File No. PCAOB-2024-04
Consists of 361 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed amendment to PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (collectively, the "proposed rules"). The proposed rules changes are attached as Exhibit A to this rule filing. In addition, to the extent that Section 103(a)(3)(C) of the Act applies to the proposed rules, the Board is also requesting the SEC's approval, pursuant to that provision, of the application of the proposed rules to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934. Section 104 of the Jumpstart Our Business Startups Act provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." *See* Exhibit 3.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its open meeting on June 12, 2024. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to James Cappoli, General Counsel, Office of the General Counsel (202/591-3105, cappolij@pcaobus.org); Connor Raso, Deputy General Counsel, Office of the General Counsel (202/591-4478, rasoc@pcaobus.org); Drew Dropkin, Senior Associate General Counsel, Office of the General Counsel (202/591-4393, dropkind@pcaobus.org); and Damon Andrews, Associate General Counsel, Office of the General Counsel (202/591-4363, andrewsd@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules Change

(a) Purpose

Congress authorized the Board to promulgate rules and standards to govern auditor conduct.[1] To that end, in 2005, the Board codified auditors' longstanding ethical obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.[2] For well over a decade now, the Board has brought enforcement proceedings against associated persons pursuant to Rule 3502.

Yet Rule 3502's current formulation contains an incongruity that places negligent contributors to firms' violations beyond the rule's reach. That incongruity stems from the notion that registered firms, like any legal entity, can act only through natural persons. It

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[1] *See* Section 103(a)(1) of Sarbanes-Oxley; *see also, e.g.*, *id.* 101(c)(2), (c)(4), (c)(6) & (g)(1).

[2] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf ("The Board proposed [Rule 3502] to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit [ ] violations.").

logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to at least one natural person's negligence.

Rule 3502, however, at present requires a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who directly and substantially contribute to firms' negligence-based violations. Put another way, Rule 3502 requires a showing of more than negligence by individuals for the Board to sanction them for conduct resulting in negligence by firms. Thus, under current Rule 3502, associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not. The Board believes that amending Rule 3502 addresses this incongruity, and therefore better protects investors and promotes quality audits.

See Exhibit 3 for additional discussion of the purpose of this rulemaking.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impacts of the proposed rules is discussed in Exhibit 1.II.D.

5. Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others

The Board initially released the proposed rules for public comment on September 19, 2023. *See* Exhibit 2(a)(A). The Board received 28 written comment

letters (one of which was subsequently withdrawn) relating to its initial proposed rules. *See* Exhibits 2(a)(B) and 2(a)(C).

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

Exhibit A –	Text of the Proposed Rules.
Exhibit 1 –	Form of Notice of Proposed Rules for Publication in the Federal Register.
Exhibit 2(a)(A) –	PCAOB Release No. 2023-007 (Proposing Release).
Exhibit 2(a)(B) –	Alphabetical List of Comments on the rules proposed in PCAOB Release No. 2023-007.
Exhibit 2(a)(C) –	Written comments on the rules proposed in PCAOB Release No. 2023-007.
Exhibit 3 –	PCAOB Release No. 2024-008 (Adopting Release).

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: 

Phoebe W. Brown
Secretary

June 20, 2024

EXHIBIT A – TEXT OF THE PROPOSED RULES

Below is the text of the proposed amendments to PCAOB Rule 3502. Proposed new language is underlined; proposed deletions are in brackets. Text that remains unchanged is either specified or indicated by "* * * *" in the text below.

RULES OF THE BOARD

SECTION 3. Auditing and Related Professional Practice Standards

* * * *

Rule 3502. Responsibility Not to [Knowingly or Recklessly] Contribute to Violations

A person associated with a registered public accounting firm shall not [take or omit to take an action knowing, or recklessly not knowing, that the act or omission would] directly and substantially contribute to a violation by that registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, by an act or omission that the person knew or should have known would contribute to such violation.

* * * *

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-XXXXX; File No. PCAOB-2024-04)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendment to PCAOB Rule 3502 Governing Contributory Liability

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), notice is hereby given that on [Date of Form 19b-4 Submission], the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 12, 2024, the Board adopted an amendment to PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (collectively, the "proposed rules"). The text of the proposed rules appears in Exhibit A to the SEC Filing Form 19b-4 and is available on the Board's website at https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-053 and at the Commission's Public Reference Room.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. In addition, to the extent that Section 103(a)(3)(C) of the

Act applies to the proposed rules, the Board is requesting that the Commission approve the proposed rules, pursuant to that provision, for application to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act"). The Board's request is set forth in section D.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Congress authorized the Board to promulgate rules and standards to govern auditor conduct.[1] To that end, in 2005, the Board codified auditors' longstanding ethical obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.[2] For well over a decade now, the Board has brought enforcement proceedings against associated persons pursuant to Rule 3502.

