, accounting, and corporate governance with SEC
enforced federal rules." In fact, no other SEC chairman ever addressed so many fundamental problems simultaneously. Although not all of his initiatives succeeded, his chairmanship was "the most accomplished in the SEC's history" because it set up a framework for "federal corporation's law that was to guide the next two generations of corporate reform efforts." However, with Douglas' departure, the SEC passed its historic zenith. Never again would the Commission receive such strong support from the White House, Congress, and the public. In fact, the SEC was built up by Kennedy, Landis, and Douglas, thus making these three men an important part of the Commission's history and its development.

In a sense, the SEC was created for the purpose of promoting fairness in securities transaction because the far-reaching responsibilities and competing demands of Congress prevent it from doing so. In fact, the growth of regulation is due "largely to two factors: (1) the recognition that an absolutely free and totally unregulated market may not best serve the nation's welfare and (2) the inability of Congress to specify detailed rules for regulating the market." Thus, the SEC was created as a result to try and alleviate this problem.

Through the years, the SEC has also dealt with various problems relating to its area of expertise. For example, in 1946 the SEC filed suit against W.J. Howey Company because Howey failed to register with the SEC or meet the other administrative requirements that issuers of securities must adhere to. In the case, Securities and Exchange Commission v. W.J. Howey Company, the
SEC sued to enjoin Howey from continuing to offer land sales and service contracts, however Howey claimed that no SEC violation existed because no securities were issued. Consequently, the Supreme Court agreed with the SEC and found that the investment contract was, in fact, a security. Thus, Howey was required to file the registration statement.\(^{36}\) This case is ultimately an example of how difficult it can be to assess whether or not an item falls under the definition of being a security. Ultimately, the SEC was correct in its assessment in this case. However, the SEC is not always so lucky. For instance, in *Dirks v. Securities and Exchange Commission* the SEC was found to be wrong in its assessment of whether or not the information that Dirks, an officer of a New York broker-dealer firm, constituted insider information. Inevitably, the Supreme Court found that the SEC was wrong and that Dirks, under the circumstances of this case, had no duty to refrain from the use of the inside information that he had acquired.\(^{37}\) From these two cases, one can understand the difficulty the SEC has in filling its regulatory duties.

However, no matter how difficult its job is, the Securities and Exchange Commission retains its reputation as being "an outstanding example of the independent commission at its best."\(^{38}\) Although the wisdom of specific policies of the SEC can be reasonably doubted, the overall value that this agency provides cannot be. In reducing securities fraud and unfairness through its corporate disclosure and enforcement programs, restructuring the public utility industry, and eliminating anti-competitive practices
in the stock markets, the Securities and Exchange Commission makes significant contributions to the nation's financial system. In fact, the SEC's history illustrates the usefulness of a well-administered federal regulatory agency.

However, the Securities and Exchange Commission also plays an important role in regulating the legal responsibilities of accountants. The laws that have developed are important not only to protect clients from wrong-doings, but also to protect accountants from unwarranted charges. For instance, clients who are not competent enough to fully understand the financial statements have a tendency to put the blame of investment losses on the accountants. Therefore, accountants and clients need to know how and under what circumstances they can be liable.

Therefore, the Securities Act of 1933 was created to help define accountants' liability. Although the act contains many parts, Section 11 is the one most relevant to accountants' liability. When a company wants to issue new stock whose value exceeds $1.5 million, it is required to file a registration statement with the SEC. Usually, accountants are hired to complete these registration statements since they require a great amount of detail. Section 11 of this act holds an accountant liable for misstatements and omissions of material facts in these registration statements. The accountants are not only liable to the company who wants to issue stock, but they are also liable to anyone who purchases a security that was covered by the false registration statement. The only fact that this third party purchaser must
prove after the statement is shown to have misstatements or
omissions is that he suffered injury because of it. He does not
need to show privity or even that he relied upon the registration
statement when making his decision about whether or not to buy the
stock. In fact, the accountant bears the burden of proving his
innocence. 39

An accountant has many ways in which to do this, however.
First and most common is for the accountant to prove that he acted
with due diligence. However, in order to prove due diligence the
accountant must show three things. First, he must prove that he
had reasonable grounds to believe that the financial statements and
other parts of the registration statements were true. Second, he
must prove that he actually did believe everything to be true. And
third, the accountant must show that he did a reasonable
investigation of all the findings. Because the accountant must
show due diligence when he completes registration forms, the
accountant is required to verify all information that is provided
to him by directors and employees of the corporation. Failure to
comply with generally accepted accounting principles or generally
accepted auditing standards is an automatic proof of lack of due
diligence. 40

A case that illustrates the idea of due diligence is Escott v.
BarChris Construction Corporation. In this case, purchasers of
BarChris stock brought action against any person who signed the
registration statement. They claimed that the statements contained
materially false statements and omissions. Consequently, the
auditors were unable to prove due diligence and were ultimately found liable. However, the important part of this case is the comments made by the court: "the auditor was too easily satisfied with glib answers to his inquiries [and] it is not always sufficient to merely ask questions." Obviously, the court felt that the reasonable investigation of due diligence was not adequately satisfied. Even though this case did not occur until 1968, it is often considered to be the first judicial treatment of accountants' liability under the Securities Act of 1933.

