CRE Report Card
SEC's Proposed Rule on Auditor Independence

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A. Goals, Methodology, Conclusions and Recommendations.

1. Goals.

The goals of this Report Card are:

-- To delineate systematically the policies and requirements imposed by Congress and the Administration on the Securities and Exchange Commission's ("SEC") rulemaking proceeding to promulgate a regulation governing auditor independence.

-- To assess the extent to which the SEC has complied with these policies and requirements; and

-- To the extent that infirmities are identified, to suggest what the SEC (and oversight agencies such as the Office of Management and Budget ("OMB") and the Congressional Budget Office ("CBO") could do to correct the infirmities.

2. Methodology.

CRE reviewed nine statutes and executive orders, and developed a roster of 48 principles and requirements designed by Congress and the Clinton Administration to ensure that Federal agencies address the following broad concerns:

-- Clarity of the result to be achieved by the regulation, taking into account the agency's delegated authorities and seriousness of the problem addressed by the regulation;

-- Openness and inclusion of all stakeholders, including meaningful consideration of concerns addressed by stakeholders;

-- Practical effectiveness of the approach selected by the agency, taking into account alternative approaches to achieve the same result; and

-- Appropriateness of costs stemming from the regulation, taking into account demonstrated need.

These four broad concerns pervade the 48 specific principles and requirements addressed in the pages that follow.

For each of the 48 requirements, CRE reviewed the administrative record, and in particular the NPRM, the Initial Regulatory Flexibility Analysis prepared by the SEC in support of the NPRM, and the "Supporting Statements" submitted by the SEC to OMB pursuant to the Paperwork Reduction Act. CRE also took into consideration the written testimony of witnesses who gave testimony at the hearing held by the SEC on its proposed rule.

3. Conclusions and Recommendations.

CRE's conclusions and recommendations are summarized in the chart on pages 1-3 above, and are detailed under the "**COMPLIANCE/NONCOMPLIANCE**" and "**SUGGESTED REMEDIAL ACTION**" headings for each of the 48 rulemaking principles and requirements. The following summarizes the steps that must be taken to cure the cited deficiencies in the rule and the rulemaking process:

a. The SEC must consider whether a new regulation would be appropriate at the present time in light of the existing private sector standards and the in-progress efforts of the Independent Standards Board ("ISB").

b. In order to justify any rulemaking, the SEC must document that: (i) there is a problem in need of a solution; and (ii) the agency has chosen the least-costly regulatory alternative.

c. If the SEC continues to believe that a new rule would be appropriate, the SEC must satisfy various procedural and substantive requirements set forth in applicable Federal law. This would likely require publication of a new notice of proposed rulemaking ("NPRM").

d. OMB and the CBO need to provide greater oversight in ensuring the SEC's compliance with these recommendations and the 48 Requirements generally.

CRE notes that the principles and requirements described in this Report Card were imposed by Congress, the Clinton Administration, and oversight agencies such as OMB to ensure that regulations, such as the SEC's proposed auditor independence regulation, would be procedurally and substantively fair to all affected parties. These requirements are designed to ensure that all conceivable impacts of a proposed rule are adequately addressed by the promulgating agency *and* that any and all concerned members of the public have and opportunity to know and understand the issues and to have their voices meaningfully considered before the agency makes its final decision.

B. Executive Order 12866 on Regulatory Planning and Review.

Preliminary Note: Although the principles of regulatory planning and review set forth in Executive Order 12866 are not legally binding on independent agencies, virtually all Federal agencies recognize that these principles represent the accepted standard of good practices in conducting rulemaking proceedings. Moreover, during the Reagan Administration the SEC informally agreed to comply with the predecessor to this executive order, which set forth substantially the same principles.

1. Compelling Public Need.

REQUIREMENT: A federal agency should not promulgate a regulation unless there is a "compelling public need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well-being of the American people." (Exec. Order 12866 § 1(a).) Compelling public need should take into account costs and benefits. Id.

COMPLIANCE/NONCOMPLIANCE: The SEC's justification for the proposed rule is twofold. First, the SEC states that there might be a lack of independence and objectivity in the performance of audits by accounting firms providing non-audit services to the same audit clients. Second, the SEC states that, even if there is not an actual independence/objectivity problem, it may be the case that investors perceive such a problem. The evidence in the record so far, however, demon-
strates that neither of these two possible problems in fact exists, and that, on the contrary, private market mechanisms established by the securities industry, together with existing SEC rules, have done a yeoman's job of setting a global standard of excellence in accounting and auditing practices:

ACTUAL INDEPENDENCE AND OBJECTIVITY

(a) Practical incentives. Accounting firms have a number of practical incentive to ensure independence and objectivity in the performance of audits. These include: (i) the risk of legal liability for improperly performed audits; and (ii) the necessity to maintain the firm's reputation so as to attract future business from the audit client, as well as from other clients. It is precisely because these practical incentives exist that Congress drafted the securities laws in a way that permits the audit client to pay the auditor's fee.

Accounting irregularities, and related negative public perceptions, harm both the audit client and the accounting firm. The latter suffers damage to its ability to retain, and attract new work from, the audit client, in addition to harming the accounting firm's reputation within the industry. These considerations result in accounting firms imposing a significant degree of self discipline.

(b) US Chamber of Commerce study. The US Chamber of Commerce reviewed the empirical data, and concluded that "the accounting profession is exercising its responsibilities with the requisite degree of independence and discretion."

(c) Statement of former SEC Commissioner Wallman. According to former SEC Commissioner Steve Wallman, "a prohibitive approach focusing on the provision of non-audit services to audit clients...appears to be wholly without empirical support indicating any lack of objectivity in fact resulting from the provision of non-audit services to audit clients."

(d) Office of the Comptroller of the Currency study. An OCC study of bank financial statements concluded that there was no evidence of audit failure linked to the provision of non-audit services to audit clients.

(e) General Accounting Office study. A GAO study found that, not only is there no conclusive evidence that providing traditional management consulting services compromises auditor independence, but the synergies inherent in providing many types of services benefits both the audit client and investors. (GAO. "The Accounting Profession, Major Issues: Progress and Concerns" (Sept. 1996).)

(f) O'Malley Panel report. According to the O'Malley Panel study, which was conducted at the behest of the SEC, "[t]he QPR [Quasi Peer Reviews] did not identify any instances in which providing non-audit services had a negative effect on audit effectiveness. On about a quarter of the engagements in which non-audit services had been provided, the QPR reviewers concluded that those services had a positive impact on the effectiveness of the audit." (The Panel on Audit Effectiveness: Report and Recommendations, Exposure Draft ¶ 5.17 at 103 (May 31, 2000).)

INVESTOR PERCEPTIONS

(g) Earnscliffe study. The independent survey conducted by Earnscliffe Research & Communications in 1999 ("Earnscliffe study") concluded that: (i) the vast majority of respondents believe that auditors presently conform to a high standard of objectivity and independence; (ii) most interviewees felt that the general standard of financial reporting in the US is the highest in the world; and (iii) the role played by periodic statements in investor decisionmaking and investor confidence is declining, due to the increasing role played by time-sensitive information.

(h) Testimony of J. Terry Strange. J. Terry Strange, who testified on behalf of KMPG LLP, pointed out that if investors perceived that the provision of both audit and non-audit services to the same company presented a problem, as suggested by the SEC, then: (i) such investors would "penalize" such companies "by imposing a higher cost of capital" ; and (ii) accounting firms that provide both types of services would "experience higher liability insurance rates." The facts that investors do *not* impose a higher cost of capital on companies receiving both audit and non-audit services from the same accounting firm, and that insurers do *not* impose higher liability premiums on such accounting firms disproves the SEC's thesis that the provision of both types of services might impair investor confidence in the integrity of financial reports.

(i) Testimony of Robert Garland. According to Robert Garland of Deloitte & Touch LLP, "I believe the SEC has been largely responsible for promoting this [*i.e.*, the perception of independence] issue....If it were widespread, we would see evidence as to a confidence crisis in the capital markets. This simply is not the case."