Yet Rule 3502's current formulation contains an incongruity that places negligent contributors to firms' violations beyond the rule's reach. That incongruity stems from the notion that registered firms, like any legal entity, can act only through natural persons. It logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to at least one natural person's negligence.

Rule 3502, however, at present requires a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who directly and substantially contribute to firms' negligence-based violations. Put another way, Rule 3502 requires a showing of more than negligence by individuals for the Board to sanction

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[1] *See* Section 103(a)(1) of Sarbanes-Oxley; *see also, e.g.*, *id.* 101(c)(2), (c)(4), (c)(6) & (g)(1).

[2] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf ("The Board proposed [Rule 3502] to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit [ ] violations.").

them for conduct resulting in negligence by firms. Thus, under current Rule 3502, associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not. The Board believes that amending Rule 3502 addresses this incongruity, and therefore better protects investors and promotes quality audits.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impacts of the proposed rules is discussed in section D below.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rule amendment for public comment in PCAOB Release No. 2023-007 (September 19, 2023). The Board received 28 written comment letters; one comment letter was subsequently withdrawn. The Board has carefully considered all comments received. The Board's response to the comments it received and the changes made to the rules in response to the comments received are discussed below.

INTRODUCTION

In the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), Congress established the Board in the wake of a series of high-profile corporate collapses that laid bare auditor misconduct and the need for a new type of oversight of the public accounting industry.[3]

[3] Pub. L. No. 107-204, 15 U.S.C. 7201 *et seq.*; *see* S. Rep. No. 107-205, at 3 (2002) ("The purpose of [Sarbanes-Oxley] is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years."). As the Senate Report notes, "the frequency of financial restatements by public companies

As part of its comprehensive, multipronged approach to such oversight, Congress authorized the Board to investigate, bring charges against, and sanction (when appropriate) registered public accounting firms and associated persons[4] thereof for violations of the laws, rules, and standards that Congress charged the Board with enforcing.[5] That enforcement authority covers a wide array of auditor conduct, including negligent conduct.

Congress also authorized the Board to promulgate rules and standards to govern auditor conduct.[6] To that end, in 2005, the Board codified auditors' longstanding ethical obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.[7] For well over a decade now, the Board has brought enforcement proceedings against associated persons pursuant to Rule 3502.

Yet Rule 3502's current formulation contains an incongruity that places negligent contributors to firms' violations beyond the rule's reach. That incongruity stems from the notion that registered firms, like any legal entity, can act only through natural persons. It logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to at least one natural person's negligence.

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ha[d] dramatically increased" in the run up to the passage of Sarbanes-Oxley. S. Rep. No. 107-205, at 15; *see id.* ("From 1990-97, the number of public company financial restatements averaged 49 per year, but jumped to an average of 150 per year in 1999 and 2000.").

[4] An associated person is "any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor or entity that, in connection with the preparation or issuance of any audit report . . . (1) shares in the profits of, or receives compensation in any other form from, that firm; or (2) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." PCAOB Rule 1001(p)(i). The definition of an "associated person" does not include persons engaged only in clerical or ministerial tasks. *See id.*

[5] *See* Sections 105(b) & (c) of Sarbanes-Oxley.

[6] *See id.* 103(a)(1); *see also, e.g.*, *id.* 101(c)(2), (c)(4), (c)(6) & (g)(1).

[7] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005) ("2005 Adopting Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf ("The Board proposed [Rule 3502] to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit [ ] violations.").

Rule 3502, however, at present requires a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who directly and substantially contribute to firms' negligence-based violations. Put another way, Rule 3502 requires a showing of more than negligence by individuals[8] for the Board to sanction them for conduct resulting in negligence by firms. Thus, under current Rule 3502, associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not. The Board believes that amending Rule 3502 addresses this incongruity, and therefore better protects investors and promotes quality audits.

