St. John's Law Review

Volume 76, Fall 2002, Number 4 Article 2

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UNITED STATES V. SIMON AND THE NEW CERTIFICATION PROVISIONS

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INTRODUCTION

The Sarbanes-Oxley Act of 2002[1] (the "Act") contains two well-publicized provisions requiring that Chief Executive Officers (CEO's) and Chief Financial Officers (CFO's) of public companies certify their companies' Securities and Exchange Commission (SEC) filings. Section 906 provides that each periodic report filed by an issuer with the SEC shall be accompanied by a written statement by the CEO and the CFO certifying that the report "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act")[2] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[3] Section 302 mandates that the SEC issue rules requiring that the CEO and CFO of each company that files reports under section 13(a) or 15(d) shall certify a number of facts, including—in section 302(a)(3)—that based on the officer's knowledge, "the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report."[4]

Now that the SEC has issued rules that enable section 302 to go into effect,[5] the principal difference between the section 906

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1 Pub. L. No. 107-204, 116 Stat. 745.

2 15 U.S.C. §§ 78m, 78o(d) (2000).

3 Sarbanes-Oxley Act § 906(b) (to be codified at 18 U.S.C. § 1350).

4 Sarbanes-Oxley Act § 302(a)(2) (to be codified at 15 U.S.C. § 7241).

5 Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427, IC-25722, Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,126 (Aug. 28, 2002) [hereinafter Certification Release].

certification and the section 302(a)(3) certification is the fact that the section 906 certification applies not only to the financial statements and other financial information contained in the report, but to *all* the information presented in the report.[6] More interesting is what sections 906 and 302(a)(3) have in common: the fact that false statements in either certification can be prosecuted criminally,[7] and the fact that they share a standardless requirement of "fair presentation" that is not limited to the traditional benchmark that financial statements fairly present the financial affairs of the issuer "in accordance with generally accepted accounting principles" (GAAP).[8]

Was Congress's omission of any reference to GAAP in the new certification provisions an oversight? According to the SEC, it was quite intentional. At page 7 of its Certification Release, the Commission stated:

> The certification statement [in § 302(a)(3)] regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" and is not otherwise limited by reference to generally accepted accounting principles. We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles. In our view, a "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a

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[6] *See* Sarbanes-Oxley Act § 906 (to be codified at 18 U.S.C. § 1530).

[7] *See id.* at 790. Although section 302 does not contain explicit criminal penalties, a false section 302 certification could be prosecuted as a false statement under 18 U.S.C. § 1001 (2000).

[8] § 103(a)(2)(A)(iii)(bb). Since the section 906 certification is not limited to financial information, a wholesale limitation of that section to GAAP standards would not make sense in any event. Even where section 906 does apply to financial information, however, and in section 302(a)(3) which applies only to financial information, there is no link to GAAP.

materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.[9]

In a supporting footnote to the passage quoted above, the SEC explained that "[p]resenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws."[10] The precedents cited for this proposition are *United States v. Simon*,[11] *In re Caterpillar, Inc.*,[12] and *In re Edison Schools, Inc.*[13]

Neither *In re Caterpillar, Inc.* nor *Edison Schools, Inc.* was brought under the antifraud provisions; they were reporting cases brought under section of the Exchange Act.[14] Moreover, both were settled cases that did not test in the crucible of litigation the "broader" disclosure standard that the SEC has now enunciated. The only litigated fraud case in the group, *United States v. Simon*, is a throwback to the 1960s—the last great phase of expansionist judicial opinions in the securities field. This Article attempts briefly to put *Simon* in its temporal context and then examines what *Simon* actually teaches about the permissible scope of the new certification requirements.

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[9] Certification Release, *supra* note 5, ¶ 86, 720, at 86,131.

[10] *Id.* at n.55.

[11] United States v. Simon, 425 F.2d 796, 806–09 (2d Cir. 1969) (finding accountants criminally liable for falsely representing financial statements).

[12] Caterpillar, Inc. Release No. 34-30532, Fed. Sec. L. Rep. (CCH) ¶ 73,830, at 63,050 (Mar. 31, 1992).

[13] Edison Schools, Inc., Release No. 34-45925, 77 SEC Docket 1800, 2002 WL 1315557 (May 14, 2002).