(j) Comment of US Chamber of Commerce. In a letter dated August 7, 2000 to Chairman Levitt, the US Chamber of Commerce stated that "our members believe their needs are being met, and they are, in fact, pleased that the accounting profession is expanding its roster of available services to help meet the changing needs of the information age economy."

SUGGESTED REMEDIAL ACTION: The SEC should reconsider the need for undertaking any regulatory action in light of the agency's failure to establish any material failure on the part of the private markets to adequately self-regulate auditing practices.

2. Consistency with Statutory Mandate; Promotion of President's Priorities.

REQUIREMENT: "Federal agencies should promulgate only such regulations as are required by law, [or] are necessary to interpret the law." (Exec. Order 12866 § 1(a).) Rulemaking agencies should "ensure that new or revised regulations promote the President's priorities." (Id. § 4.)

COMPLIANCE/NONCOMPLIANCE: The SEC has not complied with this principle for the following reasons. First, no regulatory interpretation of the term "auditor independence" is necessary, because in late 1999 the SEC oversaw the promulgation of a complete regulatory regime to govern auditor independence. (See discussion at Requirement No. 6.) Second, Congress did not authorize the SEC to set standards for auditor independence, and certainly did not empower the SEC to restructure the entire accounting industry. There is a serious question as to whether the proposed rule is consistent with the SEC's statutory authority. Third, there is no evidence in the administrative record that auditor independence is an Administration priority.

SUGGESTED REMEDIAL ACTION: The SEC should rescind or substantially curtail the proposed rule.

3. Assessment of Quantifiable (Economic) Costs/Benefits.

REQUIREMENT: "[A]gencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating. Costs and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully measured) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider." (Exec. Order 12866 § 1(a).)

"Each agency shall assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs." (Id. § 1(b)(6).)

COMPLIANCE/NONCOMPLIANCE: The NPRM failed to address the following eight categories of costs:

(a) Lost work opportunities for accounting firms due to express prohibitions in the proposed rule. The accounting firm would in many instances have to choose between accepting audit or non-audit assignments involving both the audit client and its affiliates. No attempt was made in the NPRM to estimate extent of such lost business opportunities and the associated costs.

This impact is exacerbated due to the fact that the prohibitions in the proposed rule would apply to "affiliates of" the accounting firms, which is defined extremely broadly to capture companies with which firms have only the most minimal connection.

(b) Lost work opportunities for accounting firms due to lack of clarity as to what is prohibited. In addition to lost business opportunities stemming from express prohibitions in the proposed rule, accounting firms would also have to forego work opportunities where it would be unclear whether the opportunity is authorized or prohibited. As is set forth at Requirement No. 17 below, a number of the rule's provisions are contradictory or unclear, so that the accounting firm would have to err on the side of caution and forego certain types of work to avoid enforcement or civil liability.

(c) Loss of qualified employees. According to the O'Malley Panel report, "[a]ttracting and retaining [qualified employees with diversified skills], and motivating them to provide direct audit support, may well be hampered significantly if they were to be prohibited from providing non-audit services to public audit clients." (O'Malley Panel Report ¶ 5.49 at 118.) Data on employment in the accounting industry indicates that there has been a steady decline, both in the number of accounting graduates, and in the number of accounting graduates who accept employment in accounting, as opposed to consulting, firms. The proposed rule would aggravate this trend.

(d) Increased costs to audit clients of audit and non-audit services. According to the Earnscliffe study, "[r]oughly half of the CEO's and CFO's interviewed said that they liked to use their audit firms for non-audit assignments, because they felt that it was likely to result in better consulting at a more reasonable cost. They reasoned that their auditors were better able to understand their needs, that they had a relationship that worked, and that the audit firm would be motivated to do a good job and charge reasonable fees, knowing that the client was long term, important relationship."

(e) Costs to audit clients stemming from impaired audit quality. (See discussion of the audit quality issue at Requirement 5(a).)

(f) Loss of employment to individual employees due to accounting firm cut-backs necessitated by the proposed rule. (See discussion of the audit quality issue at Requirement 4(c).)

(g) Restructuring costs to accounting firms required to segregate their audit and non-audit functions. Accounting firms would incur significant corporate restructuring costs.

(h) Costs to audit clients stemming from interruptions and inefficiencies in the procurement of audit and non-audit services. Under the proposed rule, companies presently employing one firm to provide audit and non-audit services would be forced to go through the cost and distraction of choosing new vendors for services.

Significantly, some of the above costs are likely to be passed through to shareholders and thus will harm public investors as well as the affected accounting and SEC registrant companies.

SUGGESTED REMEDIAL ACTION: The SEC should not proceed with its proposed rule until it has adequately assessed the quantitative economic impacts of each of the above categories. The SEC should provide notice in the Federal Register of how it arrived at its quantitative estimates for each of the above categories, and provide the public with an opportunity to comment on the same.

4. Assessment of Adverse/Beneficial Effects on the National Economy.

REQUIREMENT: The cost-benefit analysis must address "any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness)." (Exec. Order 12866 § 6(a)(3)(C)(ii).)

COMPLIANCE/NONCOMPLIANCE: The NPRM does not address the following negative impacts of the SEC's proposal:

(a) Impact on productivity. The proposed rule would prevent accounting firms from developing and evolving skills required in the "New Economy," such as mastery of skills necessary to audit state-of-the-art information technology systems, due to the prohibition against performing non-audit work for audit clients. (See Summary of Testimony for KPMG LLP ("investors in the New Economy need accounting firms with a broad range of skills and technological expertise to enable accurate and effective audits responsive to new technologies and business models. The needs of investors in the New Economy requires further study by Congress before the SEC imposes a regulatory restriction on accounting firms' scope of practice.").)

(b) Impact on small businesses. According to the US Chamber of Commerce, the proposed rule would "[p]ersuade some accounting firms, especially at the regional level, to eliminate certain services, making it more difficult for smaller businesses to obtain the professional assistance they need at a reasonable cost." (See letter of US Chamber of Commerce to Chairman Levitt (Aug. 7, 2000).)

(c) Impacts on employment. The proposed rule would have two negative impacts on employment. First, it would "[f]orce businesses to dismiss auditors who have performed well in order to avail themselves of needed non-audit services from the auditor's firm". (See letter dated August 7, 2000 from US Chamber of Commerce to Chairman Levitt.) Second, the proposed rule would make it difficult for accounting firms to attract new talent. (See Summary Testimony of KPMG LLP ("[i]n order to recruit world-class professionals, accounting firms must offer a variety of challenging opportunities on the cutting edge. The best and the brightest will not be drawn to either a specialized audit-only firm or a firm that can only serve 60% of the market in the same way they are drawn to a multi-practice cutting-edge firm that provides a broad range of services and career opportunities").)

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Action at Requirement No. 3.

5. Assessment of Qualitative Impacts.

REQUIREMENT: The cost-benefit analysis must incorporate an analysis of "qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider." (Exec. Order 12866 § 1(a).)

COMPLIANCE/NONCOMPLIANCE: The NPRM failed to consider the following qualitative considerations:

(a) Enhancement of audit quality stemming from non-audit relationship. When an accounting firm provides both audit and non-audit services to an audit client, the quality of the audit is enhanced, because the accounting firm develops a familiarity with and understanding of all of the audit client's business operations. (See letter dated August 7, 2000 from US Chamber of Commerce to Chairman Levitt (the SEC proposal would "[l]ead to less effective audits because auditors will be walled off from the expertise now provided by non-audit professionals. This would be particularly unfortunate in an era in which the increased speed and complexity of business dealings places a premium on both technical and institutional knowledge").)

In addition, some audits require input from non-audit professionals, such as information technology professionals. The proposed rule would disallow this kind of consultation, and hence impair audit quality. Moreover, if the accounting firm conducting the audit were required to seek outside assistance, the firm would be less able to impose quality controls. (Testimony of Robert Garland.)