Accordingly, following notice and comment, the Board has amended Rule 3502 by changing from recklessness to negligence the liability standard for associated persons' contributory conduct. As explained in greater detail below, the Board believes, based on its experience and having considered the comments received, that the amendment better aligns Rule 3502 with the scope of the Board's enforcement authority under Sarbanes-Oxley, thus further advancing the Board's mission of investor protection.

RULEMAKING HISTORY

On September 19, 2023, the Board proposed to amend Rule 3502 in two ways: (1) by changing from recklessness to negligence the standard of conduct for associated persons' contributory liability and (2) by providing that, to be charged with violating Rule 3502, an associated person contributing to a registered firm's violation need not be an associated person of the firm that commits the primary violation (i.e., that an associated person of one registered firm

[8] For ease of reference, this release sometimes refers to associated persons who are the contributory actors for purposes of Rule 3502 as "persons" or "individuals." The Board notes, however, that both natural persons and entities can be associated persons, and therefore Rule 3502 charges can be brought against both natural persons and entities, consistent with the meaning of the term "person associated with a registered public accounting firm."

can contribute to a primary violation of another registered firm).[9] The Board received 28 comment letters on the Proposal from commenters across a range of affiliations.[10] In general, commenters recognized the importance of an effective PCAOB enforcement program and in holding individuals accountable when there are violations of applicable laws, rules, and professional standards. The final rule amendment—which, as detailed below, does not include the second aspect of the Proposal—is informed by the comments received on the Proposal, which are discussed throughout this release.

BACKGROUND

PCAOB Rule 3502 codifies associated persons' ethical obligation not to contribute to a registered firm's violations of the laws, rules, and standards that the Board is charged with enforcing. The rule provides grounds for secondary liability when an associated person of a registered firm acts at least recklessly to directly and substantially contribute to such a violation. Although the rule as adopted in 2005 incorporated a recklessness standard, the rule as proposed in 2004 required that individuals only negligently contribute to a firm's violation to be subject to liability.[11] Whereas negligence "is the failure to exercise reasonable care or competence,"[12] recklessness requires "an extreme departure from the standard of ordinary care" that "presents a

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[9] *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, PCAOB Release No. 2023-007 (Sept. 19, 2023) ("2023 Proposing Release" or the "Proposal"), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9.

[10] Comment letters on the Proposal, as well as a staff white paper regarding characteristics of emerging growth companies, are available on the Board's website in Rulemaking Docket No. 053, *available at* https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-053/comment-letters. One of the comment letters was withdrawn.

[11] *See Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2004-015, at 18 & n.40 (Dec. 14, 2004) ("2004 Proposing Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2004-12-14_Release_2004-015.pdf.

[12] *In re S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 35 n.169 (July 3, 2013) (citation and quotation marks omitted).

danger to investors or to the markets that is either known to the (actor) or is so obvious that the actor must have been aware of it."[13] Indeed, Sarbanes-Oxley characterizes "reckless conduct" as a subset of "intentional or knowing conduct,"[14] whereas negligence is an "objective" standard that is not measured by "the intent of the accountant."[15]

The Board has adopted negligence as the liability standard for actionable contributory conduct under Rule 3502. And for good reason: A negligence standard is appropriate based on the Board's extensive experience with Rule 3502 since the rule's adoption nearly two decades ago, it closes a gap in the PCAOB's regulatory framework that can lead to anomalous results, and it advances certain objectives in the Board's 2022-2026 Strategic Plan in furtherance of the Board's overall mission.

In the first subsection below, the Board reviews the Board's 2004 proposal and 2005 adoption of Rule 3502. Then, the Board details the reasons for the amendment the Board has adopted to modernize and strengthen the rule.

A. History of Rule 3502

As part of a package of proposed ethics and independence rules, the Board proposed PCAOB Rule 3502 in 2004.[16] In issuing the proposal, the Board observed that "[w]hile certain

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[13] *Id.* at 29 (citation and quotation marks omitted); *see also Marrie v. SEC*, 374 F.3d 1196, 1204 (D.C. Cir. 2004); 2005 Adopting Release at 13 ("[T]he phrase 'knew, or was reckless in not knowing' is a well-understood legal concept, and the Board intends for the phrase to be given its normal meaning.").

[14] *See* Section 105(c)(5)(A) of Sarbanes-Oxley.