[14] 15 U.S.C. § 78m (2000). *Caterpillar, Inc.* focused on the issuer's compliance with the requirements for Management's Discussion and Analysis (MD&A) in Item 303 of Regulation S-K, 17 C.F.R. § 229.303, which requires the company to, among other things, "provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." *See also* Management's Discussion and Analysis of Financial Condition and Results of Operations Release Nos. 33-6835, 34-26831 (May 18, 1989). *Edison Schools*, likewise, was brought under the reporting, not the antifraud provisions. The reporting provisions have long contained Rule 12b-20, 17 C.F.R. § 240.12b-20 (2002), which provides that "[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading." Neither the MD&A requirements nor Rule 12b-20 have traditionally been the guideposts for liability in fraud or criminal proceedings, in which both the scienter requirements and the consequences for a violator are far more severe than in a case brought under the reporting rules. In this respect (as in others), the new certification provisions are a complete departure from prior law.

I. *SIMON* IN CONTEXT

The federal securities laws, and the attendant rules and regulations, reflect a tension between highly specific requirements and proscriptions similar to those that characterize the Internal Revenue Code, and the sorts of sweeping, goal-based mandates that appear in the Sherman Act in the antitrust realm. This dualism has deep roots.

When Congress turned its attention to the securities markets in the wake of the 1929 crash and in the depths of the Great Depression, legislators were concerned that they might not be able to anticipate the evolution of abusive conduct. Perhaps the most famous example of this concern is Congress's condemnation of a very specific litany of manipulative practices in section 9(a) of the Exchange Act,[15] followed by section 10(b) of the Exchange Act,[16] which further prohibits "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors"[17] (or, in the words of Thomas G. Corcoran, "Thou shalt not devise any other cunning devices."[18]). The SEC's 1942 exercise of this authority in the broad language of Rule 10b-5[19] almost singlehandedly spawned the huge body of judge and Commission-made "common law" that forms much of the daily grist of a securities lawyer's professional life.[20]

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[15] Securities Exchange Act of 1934 § 9(a), 15 U.S.C. § 78i (2000) [hereinafter Exchange Act].

[16] 15 U.S.C. § 78j(b).

[17] *Id.*

[18] *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934).

[19] Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002) declares that it is unlawful for any person:

> (a) to employ any device, scheme, or artifice to defraud;
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

[20] Moreover, the SEC, as an institutional plaintiff in enforcement cases, has an interest—even if only a subconscious interest—in retaining some broad, expansive "standards" for liability, which maximize both its regulatory flexibility and its ability to withstand summary judgment motions that might succeed if only the

The very breadth of section 10(b) and Rule 10b-5 fueled an expansion of securities fraud liability that continued throughout the 1960s. *Simon* was a part of that expansion.[21] Predictably, however, expanded litigation provoked what might be called a politico-judicial reaction. The explosion of class action lawsuits seeking damages in more and more creative ways (for example, where the plaintiff did not purchase or sell the security in question, or where the defendant was merely negligent or was at most a "helper" in an alleged violation), as well as innovative law enforcement actions that carried with them the threat of professional death to the defendants involved, led the Supreme Court to hand down a series of decisions between 1975 and 1994 that adopted a "strict statutory construction" approach to the securities laws.[22] When these decisions did not adequately stem

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defendant had a plain target at which to aim.

[21] The Second Circuit's opinion in *Simon* was written by Judge Henry J. Friendly. For an exhaustive discussion of Judge Friendly's impact on the securities law of his day, see Margaret V. Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777 (1997). In the 1960s, the world was also a different place in the realm of the criminal law. At the outset of his opinion in *Simon*, Judge Friendly wrote:

> While every criminal conviction is important to the defendant, there is a special poignancy and a corresponding responsibility on reviewing judges when, as here, the defendants have been men of blameless lives and respected members of a learned profession. . . . This is no less true because the trial judge, wisely in our view, imposed no prison sentences.

United States v. Simon, 425 F.2d 796, 798–99 (2d Cir. 1969). Such judicial solicitude seems almost quaint today in the wake of the Sentencing Guidelines and the draconian criminal penalties enacted by the Act.