(b) Qualitative impact stemming from inability to staff the audit. In order to perform a quality audit, members of audit team may be required to possess knowledge of such diverse fields as information technology systems, derivatives portfolios, business processes and controls, corporate finance, going concern/work-out situations, government contracts, insurance reserves, environmental exposures - - all in addition to traditional auditing/accounting skills. If team members are prohibited from working in the aforementioned non-audit areas, then they will be unable to bring these skills to the audit function.

- - Thus, the O'Malley Panel report noted that "these professionals maintain and build their skills by providing non-audit services....another unintended consequence of a prohibition would be to reduce audit effectiveness." (O'Malley Panel Report ¶ 5.49 at 118.)

(c) Impact on audit clients of the inability to obtain time-sensitive services from accounting firms. According to the O'Malley Panel report, "[w]hen timing of a project is critical and requires the rapid deployment of skilled personnel, a company should not be denied access to the services of its audit firm. This is particularly true when the company believes that the firm, because of its knowledge of the client, is best capable of providing the services and doing so on a timely basis. This is a frequently occurring, very practical consideration that ought not to be overlooked."

(d) Access to, and quality of, services. The SEC proposal would "[c]ompel businesses to accept their second choice for non-audit services in order to maintain a relationship with their existing auditor." (See letter dated August 7, 2000 from US Chamber of Commerce to Chairman Levitt.)

SUGGESTED REMEDIAL ACTION: The proposed rule should be rescinded in light of the negative qualitative impacts identified above.

6. Alternatives to Adopting a Regulation.

REQUIREMENT: "Each agency shall identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public." (Exec. Order 12866 § 1(b)(3).)

COMPLIANCE/NONCOMPLIANCE: There is an existing, elaborate, private-sector framework in place to address issues of auditor independence. In particular, the SEC created the ISB in order to resolve such issues. See SEC Release 33-39676, which states that:

> "[T]he Commission expects that the public interest will be served by having the ISB take the lead in establishing, maintaining, and improving auditor independence requirements; and that operation of the ISB will promote efficiency, competition, and capital formation. The ISB, which is composed equally of public members...and practicing accountants, has undertaken to develop an institutional framework that will permit prompt and responsible actions by the ISB and its staff flowing from research and objective consideration of the issues. Collectively, the ISB members bring substantial experience and expertise to the process. In addition, the accounting profession's commitment of financial resources to the ISB is evidence of the private sector's willingness and intention to support the ISB. Under these circumstances, the Commission expects that determinations of the ISB will preserve and enhance the independence of public accountants, and thereby promote the interests of investors." (Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence, Exchange Act Release No. 34-39676 (Feb. 18, 1998).)

The ISB recently issued several standards relating to auditor independence. These are the functional equivalent of a negotiated rulemaking, in which the SEC fully participated and gave its blessing.

The ISB is also far along in developing a comprehensive framework for evaluating auditor independence issues.

Additionally, the industry trade group, the American Institute of Certified Public Accountants ("AICPA"), has a comprehensive Code of Professional Conduct to which all of its members are subject, and the SEC Practice Section has various rules governing auditors who represent SEC registrants. Further, the SEC Practice Section ("SECPS") has a well developed peer review program, pursuant to which members are subject to review every three years.

As many of the new ISB standards did not go into effect until this year, and the Conceptual Framework Process has not yet been completed, it would be inappropriate for the SEC to effectively invalidate them through a preemptive, command-and-control regulation before there is

an opportunity to review their effectiveness. (See Testimony of William Allen (detrimental impact the SEC's proposed rule would have on development of the ISB's Conceptual Framework Project.)

SUGGESTED REMEDIAL ACTION: The SEC should not act until the ISB standards and other efforts are given an opportunity to prove their effectiveness.

7. Alternative Regulatory Approaches.

REQUIREMENT: Once it is determined that there is a valid need to adopt a regulation, the agency must develop a roster of regulatory alternatives. (See Exec. Order 12866 § 1(b)(8).)

COMPLIANCE/NONCOMPLIANCE: As stated at Requirement No. 6 above, the new regulatory standards governing auditor independence have just gone into effect. The SEC fully participated in the development of these standards, and approved their contents. These efforts, coupled with adequate SEC administrative enforcement of existing regulations governing the audit function, constitute a regulatory alternative which was not adequately considered by the SEC.

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Action at Requirement No. 6.

8. Netting to Select the Most Beneficial Alternative.

REQUIREMENT: "[I]n choosing among alternative regulatory approaches, agencies should select those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity), unless a statute requires another regulatory approach." (Exec. Order 12866 § 1(a); see also id. § 1(b)(6) (the agency may impose a given regulatory alternative "only upon a reasoned determination that the benefits...justify its costs").)

COMPLIANCE/NONCOMPLIANCE: Given the quantitative and qualitative costs that would be imposed by the SEC's proposed rule, and given the fact the accounting industry has already commenced compliance with various ISB standards, allowing the private sector to proceed represents the most cost-effective alternative regulatory approach.

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Action at Requirement No. 6.

9. Identification of Problem Necessitating Regulation.

REQUIREMENT: "Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as the significance of the problem." (Exec. Order 12866 § 1(b)(1).)

COMPLIANCE/NONCOMPLIANCE: The SEC has identified what it believes is a problem, but has not provided any evidence in support of its belief.[1] Accordingly, it was not possible for the Commission to represent the degree of significance.

SUGGESTED REMEDIAL ACTION: The NPRM should be withdrawn unless the SEC can document the existence of a problem and that the problem is sufficiently significant to warrant the extreme measures proposed.

10. Role of Existing Legal Requirements in Creating the Problem.

REQUIREMENT: "Each agency shall examine whether existing regulations (or other law) have created, or contributed to, the problem that a new regulation is intended to correct and whether those regulations (or other law) should be modified to achieve the intended goal of regulation more effectively." (Exec. Order 12866 § 1(b)(2).)

COMPLIANCE/NONCOMPLIANCE: This is not an issue in the present rulemaking proceeding.

SUGGESTED REMEDIAL ACTION: (Not applicable.)

11. Assessment of Relative Risk.

REQUIREMENT: "In setting regulatory priorities, each agency shall consider, to the extent reasonable, the degree and nature of the risks posed by various substances or activities within its jurisdiction." (Exec. Order 12866 § 1(b)(4).)

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[1] This is despite the fact that the SEC acknowledged in 1997 that updated research on the question of investor confidence was needed before a regulation could be promulgated. See Letter from SEC Chief Accountant Michael Sutton to ISB Chairman William Allen (Dec. 11, 1997) ("[i]t appears that in certain areas, new, updated research is needed--focusing on investors' confidence in the audit process and in the markets--before the ISB considers whether to abandon approaches that have been in place for 60 years. The current system, although it may be in need of repair, has worked").

COMPLIANCE/NONCOMPLIANCE: This Report Card has identified a number of adverse quantitative and quantitative impacts that would result from promulgation of the SEC's present proposal. The SEC has not, to date, evaluated these risks or impacts, nor weighed them against the potential benefits envisioned by the SEC.

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Action at Requirement 3.

12. Design of Regulation in Most Cost Effective Manner.

REQUIREMENT: "When an agency determines that a regulation is the best available method of achieving the regulatory objective, it shall design its regulations in the most cost-effective manner to achieve the regulatory objective. In doing so, each agency shall consider incentives for innovation, consistency, predictability, the costs of enforcement and compliance (to the government, regulated entities, and the public), flexibility, distributive impacts, and equity." (Exec. Order 12866 § 1(b)(5).)

COMPLIANCE/NONCOMPLIANCE: The costs of this rulemaking are exorbitant to public investors, the accounting industry, and SEC registrants. Any impairment of audit quality would inure to the detriment of investors and the public at large. As stated elsewhere, these costs have not been documented or weighed against the purported benefits. In addition, the NPRM does not reflect any consideration of the factors identified in Executive Order 12866.