[15] *In re Melissa K. Koeppel, CPA*, PCAOB File No. 105-2011-007, at 166 (Dec. 29, 2017) (quoting *In re Kevin Hall, CPA*, SEC Release No. 34-61162, at 12 (Dec. 14, 2009) (quotation marks omitted)).

[16] *See generally* 2004 Proposing Release at 18-19. As originally proposed (and adopted), Rule 3502 was entitled *Responsibility Not to Cause Violations*. *See id.* at A-4; 2005 Adopting Release at A-5. Shortly after adoption, however, the Board changed the title of the rule to its current title, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*. The Board made the change "[a]fter discussions with the SEC" and "to avoid any misperception that the rule affects the interpretation of any provision of the federal securities laws." *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-020, at 2 (Nov. 22, 2005), *available at* https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/

types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm, the firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm."[17] Accordingly, through Rule 3502, the Board sought to "codify that obligation" and "make it clear that the obligation is enforceable by the Board."[18] Using language "intended to articulate a negligence standard," the proposed version of Rule 3502 subjected associated persons to potential contributory liability if they "knew or should have known" that an act or omission by them would contribute to a firm's primary violation.[19]

Following a public comment period,[20] the Board adopted Rule 3502 with two modifications from the proposal. First, while affirming its authority to promulgate a negligence-based ethics rule prohibiting contributory conduct,[21] the Board revised the liability standard from negligence to recklessness, which the Board at that time believed would "strike[ ] the right balance in the context of th[e] rule."[22] Second, the Board modified "contribute"—the verb that describes the connection between the associated person's conduct and the firm's primary violation—by adding the words "directly and substantially."

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docket017/2005-11-22_release_2005-020.pdf?sfvrsn=69338fcd_0. In so doing, however, the Board clarified that "[t]he rule, as amended, should be interpreted and understood to be the same as the rule adopted by the Board." *Id.*

17 2004 Proposing Release at 18.

18 *Id.*

19 *Id.* at 18 n.40; *see id.* at A-4 (proposed rule text).

20 "Several commenters supported the rule as proposed and noted that they saw the rule as essential to the Board's ability to carry out its disciplinary responsibilities under the Act," 2005 Adopting Release at 9, while others did not fully endorse it. Their objections were based principally on the view that negligence might be an ill-suited liability standard "in light of the complex regulatory requirements with which auditors must comply" and out of concern that such standard "would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards." *Id.* at 9, 13. Certain commenters "also questioned the Board's authority to adopt the proposed rule, or at least the proposed rule with a negligence standard." *Id.* at 9.

21 *See id.* at 12 n.23.

22 2005 Adopting Release at 13; *see id.* at 12 & n.23.

The latter modification was made due to commenters expressing concern that, because of the collaborative nature of accounting work, each individual involved in formulating a decision or other action that ultimately leads to a firm violation could be held liable for causing the violation.[23] The Board explained that the addition of "directly" means, among other things, that an associated person's conduct must "either essentially constitute[ ] the [firm's] violation" or be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation." But, the Board clarified, "directly" does not place outside the scope of Rule 3502 contributory conduct "just because others also contributed to the violation, or because others could have stopped the violation and did not." "Substantially," the Board explained, means that an associated person's conduct must "contribute[ ] to [a] violation in a material or significant way," though it need not be "the sole cause of the violation."[24]

B. Reasons for the Amendment

As the Board previously recognized, when an associated person causes a firm to commit a violation, such conduct "operates to the detriment of the protection of investors."[25] The following subsections explain why the modification to Rule 3502 is appropriate in furtherance of the Board's mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

1. Aligning Rule 3502 with the Board's Enforcement Authority

As the Board previously has explained, a registered firm "can only act through the natural persons who serve as its agents, including its associated persons."[26] Accordingly, "a natural

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[23] *See id.* at 9, 13.

[24] *Id.* at 13.

[25] 2005 Adopting Release at 10.

[26] 2004 Proposing Release at 18; *see* 2005 Adopting Release at 12 ("[Registered] firms . . . can only act through the natural persons that comprise them, many of whom are 'associated persons' subject to the Board's

person's actions may render both the [firm] primarily liable and the natural person secondarily liable."[27] Yet under the current formulation of Rule 3502, an incongruity exists between the respective requisite mental states for liability of a registered firm resulting from an associated person's conduct and for liability of the associated person: A firm can commit a primary violation of certain laws, rules, or standards by acting *negligently*, but an associated person who directly and substantially contributed to that violation must have acted at least *recklessly* to be secondarily liable.