[22] *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (explaining that section 10(b) and Rule 10b-5 do not support claims against aiders and abettors); Dirks v. SEC, 463 U.S. 646, 667 (1983) (finding that no insider trading liability unless the information has been obtained in breach of a duty of trust or confidence); Aaron v. SEC, 446 U.S. 680, 701–02 (1980) (holding that SEC must show scienter in enforcement actions brought under section 10(b) and Rule 10b-5); Chiarella v. United States, 445 U.S. 222, 235 (1980) (finding that nondisclosure liability must be premised on a duty to speak); Santa Fe Indus. v. Green, 430 U.S. 462, 478 (1977) (holding that securities laws do not permit recovery for corporate mismanagement); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976) (private plaintiffs under section 10(b) and Rule 10b-5 must plead and prove that the defendant acted with scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754–55 (1975) (standing for private plaintiffs under section 10(b) and Rule 10b-5 limited to purchasers and sellers of securities). Recent years, however, have seen two Supreme Court decisions that take a more generous approach toward the government's securities law enforcement efforts. *See* SEC v. Zandford, 535 U.S. 813 (2002) (broadly construing the "in connection with" requirement of section 10(b) and Rule 10b-5); United States v. O'Hagan, 521 U.S. 642, 665–66 (1997) (confirming validity of "misappropriation theory" of insider trading under section 10(b) and Rule

the tide of enhanced liability, Congress passed the Private Securities Litigation Reform Act of 1995,[23] followed by the Uniform Standards Act of 1998,[24] which carved out a uniquely complex niche for securities law plaintiffs. On a more mundane level, the past seven decades have seen a substantial encrustation of highly detailed rules and regulations promulgated by the SEC, supplemented by equally detailed pronouncements by self-regulatory bodies ranging from the National Association of Securities Dealers to the Financial Accounting Standards Board. These rules are an almost inevitable consequence of a regulatory system that is administered and implemented by lawyers and accountants, who are inveterate tinkerers and often share a strong desire for certainty in the form of highly specific rules, which (in the short run, at least) make it easier both to enforce the law and to advise clients.

Early in 2002, SEC Chairman Harvey Pitt resurrected *Simon* in an effort to swing the pendulum away from what he identified as an overly slavish devotion to form over substance. Specifically, Chairman Pitt observed:

> Present-day accounting standards are cumbersome and offer far too detailed prescriptive requirements for companies and their accountants to follow. That approach, by necessity, encourages accountants to "check the boxes"—that is, to read accounting principles narrowly, to ascertain whether there is technical compliance with the applicable accounting principles.
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> But the first principle should always be the one Judge Henry Friendly articulated four decades ago in the Lybrand Ross criminal case, *US v. Simon*. There, in rejecting the auditors' claim that criminal charges were foreclosed because the financial statements literally complied with GAAP, Judge Friendly held that, if literal compliance with GAAP creates a fraudulent or misleading impression in the minds of shareholders, the accountants could, and would, be held criminally liable.[25]

10b-5).

[23] Pub. L. No. 104-67, 109 Stat. 737 (1995).

[24] Pub. L. No. 105-353, 112 Stat. 3227 (1998).

[25] Public Statement by SEC Chairman: Remarks at the Winter Bench and Bar Conference of the Federal Bar Council at 3–4 (Feb. 19, 2002), *available at* www.sec.gov/news/speech/spch.539; *accord* Public Statement by SEC Chairman: Remarks at the SEC Speaks Conference at 4–5 (Feb. 22, 2002), *available at*

It is time to examine whether *Simon* can bear the weight that the SEC is now placing upon it.

II. WHAT DID *SIMON* SAY?

Carl Simon, Robert Kaiser, and Melvin Fishman were convicted of conspiracy to violate 18 U.S.C. § 1001[26] (false statements to a government agency), 18 U.S.C. § 1341[27] (mail fraud), and 15 U.S.C. § 78ff[28] (criminal violation of the Exchange Act), as well as two substantive counts of mail fraud, in connection with their respective roles as a senior partner, junior partner, and senior associate on Lybrand, Ross Bros. & Montgomery's audit of the financial statements of Continental Vending Machine Corporation ("Continental").[29] The thrust of the government's case against the three auditors was that they were aware, but failed to disclose, that $3.9 million, shown on Continental's financial statements as loans receivable from an affiliate named Valley Commercial Corporation ("Valley"), were uncollectable because Valley had in turn loaned approximately the same amount to Harold Roth, Continental's President. Roth was unable to repay the loan and belatedly "secured" his obligation to Valley with collateral that consisted mostly of Continental common stock.[30] The essence of the charges against the defendants in *Simon* is captured below, where the actual text of Note 2 to Continental's financial statements is compared with what the government claimed defendants would have said if they had disclosed everything they knew:

Note 2 as Signed Off On by Defendants

The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable.