SUGGESTED REMEDIAL ACTION: The SEC should withdraw the NPRM and modify the release and the proposed rule to satisfy this requirement.

13. Data Supporting Selected Regulatory Approach.

REQUIREMENT: "Each agency shall base its decisions on the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation." (Exec. Order 12866 § 1(b)(7).)

COMPLIANCE/NONCOMPLIANCE: The absence of data in support of the SEC proposal is set forth at Requirement No. 1.

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Actions at Requirements Nos. 1 and 3.

14. Adoption of Performance-Based, Rather Than Command-and-Control Regulatory Solutions.

REQUIREMENT: "Each agency shall...to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt." (Exec. Order 12866 § 1(b)(8).)

COMPLIANCE/NONCOMPLIANCE: The private sector initiatives described at Requirement No. 6 are largely performance-based, particularly ISB Standard No. 1, which is premised on the idea that independent audit committees will oversee auditor independence on a company-by-company basis, and that such committees will request additional information and resolve problems on a case-by-case basis. The present SEC regulatory proposal, on the other hand, is a classic command-and-control regulation, as both the SEC acknowledges. (See NPRM § VI.)

SUGGESTED REMEDIAL ACTION: See Suggested Remedial Action at Requirement No. 6.

15. Compatibility with Regulations of Other Federal Agencies.

REQUIREMENT: "Each agency shall avoid regulations that are inconsistent, incompatible, or duplicative with its other regulations or those of other Federal agencies." (Exec. Order 12866 § 1(b)(10).)

COMPLIANCE/NONCOMPLIANCE: The SEC's proposal is entirely duplicative of an existing regulatory and self-regulatory regime which is in place and which has not been demonstrated to have failed in any significant or material way. (See discussion at Requirement No. 6 above.)

SUGGESTED REMEDIAL ACTION: The present NPRM should be withdrawn.

16. Narrowly-Tailored Requirement.

REQUIREMENT: "Each agency shall tailor its regulations to impose the least burden on society, including individuals, businesses of differing sizes, and other entities (including small communities and governmental entities), consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations." (Exec. Order 12866 § 1(b)(11).)

COMPLIANCE/NONCOMPLIANCE: The SEC proposal would impose massive burdens, both quantitative and qualitative, on accounting firms and reporting companies. The deleterious *qualitative* impacts that would flow from the SEC proposal are particularly troubling, because they have the real potential to harm the quality and reputation of the US auditing function in the international financial markets.

SUGGESTED REMEDIAL ACTION: The present NPRM should be withdrawn.

17. Easy-to-Understand Requirement.

REQUIREMENT: "Each agency shall draft its regulations to be simple and easy to understand, with the goal of minimizing the potential for uncertainty and litigation arising from such uncertainty." (Exec. Order 12866 § 1(b)(12).)

COMPLIANCE/NONCOMPLIANCE: The proposed rule fails this test, because it is unduly complex, and contains a number of inconsistencies. These inconsistencies would make it impossible for accounting firms and SEC registrants to maintain full compliance with all of the rule's provisions. For example, it would be difficult or impossible to distinguish between:

- - "assessment, design, and implementation of internal accounting and risk management controls," which would be permitted, *versus* "internal audit services" or "designing or implementing a hardware or software system used to generate information that is significant to the audit client's financial statements taken as a whole," which would be prohibited. (Proposed § 2-01(c)(4).)

- - the permitted provision of services related to the management of technology risks across an entire organization, *versus* the prohibited design and implementation of information systems relating to financial statements.

- - the permitted provision of "tax-related services," *versus* the prohibition against "[a]ny appraisal or valuation service." (Proposed § 2-01(c)(4).)

SUGGESTED REMEDIAL ACTION: The ISB standards and framework should be given an opportunity to go into full effect before any additional, overlapping requirements are imposed. This is particularly the case, as the ISB Standard provides independent audit committees with the flexibility to address individual cases based on individual circumstances, which in turn avoids the uncertainties of interpretation and implementation inherent in the SEC proposal.

18. Characterization as "Significant Regulatory Action."

REQUIREMENT: The agency and/or OMB must determine whether its proposal constitutes a "significant regulatory action." (See Exec. Order 12866 § 3(f).)

COMPLIANCE/NONCOMPLIANCE: Technically this requirement does not apply to the present rulemaking, because the SEC is an independent agency. However, principles of good government argue strongly in favor of application of the Executive Order.

SUGGESTED REMEDIAL ACTION: Given the significant impact the present proposal could have on the integrity of the US accounting profession and worldwide investor confidence in the US financial markets, OMB should exercise its general oversight authority and ensure the correction of the infirmities identified in this CRE Report Card.

19. Maximalization of Involvement of Affected Parties.

REQUIREMENT: "[B]efore issuing a notice of proposed rulemaking, each agency should, where appropriate, seek the involvement of those who are intended to benefit from and those expected to be burdened by any regulation (including, specifically, State, local, and tribal officials). In addition, each agency should afford the public a *meaningful* opportunity to comment on any proposed rulemaking, which in most cases should include a comment period of not less than 60 days." (Exec. Order 12866 § 6(a)(1) (emphasis added).)

COMPLIANCE/NONCOMPLIANCE: The SEC has not fully and fairly complied with this requirement. Although most of the key stakeholder groups have been identified, the public comment period is seriously inadequate in light of the number of issues raised and the documentation required to address those issues. (See discussion at Requirement No. 22 below.)

SUGGESTED REMEDIAL ACTION: The agency is in compliance with the requirement that it include the key stakeholder groups in the process. However, the SEC should implement the Suggested Remedial Action at Requirement No. 22.

20. Consideration of Consensual Mechanisms Such as Negotiated Rulemaking.

REQUIREMENT: "Each agency is also directed to explore and, where appropriate, use consensual mechanisms for developing regulations, including negotiated rulemaking." (Exec. Order 12866 § 6(a)(1).)

COMPLIANCE/NONCOMPLIANCE: As described at Requirement No. 6 above, the ISB standards and framework represent the product of what was effectively a negotiated rulemaking process. By proposing the present regulation, the SEC is essentially preempting that process.

SUGGESTED REMEDIAL ACTION: The present NPRM should be withdrawn pending full implementation and assessment of the effectiveness of the ISB standards. Should a new rulemaking be commenced in the future, the SEC should pursue a negotiated rulemaking.

21. OIRA Review of Significant Regulatory Actions.

REQUIREMENT: If the planned regulatory action is characterized as "significant," the Office of Information and Regulatory Affairs ("OIRA") within OMB is required to review the cost-benefit assessment. (Exec. Order 12866 § 6(a)(2)(B).) However, OIRA does not review non-significant actions. (Id. § 6(b)(1).) Moreover, when the planned regulatory action is characterized as "significant," OMB is required to make available to the public "all documents exchanged between OIRA and the agency during the review by OIRA and the agency under this section." (Id. § 6(b)(4)(D).)

COMPLIANCE/NONCOMPLIANCE: See discussion at Requirement No. 18 above.

SUGGESTED REMEDIAL ACTION: See discussion at Requirement No. 18 above.

C. Administrative Procedure Act.

22. Adequacy of Opportunity for Notice and Comment.

REQUIREMENT: "[T]he agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." (5 U.S.C. § 553(c).) The comment period is not adequate if it does not provide a "meaningful" or "fair" or "reasonable" opportunity to be heard. In particular, the agency's final rule could be subject to challenge to the extent that regulated parties are not provided with a reasonable opportunity to respond, taking into account the facts and circumstances. (See Estate of Smith v. Bowen, 656 F. Supp. 1093, 1097-98, 1099 (D. Colo. 1987) (invalidating HHS regulation due to HHS' refusal to grant an extension of the comment period).)

(It is also noteworthy that section 6(a)(1) of Executive Order 12866 implies that 60 days is the low-end threshold for the length of public comment periods. See quoted language at Requirement No. 19 above.)