This incongruity means that associated persons may have weaker incentives to exercise the appropriate level of care in their audit work. They may not exercise reasonable care (the standard for negligence) if they know that they cannot be held individually liable by the PCAOB for a firm's primary violation unless an act or omission by them amounts to an "an extreme departure from the standard of ordinary care for auditors" (the standard for recklessness).[28] The modification to Rule 3502's liability standard from recklessness to negligence closes this regulatory gap, which should incentivize associated persons to be more deliberate and careful in their actions. Indeed, "accountability frequently improves outcomes."[29]

Numerous commenters agreed with the Board's regulatory concerns noted above. These commenters generally noted that the Board's concerns were valid and clear, and that a

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ethics standards and disciplinary authority."). Indeed, as one commenter on the Proposal put it, a firm is the sum of its parts.

[27] *In re Timothy S. Dembski*, SEC Release No. 34-80306, at 13-14 n.35 (Mar. 24, 2017) (quoting *SEC v. Koenig*, 2007 WL 1074901, at *7 (N.D. Ill. Apr. 5, 2007)).

[28] *Marrie*, 374 F.3d at 1204; *see* Russell G. Pierce & Eli Wald, *The Relational Infrastructure of Law Firm Culture and Regulation*, 42 Hofstra L. Rev. 109, 129 (2013) (explaining how rules from the legal industry's governing body that would restrict lawyers' limited liability "will encourage lawyers to devote more energy to maintaining the quality of the firm because they could potentially face personal liability for poor quality services"); *see also* Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 Vand. L. Rev. 1871, 1885 (2019) (arguing that "existing deterrence mechanisms have failed to produce optimal audit quality" and "are ineffective").

[29] Honigsberg, *supra*, at 1902.

negligence standard would better align Rule 3502 with the scope of the Board's enforcement authority under Sarbanes-Oxley and provide a tool to eliminate incongruous results in liability between individuals and firms. Indeed, one commenter characterized the difference between negligence and recklessness as "substantial" and "consequential" and noted that the current gap in liability standards directly impacts the Board's ability to fulfill its statutory mission.[30]

Another commenter remarked that a negligence standard will enable the PCAOB and the U.S. Securities and Exchange Commission (SEC or "Commission") to more efficiently and effectively pursue enforcement cases regardless of which entity has the resources to bring the case. Commenters also stated that a negligence standard would appropriately align Rule 3502's liability threshold with the standard of care that auditors currently should be exercising when performing their professional responsibilities and that both the Commission and civil plaintiffs in private litigation currently can pursue cases against auditors for negligence. In encouraging the PCAOB to adopt the Proposal, one commenter further noted that the change to negligence would bolster investors' expectations that accountants will be independent and diligent in their audit work.

Other commenters, however, believed that the Proposal did not present a sufficient rationale for moving to a negligence standard after the Board previously declined to do so in 2005. These commenters opined that the same concerns about a negligence standard that existed in 2005 exist today and questioned whether there were significant enough developments to merit the change.[31] Indeed, certain commenters acknowledged the incongruity discussed in the

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[30] Comment Letter from Better Markets at 3 (Nov. 3, 2023).

[31] In support of such assertion, one commenter cited *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009). The rationale articulated in the Proposal and this adopting release, however, more than satisfies *Fox*'s criteria for a conscious change in policy. *See id.* at 515 ("[I]t suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agency *believes* it to be better, which the conscious change of course adequately indicates."). As to auditors' reliance on the standard in the current rule, as in *Fox*, the Board is

Proposal but contended either that it is not significant or problematic, that it is not an impediment to enforcement, or that closing the gap in liability standards would not change auditor conduct.[32] One commenter stated explicitly that no incongruity or gap exists.

Several commenters also stated that auditors are subject to sufficient oversight under the current framework, including via the PCAOB's inspection program, enforcement in Commission proceedings, and enforcement by state regulatory agencies. Certain of these commenters further stated that a negligence standard would risk, among other things, disturbing the PCAOB's inspection process by upsetting inspection dynamics and threatening the cooperative and constructive nature of the process that has developed over time.