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www.sec.gov/news/speech/spch.540.

26 18 U.S.C. § 1001 (2000).

27 18 U.S.C. § 1341 (2000).

28 15 U.S.C. § 78ff (2000).

29 *See* United States v. Simon, 425 F.2d 796, 798 (2d Cir. 1969).

30 *Id.* at 799.

Note 2 as the Government Would Have Had It Read

The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder), which bears interest at 12% a year, was uncollectable at September 30, 1962, since Valley had loaned approximately the same amount to Mr. Roth who was unable to pay. Since that date Mr. Roth and others have pledged as security for the repayment of his obligation to Valley and its obligation to Continental (now $3,900,000, against which Continental's liability to Valley cannot be offset) securities which, as of February 13, 1963, had a market value of $2,978,000. Approximately 80% of such securities are stock and convertible debentures of the Company.

The government also contended that by the date of the auditors' opinion, the defendants knew or should have known that the value of Roth's collateral amounted to only two-thirds of the value stated in Continental's financials.[31]

At their jury trial, the defendants called eight independent accounting experts, who testified that the treatment of the Valley receivable described in Note 2 was not inconsistent with either GAAP or generally accepted auditing standards (GAAS), and that neither required that the auditors disclose the make-up of the collateral, or the fact that the receivable had increased after the closing date of the financial statements. All eight also testified that the Roth borrowings from Valley did not need to be disclosed, and seven of the eight stated affirmatively that disclosure would have been inappropriate.[32]

On appeal, the defendants made two arguments based on their accounting experts' testimony. First, they contended that the trial judge had erred in refusing to instruct the jury that the defendants could be found guilty only if, according to GAAP, the financial statements as a whole did not fairly present Continental's financial condition, and then only if the defendants' departure from accepted professional standards was due to willful disregard with knowledge of the statements' falsity and intent to deceive. The Second Circuit rejected this argument, holding instead that the judge had properly instructed the jury that "the 'critical test' was whether the financial statements as a whole 'fairly presented the financial

[31] *See id.* at 801.
[32] *See id.* at 805.

position of Continental as of [their date],' " and if they did not, the issue was whether defendants had acted in good faith, as to which proof of compliance with GAAP and GAAS was " 'evidence which may be very persuasive but not necessarily conclusive.' "[33] In language that, as highlighted below, contains some important qualifications, the appellate court said:

> We do not think the jury was . . . required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, *at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for an auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made.* Such evidence may be highly persuasive, but it is not conclusive, and so the trial judge correctly charged.[34]

Defendants next attacked the verdict on the ground that the evidence was insufficient as a matter of law to allow the jury to consider the charges against them, particularly in light of the expert testimony. Here, the Second Circuit focused not on the abstract issue of whether compliance with GAAP and GAAS is a defense, but instead on the particular fact that Continental was being looted (in response to which, in the court of appeals' view, GAAP and GAAS themselves required the defendants to do more than they did):

> We join defendants' counsel in assuming that the mere fact that a company has made advances to an affiliate does not ordinarily impose a duty on an accountant to investigate what the affiliate has done with them or even to disclose that the affiliate has made loan to a common officer if this has come to his attention. *But it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president.* For a court to say that all this is immaterial as a matter of law if only such loans are thought to be collectible would be to say that independent accountants have no responsibility to reveal known dishonesty by a high corporate officer. *If certification does not at least imply that the corporation has not been looted by insiders so far*

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[33] *Id.* at 805–806.

[34] *Id.* at 806 (emphasis added).