COMPLIANCE/NONCOMPLIANCE: A number of witnesses at the SEC hearing argued that the 75 day time period for public comment set forth in the NPRM is grossly inadequate, given the magnitude and importance of the issues involved. (See, e.g., letter dated Aug. 7, 2000 from US Chamber of Commerce to Chairman Levitt.)

SUGGESTED REMEDIAL ACTION: A minimum of three additional months should be provided, so that stakeholders can develop the empirical data to demonstrate the need and efficacy, or lack thereof, of the proposed rule.

D. Regulatory Flexibility Act.

23. Determination of "Significant Economic Impact" on "Substantial Number of Small Entities."

REQUIREMENT: The Regulatory Flexibility Act is drafted in a manner that creates a presumption that a proposed rule would have a "significant economic impact" on a "substantial number of small entities," unless the agency officially "certifies" otherwise. (See 5 U.S.C. § 605(b).) If the proposed rule would *not* significantly impact a substantial number of small entities, then the agency is exempted from the requirement of preparing initial and final regulatory flexibility analyses. (Id. § 605(b).) The language of section 605 indicates that an agency's failure to certify affirmatively that a proposed rule would *not* significantly affect small entities triggers the applicability of sections 603 and 604, requiring the initial and final regulatory flexibility analyses. This is significant in light of the Regulatory Flexibility Act's judicial review provisions. (See id. § 611.)

COMPLIANCE/NONCOMPLIANCE: The SEC has not identified: (i) the full range of types of "small entities" that would be significantly affected if the proposed rule goes into effect; (ii) the number of such entities; and (iii) the types of impacts that would apply to each. Therefore, the Initial Regulatory Flexibility Analysis is inadequate.

SUGGESTED REMEDIAL ACTION: The SEC must prepare a complete and accurate Initial Regulatory Flexibility Analysis. The present NPRM must be withdrawn, and then resubmitted at such time as a complete Initial Analysis has been prepared.

24. Inclusion of the Planned Regulation in the *Unified Federal Regulatory Agenda*.

REQUIREMENT: "[E]ach agency shall publish in the Federal Register a regulatory flexibility agenda which shall contain...(1) a brief description of the subject area of any rule which is likely to have a significant economic impact on a substantial number of small entities..." (5 U.S.C. § 602(a)(1).)

COMPLIANCE/NONCOMPLIANCE: The SEC has only partially complied with this requirement. The agency did not publish an entry in the October 1999 Unified Agenda. Although the SEC did include an entry in the April 2000 Unified Agenda, the entry was cursory and vague, and incorrectly listed this rulemaking proceeding as "nonsignificant." (See 65 Fed. Reg. 22481, 23959 (Apr. 24, 2000).)

SUGGESTED REMEDIAL ACTION: There is no available corrective action. However, the SEC should ensure that more adequate information is provided in the October 2000 Unified Agenda.

25. Initial Regulatory Flexibility Analysis.

REQUIREMENT: Whenever a proposed rule would have a significant economic impact on a substantial number of small entities, the agency must prepare, and make available for public comment, an initial regulatory flexibility analysis. (5 U.S.C. § 603(a).) The initial analysis must identify "any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities." Specific alternatives that must be addressed include:

(i) Establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;

(ii) Clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities;

(iii) Use of performance rather than design standards; and

(iv) Exemption from coverage of all or part of the rule for such small entities.

Id. § 603(c).

COMPLIANCE/NONCOMPLIANCE: The SEC has failed to comply with this requirement for three key reasons. First, what the SEC has denominated as an "Initial Regulatory Flexibility Analysis," is in reality merely a request for information on the number of "small entities" to be affected by the proposal. In other words, the SEC has not complied with the requirement that a complete Initial Analysis be prepared as of the date of the NPRM. Put another way, the discussion set forth in the SEC's discussion of the Regulatory Flexibility Act should have been published at the ANPRM stage, *i.e.*, so that the SEC would have then been able to prepare an adequate Initial Analysis as of the date of the NPRM.

Second, the SEC has not adequately assessed the impact its proposal would have on smaller registrants. And finally, the SEC has not made any meaningful attempt to develop any of the four types of alternatives set forth in the statute designed to minimize the burden on small entities.

SUGGESTED REMEDIAL ACTION: The NPRM is premature in light of the fact that the SEC had not completed a proper Initial Regulatory Flexibility Analysis as of the time the NPRM was published in the Federal Register. Therefore, the NPRM should be withdrawn pending completion of the Initial Analysis.

26. Review of Initial Regulatory Flexibility Analysis by Small Business Administration.

REQUIREMENT: "The agency shall transmit a copy of the initial regulatory flexibility analysis to the Chief Counsel for Advocacy of the Small Business Administration." (5 U.S.C. § 603(a).) If the agency determines that the proposed rule would not have a significant economic impact on a substantial number of small entities, "[t]he agency shall provide such certification and statement to the Chief Counsel for Advocacy of the Small Business Administration." (Id. § 605(b).)

COMPLIANCE/NONCOMPLIANCE: Neither the NPRM nor the Initial Regulatory Flexibility Analysis indicate that SBA has reviewed or commented on the Initial materials prepared by the SEC.

SUGGESTED REMEDIAL ACTION: OMB should ensure that SBA works with the SEC to prepare a complete and accurate Initial Regulatory Flexibility Analysis, and that SBA reviews the same.

27. Special Notice and Consultation Requirements for Small Businesses.

REQUIREMENT: "When any rule is promulgated which will have a significant economic impact on a substantial number of small entities, the head of the agency promulgating the rule or the official of the agency with statutory responsibility for the promulgation of the rule shall assure that small entities have been given an opportunity to participate in the rulemaking for the rule through the reasonable use of techniques such as... (3) direct notification of interested small entities; and... (5) the adoption or modification of agency procedural rules to reduce the cost or complexity of participation in the rulemaking by small entities." (5 U.S.C. § 609(a).)

COMPLIANCE/NONCOMPLIANCE: Neither the NPRM nor the Initial Regulatory Flexibility Analysis indicate that the SEC has complied with this requirement. This may account for the statement in the NPRM to the effect that the SEC was unable to devise a performance-based mechanism to ensure auditor independence that could be applied to small accounting firms.

SUGGESTED REMEDIAL ACTION: See suggested remedial action at Requirement No. 26.

E. Paperwork Reduction Act ("PRA").

28. Adequacy of Notice and Opportunity to Submit Comments to OMB.

REQUIREMENT: Under the Paperwork Reduction Act, 44 U.S.C. §§ 3501, *et seq*., an agency must obtain OMB's approval before imposing recordkeeping or reporting requirements (referred to as "information collection requirements") on the public. The notice must provide the public with a minimum of 30 days within which to submit comments to the appropriate "desk officer" at OMB. (See 44 U.S.C. § 3507 (a)(1)(D); 5 C.F.R. §§ 1320.8(d)(1), 1320.11(a).)

COMPLIANCE/NONCOMPLIANCE: The SEC is in technical compliance with the notice requirement of the above-cited OMB implementing regulation. However, CRE has identified the following two problems with the notice. First, an extension of the comment period is needed so that respondents can provide the SEC and OMB with specific data on the recordkeeping and reporting burdens to be imposed by the proposed rule (and hence on the accuracy or inaccuracy of the SEC's estimates of the same). The PRA clearly anticipates a time period in excess of three months during which stakeholders can submit comments on "proposed information collection requests" to both the rulemaking agency (60 days) and OMB (30 days), in addition to the time the agency is supposed to take to review comments filed pursuant to the first, agency-level

comment period. (Compare 44 U.S.C. §§ 3506(c)(2)(A) and 3507(a)(1)(A), (B), (C), (a)(2).)