The Board is mindful of the efficiencies gained through open dialogue with firms and individuals alike during the inspection process. Given that firms and individuals already are subject to a negligence standard for *primary* violations, however, the Board does not believe that the incremental change of moving from recklessness to negligence for *contributory* conduct will have a chilling effect on inspections, especially given that the Board will continue to exercise discretion about when to bring Rule 3502 charges.[33]

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not "punishing [auditors] without notice of the potential consequences of their action." *Id.* at 518. That is so because the adoption of a negligence standard, by itself, does not impose any civil money penalty or other sanction; rather, sanctions are available only if Rule 3502 is *violated* after the amended rule becomes effective.

[32] One commenter stated that the Proposal failed to articulate how the change to negligence would align Rule 3502 with Sarbanes-Oxley and questioned whether there were cases where the current recklessness standard did not suffice to hold persons accountable. The Proposal, however, made both of these points clear. *See* 2023 Proposing Release at 7 (describing the current misalignment with Sarbanes-Oxley); *id.* at 24-25 (discussing estimated cases in 2022). That commenter and one other also noted that the PCAOB has been able to assess significant penalties under the current Rule 3502 formulation and that the Board's disciplinary proceedings have resulted in collateral consequences for firms and individuals. While that may be the case, the Board did not adopt a negligence standard for the purpose of facilitating an increase in *penalties*; rather, as the Proposal explained, the Board proposed—and has adopted—a negligence standard to facilitate an increase in *accountability* and *deterrence*. *See* 2023 Proposing Release at 7.

[33] One commenter expressed concern over whether the inspection process is sufficiently robust to conclude that an associated person has contributed to a firm's negligence-based violation, and relatedly, another asserted that auditors believe that the Board is holding them to an inspections bar that constantly evolves. Inspection staff's findings, however, are not conclusive for purposes of imposing legal liability under Rule 3502 (or any PCAOB rule). *See PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections*

Commenters also opined that amending Rule 3502 is unnecessary because the Board's then-proposed (now-adopted[34]) QC 1000 standard provides clearer expectations with regard to individuals in quality control (QC) roles.[35] Although the Board agrees that QC 1000 crystallizes the responsibilities of certain individuals serving in QC roles, Rule 3502 applies more broadly than to just those particular individuals. Thus, although QC 1000 and Rule 3502 could overlap to cover the same conduct in some circumstances, there are other circumstances in which there would not be overlap.[36]

Commenters similarly expressed mixed views about whether the change to negligence would incentivize auditors to more fully comply with applicable laws, rules, and standards that the Board is charged with enforcing. Multiple commenters remarked in the affirmative, noting that such incentivization is foreseeable and that a negligence standard will encourage individuals and firms to maintain a high level of quality in their audit work, which in turn benefits investors and financial markets alike. Indeed, one commenter remarked that the current recklessness standard *in*adequately incentivizes associated persons to exercise the appropriate level of care in their audit work. This commenter also noted that, beyond incentivizing individuals' compliance,

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Conducted?, *available at* https://pcaobus.org/oversight/inspections/inspection-procedures ("[A]ny references in [an inspection] report to violations or potential violations of law, rules, or professional standards are not a result of an adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability."). Rather, whether there is legal liability for a violation and whether conduct merits sanctions (and if so, what the sanctions are) are determined through the adversarial process involving the Board's Division of Enforcement and Investigations and only after respondents have been afforded the opportunity to present a defense.

[34] This release references several professional standards that the Board has adopted but which are pending Commission approval, and which therefore are subject to change. *See* Section 107(b) of Sarbanes-Oxley.

[35] See generally A Firm's System of Quality Control and Other Amendments to PCAOB Standards, Rules, and Forms, PCAOB Release No. 2024-005 (May 13, 2024) ("QC 1000 Release").

[36] *See, e.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983) ("While some conduct actionable under Section 11 may also be actionable under Section 10(b), it is hardly a novel proposition that the 1934 [Securities Exchange] Act and the 1933 [Securities] Act 'prohibit some of the same conduct.' 'The fact that there may well be some overlap is neither unusual nor unfortunate.'" (citations omitted)).

a negligence standard also would incentivize *firms* to ensure, through training and other measures, that their employees are complying with applicable professional standards.

By contrast, other commenters argued that a negligence standard will not incentivize compliance, for a variety of reasons. Multiple commenters premised such view on the downstream effects that oversight with respect to firms has on individuals. According to certain of these commenters, such effects (e.g., reduced responsibility on audits, compensation- and promotion-related consequences), as well as other firm policies and preventative measures (such as training), are sufficient to guard against negligence and incentivize individual compliance. Another commenter opined that the auditor reporting model and the identification of auditors in Form AP suffice to address individual accountability.