Furthermore, damages paid to the purchaser if the accountant is found liable under the Securities Act of 1933 are also a bit difficult to visualize. For instance, the purchaser may recover the amount paid for the security less one of the following: either the value of the security at the time the suit was brought, the price at which the security was sold before the suit was brought, or if less than the value of the stock, the price at which the security was sold after the suit but before judgment. For example, if a purchaser buys stock for $200, still owns this stock at the time of the suit, and the stock has a value of twenty dollars, the purchaser will be rewarded one hundred and eighty dollars. But, if the purchaser sells this stock for thirty dollars before the suit, he will receive only one hundred and seventy dollars. In essence, he will receive the amount of money that he lost on the investment.

One part of accountants' liability that is the same for both the Federal Securities Act of 1933 and the Securities Exchange Act
of 1934 is that liability is not just limited to the individual auditor. Liability can also be found with others involved in the filing and reporting process such as issuers, officers, directors, legal counsel, and underwriters.

And finally, the last part of accountants' liability is the Securities Exchange Act of 1934. Unlike the Act of 1933, which is often referred to as the selling statute, this act is often referred to as the period reporting statute. This act not only involves registration statements, but also dealings with securities--sold or unsold--after they have been approved for sale.

The major difference between these two acts is the burden of proof that the accountant and plaintiff have. In the previous act, the Act of 1933, the plaintiff only had to prove he was injured, and the accountant bore the heaviest burden of truth. This is directly opposite to Section 18 of the Act of 1934. In this act, the plaintiff has a substantially heavier burden of truth. In fact, the accountant no longer has to prove due diligence. On the other hand, the plaintiff must prove that a false or misleading statement occurred, that this statement affected the price of the security, and that he relied on the statement not knowing that it was false.43

Thus, with this act, the accountant is able to use a good faith defense. If the accountant uses good faith, it means that he has no knowledge that any statement was false and that he has no intention to defraud. He can also use as a defense that the buyer or seller knew of the misleading statement.44
Another major difference between the two acts is what they can hold accountants liable for. In the last act, an accountant could be held liable for negligence. However, this is not the case with the 1934 Act. Section 10 (b) of this act only pertains to cases of fraud. The act also states that a person is acting unlawfully if, when dealing with securities, he uses any scheme to defraud, to make an untrue statement or omission of a material fact, or to engage in an act which operates as fraud. Usually, when accountants are sued, the plaintiff sues under Section 10 (b) of this act.45

One such case where accountants were sued under Section 10 (b) is Ernst and Ernst v. Hochfelder. The plaintiffs in this case were customers of a bank who unknowingly invested in fake escrow accounts created by the president of the bank. When the president committed suicide and the scam was revealed, the customers sued the accountants of the bank claiming they should have uncovered the scheme had they performed more complete audits. The case went to the Supreme Court where the ruling was that even if negligence were proven, it is not sufficient to establish liability under Section 10 (b). Consequently, Section 10 (b) applies only to cases of fraud.46

In its construction, not only has the Securities and Exchange Commission been given the statutory power to administer and enforce all securities laws, but it also has the power to take disciplinary action against an accountant, thereby preventing the individual or firm from carrying out its responsibilities to its publicly traded
clients. Thus, it is important for all accountants to not only understand their own professional standards, but also the rules and regulations governing their profession that are set forth by the SEC. In essence, by setting forth accounting and securities standards, the Securities and Exchange Commission ultimately makes significant contributions to the accounting profession and to the nation's financial system.

2. *Id.* p. 24.
3. *Id.* p. 25.
4. *Id.* p. 25.
6. *Id.* p. 39.


9. Buckley, Supra. p. 27.

10. Id. p. 27.


13. Id. p. 33.


16. Buckley, Supra. p. 28.

17. Id. p. 28.


22. Id. p. 29.


24. Id. p. 103.

25. Id. p. 103.

26. Id. p. 104.

27. Id. p. 123.

28. Id. p. 123.
29. **Id.** p. 124.
30. **Id.** p. 124.
31. **Id.** p. 125.
32. **Id.** p. 155.
33. **Id.** p. 156.
34. **Id.** p. 157.
41. **Id.** p. 1012.
42. **Id.** p. 1012.
43. **Id.** p. 1013.
44. **Id.** p. 1014.
45. **Id.** p. 1014.
46. **Id.** p. 1014.
Works Cited


Securities Act of 1933. **US Code**, Title 15 Section 77t (a): 238.