> *as the accountants know, or, if it has been, that the diversion has been made good beyond peradventure (or adequately reserved against) and effective steps taken to prevent a recurrence, it would mean nothing, and the reliance placed on it by the public would be a snare and a delusion.* Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then, as the Lybrand firm stated in its letter accepting the Continental engagement, he must "extend his procedures to determine whether or not such suspicions are justified." If as a result of such an extension or, as here, without it, he finds his suspicions to be confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established. *At least this must be true when the dishonesty he has discovered is not some minor peccadillo but a diversion so large as to imperil if not destroy the very solvency of the enterprise.*[35]

The foregoing discussion suggests two important limiting principles on *Simon*'s holding with respect to the dispositive nature of GAAP compliance: first, that the persuasive nature of GAAP will vary depending on whether it explicitly supports—or, as in *Simon*, simply does not prohibit—the disclosure at issue; second, that GAAP compliance is a weak defense if the government can show that the defendants deliberately misled investors about an extraordinary fact, such as the looting of a corporation by its officers, but not otherwise.

III. *SIMON* IN THE SECOND CIRCUIT

In the years after *Simon* was decided, it was cited occasionally within the Second Circuit for the proposition that conformity with GAAP is not dispositive of a Rule 10b-5 defendant's duty to disclose.[36] Interestingly, another holding of *Simon*—that a defendant's claim he had nothing to gain from

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[35] *Id.* at 806–07 (emphasis added).

[36] *See* Siemens Info. Sys., Inc. v. TPI Enter., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,573, at 92,662 (Mar. 12, 1992); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), *rev'd in part on other grounds*, 540 F.2d 27, 27 (2d Cir. 1976); *see also* Straus v. Holiday Inns, Inc., 460 F. Supp. 729, 736 (S.D.N.Y. 1978).

committing securities fraud is not dispositive of his scienter if the government can prove that he acted deliberately[37]—received somewhat more attention, forming the basis for a line of cases holding that, even in the absence of a plausible motive on defendant's part, a plaintiff may satisfy his obligations to plead fraud with particularity under Federal Rule of Civil Procedure 9(b) by identifying circumstances indicating conscious misbehavior.[38] By their very focus on the deliberate nature of the defendants' conduct in *Simon*, these cases point up the second limitation on *Simon's* sweep: namely, that the Second Circuit's holding that "GAAP compliance isn't enough" arose in a case where the defendants were faced with evidence of actual looting of the corporation.[39]

IV. THE NINTH CIRCUIT'S VIEW

The Ninth Circuit's treatment of *Simon* illustrates both of the limitations noted above. In *SEC v. Arthur Young & Co.*,[40] the Ninth Circuit affirmed a district judge's refusal to enjoin an accounting firm from further violations of the securities laws despite the SEC's contention at trial that the accountants had failed to comply with GAAS in conducting the audit at issue, and "should have done more" to uncover their client's fraud.[41] By the time of its oral argument in the court of appeals, the SEC apparently had defined "more" to mean that the auditor should have "performed his audit functions in a manner that would have revealed to an ordinary prudent investor, who examined the accountant's audits or other financial statements, a reasonably accurate reflection of the financial risks such an investor presently bears or might bear in the future if he invested in the audited endeavor."[42] After noting the auditing

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37 *See Simon*, 425 F.2d at 808–10.

38 *See* Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987); Ray v. General Motors Acceptance Corp., 1995 U.S. Dist. LEXIS 21467, at *15 (E.D.N.Y. Mar. 28, 1995); Tribune Co. v. Purcigliotti, 869 F. Supp. 1076, 1091 (S.D.N.Y. 1994); *In re* Crazy Eddie Sec. Litig., 812 F. Supp. 338, 352 (E.D.N.Y. 1993).

39 *See In re* Crazy Eddie Sec. Litig., 812 F. Supp. at 352 (summarizing *Simon*, stating that it "affirm[ed] criminal conviction of accountants . . . who knowingly drew up and certified false and misleading corporate financial statements where jury could find that accountants knew of looting by the corporate President").

40 590 F.2d 785 (9th Cir. 1979).

41 *Id.* at 787.