The second problem, related to the first, stems from the fact that OMB's implementing regulation is not in conformity with the PRA. To be in compliance with the statute, as opposed to the implementing regulation, there should be two separate and distinct comment periods, a 60-day comment period at the SEC and a 30-day comment period at OMB, as well as an interim period during which the SEC is supposed to consider modifying the proposal before transmitting its final "clearance package to OMB."[2]

SUGGESTED REMEDIAL ACTION: The SEC and OMB must provide additional time to stakeholders to give them a reasonable opportunity to demonstrate the accuracy or inaccuracy of the SEC's burden estimates, as well as to address other issues under the PRA (described at Requirements Nos. 29-38 below). To prevent confusion to the stakeholders and actual OMB consideration of all of the comments: (i) the deadline should be synchronized with the revised deadline for non-PRA comments to be filed in the SEC docket; (ii) The SEC should transmit all PRA-related comments to OMB so as to ensure that such comments are considered by OMB; and (iii) OMB should agree not to make its final decision to approve or disapprove the SEC's proposed information collection request until after the close of the comment period and after

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[2] The purpose of the first comment period is to enable the agency to pre-view the public comments, and to revise the proposed information collection request based on those comments *prior to* submitting the official information collection request (also referred to as a "clearance package") to OMB. After the first comment period has been completed, the rulemaking agency is supposed to do the following: (i) consider the PRA-related comments; (ii) determine whether the initial paperwork requirements should be revised in light of the comments; (iii) prepare a clearance package for OMB; (iv) include in the clearance package the ten certifications set forth at section 3506(c)(3)(A)-(J); (iv) document the certifications with references to the public comments. (See id. § 3506(c)(2), (c)(3).) After the agency has complied with all of these requirements, OMB is supposed to provide a second comment period of at least 30 days. The idea behind having a second comment period is that: (i) the paperwork requirements may have been modified in response to the agency-level comments; and (ii) the comments are now being filed directly with OMB.

Where the proposed information collection request is contained in an NPRM, the PRA allows the first, agency-level comment period to be subsumed into the APA comment period. However, the PRA does not anticipate that the second PRA comment period, *i.e.*, the OMB comment period, is also to be subsumed into the APA comment period. The OMB implementing regulation combines both the agency-level and OMB-level PRA comment periods into the APA comment period. In doing so, the OMB regulation violates the statute it is attempting to implement.

OMB has reviewed all PRA-related comments in the docket.[3] While these corrective actions are pending, OMB should reject the SEC's clearance package until such time as the SEC has attained full compliance with the substantive PRA standards described at Requirements Nos. 29-38 of this Report Card.

29. Purpose, Need and "Practical Utility" Requirements.

REQUIREMENT: Before imposing a paperwork requirement on the public, the sponsoring agency must demonstrate that "the proposed collection is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility." (44 U.S.C. § 3506(c)(2)(A)(i), (c)(3)A).) "Practical utility" is defined as "the actual, not merely the theoretical or potential, usefulness of information to or for an agency, taking into account its accuracy, validity, adequacy, and reliability, and the agency's ability to process the information it collects...in a useful and timely fashion." (5 C.F.R. §1320.4(*l*).) Moreover, a proposed information collection should be approved only if it would "enhance the quality, utility, and clarity of the information to be collected." (44 U.S.C. § 3506(c)(2)(A)(iii).)

COMPLIANCE/NONCOMPLIANCE: The SEC has not made a convincing case that the collection and disclosure of this data would in any significant way enhance investor confidence in the securities markets.[4] Therefore, the information collection requirements set forth in the SEC's

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[3] Alternatively, to correct the procedural discrepancy caused by OMB's implementing regulation, the SEC and OMB should re-notice the PRA comment periods, in accordance with the statutory language, as follows: (i) The notice in the NPRM should be deemed a notice pursuant to section 3506(c)(2)(A) and (B), and should be extended so that a minimum comment period of 60 days is provided. The notice should direct comments to the SEC, not OMB. (ii) After receiving PRA-related comments, the SEC should consider the same, determine whether it can make the certifications set forth at section 3506(c)(3)(A)-(J) in good faith, or, alternatively, whether the proposal should be revised. (iii) The SEC should transmit its clearance package to OMB. The clearance package should contain the section 3506(c)(3)(A)-(J) certifications. In addition, a second Federal Register notice should be published providing the public with the second, statutorily-required comment period, and directing comments to OMB.

[4] In 1982, when the SEC rescinded a disclosure requirement similar to the one now under consideration, the Commission concluded that the information was "not generally of sufficient utility to investors to justify continuation of the disclosure requirement." See Accounting Series Release No. 304, "Relationships Between Registrants and Independent Accountants" (Jan. 28, 1982). Although the present NPRM contains descriptions of changes in the accounting industry since that time, the NPRM does not contain any explanation of why or how the revival of command-and-control

proposed rule would not have "practical utility."

SUGGESTED REMEDIAL ACTION: OMB should disapprove the proposed information collections set forth in the NPRM.

30. Accuracy of Burden Estimates.

REQUIREMENT: The "sponsoring agency" (*i.e.*, the SEC) is required to "evaluate the accuracy of the agency's estimate of the burden of the proposed information to be collected." (44 U.S.C. § 3506(c)(2)(A)(ii).) OMB's ongoing and consistent practice is to require sponsoring agencies to submit *accurate* estimates of burden. When a sponsoring agency's burden estimate is demonstrably and materially inaccurate, *e.g.*, due to the failure to assess whole categories of burden, OMB's practice is to return the "clearance package" containing the proposed paperwork requirements to the sponsoring agency, and to require the agency to resubmit the clearance package with corrected burden estimates. The reason for this practice is that OMB cannot make key determinations without possessing accurate burden data. For example, without accurate data, OMB cannot determine whether the paperwork burdens to be imposed on respondents are justified based on the benefits to be provided by the information to be collected by the agency.

COMPLIANCE/NONCOMPLIANCE: The SEC estimates that one hour would be needed for issuers to translate information provided by their auditors into useable data for reporting to the Commission. The SEC failed to take into consideration burdens relating to: (i) design, creation and maintenance of computerized storage systems; (ii) instructing personnel in the information to be maintained and procedures for retrieval; (iii) retrieval of data from the new information system; (iv) reviewing the data and compiling it for entry in Schedule 14A or 14C; (v) hiring of outside professional to assist in compliance with the new requirements.

Another fundamental problem with the burden estimates stems from the fact that the SEC estimates that only 25% of issuers would be affected. In fact, although the percentage might be within the 25% range *in any one given year*, the use by issuers of both audit and non-audit services of one accounting firm varies from year to year, so that the total number of companies that would have to monitor (*i.e.*, maintain records of) their use of specific categories of services provided by their accounting firms would actually be much higher.

In addition, it appears that the SEC may not have adequately considered the fact that, in some

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disclosure requirements would be of "utility" in today's global economy.

instances (*e.g.*, when international branch offices are involved), respondents would have to work with "leased" personnel and entities to obtain the relevant information.

SUGGESTED REMEDIAL ACTION: In accordance with its general practice, OMB should return the SEC's clearance package to the SEC, and require the package to be re-submitted with corrected burden estimates. Before developing such corrected burden estimates and re-submitting the same to OMB, the SEC should work with key stakeholders to ensure their accuracy.

31. Preparedness of Designated Agency Office to Process the Information to Be Collected; Plan for Effective and Efficient Management of the Information.

REQUIREMENT: The agency must certify to OMB that the proposed information collection requirement "has been developed by an office that has planned and allocated resources for the efficient and effective management and use of the information to be collected, including the processing of information in a manner which shall enhance, where appropriate, the utility of the information to agencies and the public." (44 U.S.C. § 3506(c)(3)(H).) Moreover, prior to submitting the proposed information collection to OMB, the agency is required to have established "a plan for the efficient and effective management and use of the information to be collected, including necessary resources." (Id. § 3506(c)(1)(A)(vi).)

COMPLIANCE/NONCOMPLIANCE: The SEC has not documented that investors will be able to use the information to be disclosed.

SUGGESTED REMEDIAL ACTION: The SEC should correct this omission from its two "Supporting Statements" filed with to OMB. OMB should refrain from making a decision to approve or disapprove the SEC's proposed collection of information until the Supporting Statements are corrected and the public has had an opportunity to comment on the corrected submissions.