42 *Id.* at 787–88.

firm's contention that good faith compliance with GAAS should immunize it from liability, the Ninth Circuit rejected the SEC's expansive view of an auditor's liability in ringing terms:

> To accept the SEC's position would go far toward making the accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier *with the accountant* it would have caught the scent of wrong-doing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on existing securities laws.[43]

The court of appeals responded to *Simon* with the following statement:

> *Simon* recognized that compliance with [GAAP] would not immunize an accountant when he consciously chose not to disclose on a financial statement a known material fact. No such deliberate concealment was found by the trial court to exist in this case. Thus, although we assume arguendo that *Simon* strips the accountant of the protection that compliance with GAAS (*Simon*, incidentally, was concerned only with GAAP) normally affords when he fails to reveal material facts which he knows or which, but for a deliberate refusal to become informed, he should have known, there exists no basis in the trial court's findings for so applying *Simon*. We cannot say such findings in this respect are clearly erroneous.[44]

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[43] *Id.* at 788. In the SEC's view, Congress enacted a "conscription bill" sixteen years later when it amended the Exchange Act to add a new section 10A, 15 U.S.C. § 78j-1, requiring auditors to report illegal acts that they find in the course of their audits to the client's audit committee and, in some circumstances, the SEC. *See generally* Paul Huey-Burns and Liza M. Ray, *The SEC's Enforcement Program and Section 10A*, 29 SEC. REG. L.J. 199 (2001). Whether the scope of section 10A's "duty to report" is as broad as the SEC contends is doubtful. *See* Thomas L. Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood 'Illegal Act' Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417, 1422 (2001). In any event, section 10A does not purport to expand the scope of section 10(b) or Rule 10b-5.

[44] *Arthur Young*, 590 F.2d at 788–89 (footnote omitted). A few years later, in *SEC v. Seaboard Corp.*, the Ninth Circuit summarized *Arthur Young* as follows:

> We have said that an accountant has no duty beyond compliance with generally accepted accounting standards to ensure his client's honesty and to enforce his client's duty with the security acts and regulations. . . . But

In 2001, the Ninth Circuit was called upon to decide *SEC v. Dain Rauscher, Inc.*,[45] an enforcement action that arose out of the Orange County, California financial crisis. Defendant Dain Rauscher had acted as senior underwriter for nine municipal note offerings, and as a senior advisor for a tenth.[46] The SEC contended that one of Dain Rauscher's officers, Kenneth Ough, had violated section 10(b) of the Exchange Act and Rule 10b–5, as well as sections 17(a)(1)–(3) of the Securities Act,[47] in his conduct with respect to the offerings.[48] The district judge had granted summary judgment to Ough on the basis of his showing that he had conformed to industry practice for municipal finance professionals.[49] The court of appeals reversed, agreeing with the SEC that "the standard of care by which Ough's conduct must be measured is not defined solely by industry practice, but must be judged by a more expansive standard of reasonable prudence, for which the industry standard is but one factor to consider."[50]

To reach this conclusion, the Ninth Circuit had to address Ough's contention that he should receive the same treatment that the court had afforded auditors in *Arthur Young*.[51] The court of appeals rejected Ough's argument, but in so doing reaffirmed the central holding it had reached in *Arthur Young*:

> There, we held that accountants who acted in accordance with Generally Accepted Auditing Standards (GAAS) were not liable under section 17(a), Secton 10(b) or Rule 10b–5, and that the industry standard, namely compliance with GAAS, was the relevant standard for measuring the accounts' [sic] conduct.
>
> *Arthur Young* does not require us to hold that compliance with an industry standard absolves a securities professional from liability under federal securities laws. Our holding in *Arthur Young* was made in the particular context of the accounting profession. GAAS guidelines establish accounting standards that are explicitly defined in authoritative, publicly available

> we have noted, with reference to *United States v. Simon*, that in certain circumstances generally accepted accounting principles will not immunize an accountant if he consciously chose not to disclose a known material fact.

677 F.2d 1301, 1313 n.15 (9th Cir. 1982) (citations omitted).

45 254 F.3d 852 (9th Cir. 2001).

46 *Id.* at 854.

47 15 U.S.C. § 77q(a)(1) (2000).

48 *Rauscher*, 254 F.3d at 853.

49 *Id.* at 855.

50 *Id.* at 856.