32. Testing of Proposed Information Collection.

REQUIREMENT: The agency must "review each collection of information before submission to the Director [*i.e.*, of OMB] for review under this chapter, including... (v) a test of the collection of information through a pilot program, if appropriate." (44 U.S.C. § 3506(c)(1)(A)(v).)

COMPLIANCE/NONCOMPLIANCE: This requirement is arguably inapplicable to the present rulemaking.

SUGGESTED REMEDIAL ACTION: (Not applicable.)

33. Duplicativeness with Information Otherwise Available to the Agency.

REQUIREMENT: The agency must certify to OMB that, based on public comments received, the proposed information collection "is not unnecessarily duplicative of information otherwise reasonably accessible to the agency." (44 U.S.C. § 3506(c)(3)(B).)

COMPLIANCE/NONCOMPLIANCE: The SEC's NPRM violates this requirement. The NPRM states that much of the information the SEC seeks to have reported is already made available to the SEC through the SECPS. (See NPRM at section VII, 4th ¶.) Moreover, this data could be made available to the public directly from SECPS, rather than requiring it to be re-formulated and re-submitted by respondents in violation of the PRA.

SUGGESTED REMEDIAL ACTION: OMB should disapprove the SEC's information collection request to the extent that information is sought that is already provided to the SECPS.

34. Understandability.

REQUIREMENT: The agency must certify to OMB that, based on the public comments received, the proposed information collection "is written using plain, coherent, and unambiguous terminology *and* is understandable to those who are to respond." (44 U.S.C. § 3506(c)(3)(D) (emphasis added).)

COMPLIANCE/NONCOMPLIANCE: Although the discussion at Requirement No. 17 identifies a number of inconsistencies which would make it difficult for respondents to know which activities would and would not be authorized, it appears that the reporting requirement would apply to all activities, both authorized and unauthorized. On this basis, it tentatively appears that the "understandability" requirement of the PRA has been met.

SUGGESTED REMEDIAL ACTION: (The SEC is in compliance.)

35. Implementation Consistent and Compatible with Existing Requirements.

REQUIREMENT: The agency must certify to OMB that, based on the public comments received, the proposed information collection "is to be implemented in ways consistent and compatible, to the maximum extent practicable, with the existing reporting and recordkeeping practices of those who are to respond." (44 U.S.C. § 3506(c)(3)(E).)

COMPLIANCE/NONCOMPLIANCE: The proposed rule is consistent with existing proxy statement requirements.

SUGGESTED REMEDIAL ACTION: (The SEC is in compliance with this Requirement.)

36. Duration of Record Retention Period.

REQUIREMENT: The agency must indicate "for each recordkeeping requirement the length of time persons are required to maintain the records specified." (44 U.S.C. § 3506(c)(3)(F).)

COMPLIANCE/NONCOMPLIANCE: To the extent that the recordkeeping and reporting requirements in the SEC's proposed rule are part of the broader proxy rules, and to the extent that the duration of maintenance of records under the proxy rules are clear, the SEC would appear to be in compliance with this PRA requirement.

SUGGESTED REMEDIAL ACTION: The SEC appears to be in compliance with this requirement.

37. Allowance of Reduced or Alternate Requirements for Small Businesses.

REQUIREMENT: The agency must sign a certification to OMB stating that the proposed paperwork requirements "reduce[] to the extent practicable and appropriate the burden on persons who shall provide information to or for the agency, including with respect to small entities...(i) establishing differing compliance or reporting requirements or timetables that take into account the resources available to those who are to respond;...and (iii) an exemption from coverage of the collection of information, or any part thereof." (44 U.S.C. § 3506(c)(2)(C).)

COMPLIANCE/NONCOMPLIANCE: The SEC has not made a reasonable attempt to determine whether reduced requirements could be allowed with respect to "small entities." In fact, the SEC appears to have prejudged this question by submitting its two Supporting Statements for clearance by OMB without waiting for public comments on this question.

SUGGESTED REMEDIAL ACTION: OMB should not consider the merits of the SEC's clearance packages until such time as the SEC has obtained and considered public comments considering alternative or reduced requirements for smaller registrants.

38. Use of Information Technology to Reduce Burden.

REQUIREMENT: The agency must certify to OMB that, based on the public comments received, the proposed information collection "to the maximum extent practicable, uses information technology to reduce burden and improve data quality, agency efficiency and responsiveness to the public." (44 U.S.C. § 3506(c)(2)(I).)

COMPLIANCE/NONCOMPLIANCE: Neither the NPRM nor the SEC's two Supporting Statements address this Requirement. To the extent that electronic filing of proxy statements is permitted, this Requirement would appear to be met.

SUGGESTED REMEDIAL ACTION: (Compliance status unclear.)

39. Consideration of, and Certification Regarding, Public Comments on Requirement Nos. 29-38.

REQUIREMENT: The agency is required to "certify (and provide a record supporting such certification, including public comments received by the agency) that each collection of information submitted to the Director" of OMB complies with the ten specified standards set forth at section 3506(c)(3). (44 U.S.C. § 3506(c)(3).) (These ten standards correspond roughly to the issues delineated at Requirement Nos. 29 through 38 immediately above.)

COMPLIANCE/NONCOMPLIANCE: OMB has essentially diluted this requirement by issuing a form containing boxes which are checked off and signed by an agency official. This encourages the agency official to check the boxes without seriously considering the merits of each certification. Significantly, OMB's form does not mention the public-comment-based documentation that is required by Congress to serve as the basis of the certifications. By bureaucratizing the certification process, which was intended as a means by which sponsoring agencies such as the SEC could engage in internal 'due diligence' before submitting clearance packages to OMB, OMB has deprived this process of any real meaning.

In the present instance, it is clear that the SEC has not complied with the public-comment-based-documentation requirement, because the SEC has neither obtained nor reviewed any public

comments under the Paperwork Reduction Act. (See discussion at Requirement No. 31 above.)

SUGGESTED REMEDIAL ACTION: In conjunction with the Suggested Remedial Actions set forth at Requirement No. 31 above, the SEC should resubmit a corrected clearance package with the required certifications and supporting documentation from the public comments. In other words, the SEC should not seek OMB clearance until such time as the SEC has itself reviewed comments from the public on PRA-related issues. In addition, OMB should reject the SEC's two clearance packages, and require the SEC to resubmit a corrected package.

F. Executive Order 12988 on Civil Justice Reform.

40. Duty to Promulgate Regulations That Discourage Litigation.

REQUIREMENT: "[E]ach agency promulgating new regulations...shall adhere to the following requirements:...(2) [t]he agency's proposed...regulations shall be written to minimize litigation; and (3) [t]he agency's proposed...regulations shall provide a clear legal standard for affected conduct rather than a general standard, and shall promote simplification and burden reduction." (Exec. Order 12988 § 3(a).)

More specifically, a proposed regulation must: (i) "specif[y] in clear language the effect on existing Federal law or regulation, if any, including all provisions repealed, circumscribed, displaced, impaired, or modified"; (ii) "provide[] a clear legal standard for affected conduct rather than a general standard, while promoting simplification and burden reduction"; and (iii) "specif[y] whether administrative proceedings are to be required before parties may file suit in court and, if so, describe[] those proceedings and require[] the exhaustion of administrative remedies." (Id. § 3(b)(2).)

COMPLIANCE/NONCOMPLIANCE: The NPRM does not address the possible implications of the proposed rule for securities litigation involving private parties.

SUGGESTED REMEDIAL ACTION: The SEC should explicitly address the question of possible civil litigation impacts of the proposed rule.

G. National Technology Transfer and Advancement Act of 1995; OMB Circular A-119.

41. Use of Voluntary, Private-Sector Consensus Standards.

REQUIREMENT: "[A]ll Federal agencies and departments shall use technical standards that are developed or adopted by voluntary consensus standards bodies, using technical standards as a means to carry out policy objectives or activities determined by the agencies and departments." (Tech. Transfer Act § 12(d)(1).) "All federal agencies must use voluntary consensus standards in lieu of government-unique standards in their procurement and regulatory activities, except where inconsistent with law or otherwise impractical." (OMB Circular A-119 § 6.)

COMPLIANCE/NONCOMPLIANCE: As is set forth in the discussion at Requirement No. 6, the SEC participated with a voluntary consensus standards body, the ISB, in developing a consensus standard, which was promulgated at the end of 1999. The SEC is now proposing a government-unique standard that would effectively preempt the same voluntary standard the SEC has just helped to create, despite the fact that the SEC has not had an opportunity to assess the effectiveness of the ISB voluntary consensus standard. This would appear to fly in the face of the SEC's obligations under the National Technology Transfer Act.

SUGGESTED REMEDIAL ACTION: The NPRM should be withdrawn until such time as the SEC has had an opportunity to assess the effectiveness of the ISB standards and framework.

42. Consultation with Private-Sector Standard-Setting Bodies.

REQUIREMENT: "In carrying out [Requirement No. 44], Federal agencies and departments shall consult with voluntary, private sector, consensus standards bodies and shall, when such participation is in the public interest and is compatible with agency and departmental missions, authorities, priorities, and budget resources, participate with such bodies in the development of technical standards." (Tech. Transfer Act § 12(d)(2).)

COMPLIANCE/NONCOMPLIANCE: It does not appear from the NPRM that the SEC consulted with the ISB regarding such questions as: (i) the appropriateness of promulgating a command-and-control regulation immediately after participating in the issuance of a voluntary, performance-based standard; (ii) the impact that a preemptive command-and-control regulation would have on the ability to implement ISB's performance-based standard; or (iii) the impact that the SEC's turn-around will have on the willingness of industry stakeholders to participate in

any future activities of the ISB, and, hence, on the future viability of the ISB.

SUGGESTED REMEDIAL ACTION: (See Suggested Remedial Action at Requirement No. 41 above.)

43. Reporting to OMB Through NIST.

REQUIREMENT: Before a Federal agency can lawfully adopt a government-unique standard instead of an existing voluntary consensus standard, the agency must provide a written report to OMB, through the National Institute for Standards and Technology ("NIST"), including an "explanation of the reason(s) for using government-unique standards in lieu of voluntary consensus standards." (OMB Circular A-119 § 6; see also Tech. Transfer Act § 12(d)(3).)

COMPLIANCE/NONCOMPLIANCE: The NPRM does not indicate that the SEC has complied with this requirement.

SUGGESTED REMEDIAL ACTION: The NPRM should be withdrawn until such time as the SEC complies with this requirement.

44. Notice and Comment re Government-Unique Standards.

REQUIREMENT: "When your agency is proposing to use a government-unique standard in lieu of a voluntary consensus standard, provide a statement which identifies such standards and provides a preliminary explanation for the proposed use of a government-unique standard in lieu of a voluntary consensus standard." (OMB Circular A-119 § 11(a)(1).)

COMPLIANCE/NONCOMPLIANCE: The NPRM does not address, or request public comment on, whether the SEC's proposed rule would be consistent with the SEC's obligations under the National Technology Transfer Act or OMB's implementing Circular A-119. Nor does the Commission justify its failure to rely on private initiatives.

SUGGESTED REMEDIAL ACTION: (See Suggested Remedial Action at Requirement No. 43 above.)

45. International Harmonization of Standards.

REQUIREMENT: "On the international level, the U.S. must work toward harmonizing, or recognizing as equivalent, standards throughout the world....At the same time, NIST and other federal agencies must identify globally accepted U.S. developed standards...and other multinational standards and professional bodies." (NIST "Plan of Implementation" for the National Technology Transfer Act.)

COMPLIANCE/NONCOMPLIANCE: The NPRM does not take cognizance of the fact that the International Federation of Accountants ("IFAC") has promulgated a "Code of Ethics for Professional Accountants" which contains a detailed standard, with commentary, governing independence. (See IFAC Code of Ethics for Professional Accountants, Part B, §§ 8.1-8.14.) More specifically, the SEC has not considered: (i) whether the requirements of the SEC's proposed rule would conflict with auditors' obligations under the international standard; or (ii) whether the international standard would be more appropriate than the SEC proposal.

SUGGESTED REMEDIAL ACTION: (See Suggested Remedial Action at Requirement No. 43 above.)

H. Executive Order 12606 on Family Considerations in Policy Formulation and Implementation.

46. Identification of Family Impacts of Proposed Regulations.

REQUIREMENT: "Executive departments and agencies shall identify proposed regulatory and statutory provisions that may have a significant potential negative impact on the family well-being and provide adequate rationale on why such proposal should be submitted. The head of the department or agency shall certify in writing that, to the extent permitted by law, such measure has been assessed in light of the criteria in Section 1 of this Order and how such measures will enhance family well-being. Such certification shall be transmitted to the Office of Management and Budget. Departments and agencies shall give careful consideration to family-related concerns and their impact in notices of proposed rulemaking and messages transmitting legislative proposals to the Congress." (Exec. Order 12606 § 2(a).)

Section 1 criteria include whether the proposal would: (i) "help the family perform its functions"; or (ii) "increase or decrease family earnings." (See id. § 1(c), (d).)

COMPLIANCE/NONCOMPLIANCE: The proposed rule may be viewed as advancing family well-being by narrowing the range of family member investments and relationships that would be subject to affiliate limitations.

SUGGESTED REMEDIAL ACTION: The SEC is in compliance with this requirement.

I. Small Business Regulatory Enforcement Fairness Act ("SBREFA") - - Congressional Review Provisions.

47. Characterization as "Major Rule."

REQUIREMENT: The determination of whether a rule is "major" is made by OMB. However, the promulgating agency's (*i.e.*, the SEC's) determination that a rule is or is not "significant" under Executive Order 12866 and the Regulatory Flexibility Act will have an impact on the position to be taken by OMB. For purposes of SBREFA, a "major rule" is one that "has resulted in or is likely to result in -- (A) an annual effect on the economy of $100,000,000 or more; (B) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (C) significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets." (5 U.S.C. § 804(2).)

COMPLIANCE/NONCOMPLIANCE: Although the statute does not prescribe when OMB must make its determination regarding the major or non-major status of a rule, arguably the determination is not required to be made until shortly before promulgation as a final rule. CRE notes that OMB's determination should take into account the quantitative estimates submitted by stakeholders, as well as the knowledge gained by OMB as a result of its review of the proposed rule pursuant to the PRA and Executive Order 12866.

SUGGESTED REMEDIAL ACTION: (Compliance deadline pending.)

48. Transmission of Report and Supplementary Materials to Congress and GAO.

REQUIREMENT: Upon promulgating a final rule, the agency must transmit to each House of Congress and to the Comptroller General: (i) a copy of the rule; (ii) a concise general statement relating to the rule, including whether it is a "major rule"; (iii) the proposed effective date; (iv) a

complete copy of the cost-benefit analysis of the rule; (v) a copy of the agency's analyses under the Regulatory Flexibility Act; (vi) a copy of the agency's statements under the Unfunded Mandates Reform Act; and (vii) copies of any other statements or analyses prepared under any other applicable statutes or executive orders. (5 U.S.C. § 801(a)(1)(A), (B).)

The purpose of this requirement is to enable Congress to determine whether the final rule should be invalidated (pursuant to a congressional "joint resolution of disapproval") due to the agency's failure to comply with the statutes and executive orders described in this Report Card.

COMPLIANCE/NONCOMPLIANCE: (Compliance deadline pending.) (It is noteworthy that, to the extent that the infirmities set forth in this Report Card are not corrected, Congress may have substantial grounds for enacting a joint resolution of disapproval invalidating any final rule promulgated by the SEC.)

SUGGESTED REMEDIAL ACTION: The SEC's proposal should be reformulated, in conformity with all of the procedural and substantive requirements described in this Report Card. In particular, the SEC should comply with both the letter and the spirit of the stakeholder input requirements described herein.