51 590 F.2d 785 (9th Cir. 1979).

pronouncements issued by recognized sources and utilized throughout the accounting profession.[52]

Finding that there was no such time-honored, authoritative industry standard of conduct for municipal finance professionals, the court of appeals declined to treat the standards of that industry as anything more than a "relevant factor" in assessing reasonable prudence.[53] In so doing, the Ninth Circuit reinforced the Second Circuit's statement in *Simon* that a GAAP defense will be more persuasive where the applicable accounting principles are clear. And, echoing the second limitation on *Simon*, the Ninth Circuit reiterated that in *Arthur Young* it had "declined to hold that compliance with GAAS alone would immunize an accountant who failed to reveal material facts that were known or which, but for a deliberate refusal to become informed, should have been known."[54]

V. *SIMON'S* LEGACY

On one level, the certification provisions' standardless duty of "fair presentation" is simply a statutory vessel that will have to be filled by judicial construction. But the government and the courts must be careful to fill that vessel in a way that leaves businessmen and businesswomen with some meaningful guidance as to what is, and is not, prohibited. As we have seen from the foregoing discussion of *Simon* and *Arthur Young*, the most that the existing antifraud case law would seem to support is that GAAP governs financial disclosure if GAAP requires a particular treatment. Where GAAP permits (but does not require) a certain result, GAAP should nevertheless govern, unless the party making the disclosure knows, or has deliberately refused to become informed about, a fact that is so material that GAAP compliance is effectively meaningless.[55] If

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52 *Rauscher*, 254 F.3d at 857 (citations omitted).

53 *Id.*

54 *Id.* at n.4.

55 In a recent settled enforcement action, In re *Dynegy Inc.*, Securities Act Release No. 8134, Exchange Act Release No. 46537, AAER No. 1631 (Sept. 24, 2002), the SEC cited, in place of *Simon*, the Fourth Circuit's considerably more recent opinion in *Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994), in which the court observed that " 'In some circumstances, courts have found defendants liable for securities fraud under Rule 10b-5 despite having complied with GAAP.' " In re *Dynegy Inc.*, at 9, quoting *Malone*, 26 F.3d at 478. *Malone* does not advance the inquiry into when compliance with GAAP will be found sufficient in a fraud or a

the SEC, or Congress, wish to move the law beyond the line drawn in *Simon*, they should make the new standard clear. It is bad regulatory and law enforcement policy to take the GAAP standard away and leave persons facing criminal sanctions with nothing. In particular, an empty formulation, such as the SEC's statement in its Certification Release, that compliance with GAAP "may not necessarily satisfy obligations under the antifraud provisions" is not helpful, and may lead the government to suffer needless judicial reverses as it attempts to enforce the new law.[56]

criminal case, and when it will not. The language quoted from *Malone* was pure dictum; the issue before the Fourth Circuit in that case was whether a trial judge had erred in granting defendants judgment as a matter of law in the face of expert testimony adduced by the plaintiffs stating that the defendants had violated Statement of Financial Accounting Standards No. 48 (Fin. Accounting Standards Bd. 1981). *Malone*, 26 F.3d at 477–78. Moreover, the only authority that the *Malone* court itself cited for the proposition that GAAP might be insufficient "in some circumstances" was one of *Simon*'s early progeny, *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 121–22. *See supra* note 21. In *Herzfeld*, the district court found that extended discussion of GAAP compliance "misse[d] the point" where the defendant accountants had issued a report concluding that a nursing home sale—the largest transaction in which the issuer had ever participated—was a good sale, and permitting income from the transaction to be recorded, when the accountants knew among other things: that neither the sale nor the preceding purchase was recorded in the issuer's books; that the issuer would have shown a loss if the income from the transactions were not realized; that the issuer had not acquired title to the nursing home properties; that no deed, title search, or title insurance had ever been obtained by the issuer; and that the legal opinion on which the accountants relied had been obtained over the telephone from an attorney who had neither seen the relevant contract, nor had it read to him over the telephone. *Id.* at 121, 125–26. It is easy to see, in these facts, not only an illustration of the second limitation discussed in text above (known, extraordinarily material facts that make the question of GAAP compliance effectively meaningless), but in all likelihood a GAAP violation as well.

[56] *See* Banca Cremi v. Alex Brown & Sons, Inc., 132 F.3d 1017, 1035 (4th Cir. 1997); Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996).