While the Board agrees that each of the above factors may play a role in driving individual accountability in certain respects, none is a form of *regulatory* accountability that is akin to the Board's authority to bring enforcement proceedings and impose publicly a range of disciplinary sanctions as remedial measures. Moreover, the market-driven consequences relating to the auditor reporting model and identification of auditors on Form AP are felt primarily (if not exclusively) by the engagement partner on an audit, while Rule 3502 applies more broadly.

Another commenter questioned whether a negligence standard would have a deterrent effect (or close any gap) given that auditors already are subject to a negligence standard for contributory liability in Commission actions. One commenter noted that, given that auditors already are subject to negligence actions by other entities (including the Commission and state regulators), empirical evidence should be provided to support how auditor behavior would

change under a negligence standard for Rule 3502.[37] As the Board previously noted, however, an increase in the *number* of regulators on alert for the same or similar violative conduct increases the likelihood of that conduct being detected and, consequently, the likelihood that the conduct would be sanctioned.[38]

In other commenters' views, a negligence standard would not incentivize compliance because sanctions are ineffective to deter mere errors in judgment. As explained below, however, the amendment does not target mere errors in judgment, but rather *unreasonable* conduct. Multiple commenters also posited that a lower threshold for auditor liability may have a negative impact on audit quality, including at smaller firms. Indeed, one commenter asserted that the impact of the proposed rule change (and proceedings brought pursuant to it) would be felt more acutely by firms that are not affiliated with the largest global networks, despite those firms having a significantly smaller share in auditing the market capitalization of U.S. issuers. These commenters generally attributed what they view as a potential loss in audit quality to several factors, including recruiting, retention, and staffing challenges; reduced collaboration among auditors; and auditors engaging in unproductive, excessive self-protective behavior. The Board addresses below commenters' concerns about the amendment's potential impacts on audit quality and smaller firms, respectively.

2. The Board's Implementation Experience

Although the Board viewed Rule 3502's recklessness liability threshold as "strik[ing] the right balance in the context of th[e] rule" at the time of the rule's adoption in 2005, the threshold had not yet been tested in practice by the PCAOB, and experience has shown that it prevents the

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[37] This commenter did not provide the source of any data or propose any methods by which to generate empirical evidence on this subject.

[38] 2023 Proposing Release at 14 n.51.

Board from executing its investor-protection mandate to the fullest extent that Congress authorized in Sarbanes-Oxley.

In the instances in which the Board has instituted proceedings against firms for negligence-based violations, the Board has not been able to charge Rule 3502 violations against the individuals that negligently contributed to those firms' violations. Although the decision not to bring charges against individuals varies case by case and is at the Board's discretion, it remains that the Board has been legally barred by the current formulation of Rule 3502 from holding accountable under Rule 3502 individuals who negligently, directly, and substantially contributed to the firms' violations.[39]

The Board's application of Rule 3502 in various contexts supplies experience-based reasons for the proposed amendment to the liability standard. For example, when dealing with the design and implementation of firm QC policies and procedures under applicable QC standards, the Board has observed that registered firms that commit a QC violation often have multiple individuals with overlapping QC responsibility but that no single individual was reckless in failing to act, and thus no individual can be held personally accountable for the firm's QC failure.[40] And yet, individuals with QC responsibility at a firm are often in some of the most important decision-making roles within the firm because a compliant QC system serves as the backstop to ensure that all *other* professional standards are followed.[41]

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[39] As the 2005 Adopting Release notes, however, Rule 3502 "is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons." 2005 Adopting Release at 14 n.25.

[40] The Board's recently adopted QC 1000 standard mitigates this concern to an extent by requiring firms to assign one or more individuals to certain roles with designated responsibilities within a firm's QC system. *See* QC 1000 Release at 82-86. The concern remains, though, because "[a] firm may have multiple individuals or multiple layers of personnel supporting these roles." *Id.* at 83.

[41] *See* QC § 20.03, *System of Quality Control* ("A firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel

Multiple commenters suggested that a negligence standard should not apply to enforcement of QC matters because the Board's inspection function already provides it with transparency into a firm's QC system. Inspections (and, relatedly, remediation) of QC matters, however, are distinct from enforcement, including with respect to the available potential consequences for firms and individuals, respectively. Yet Congress also expressly envisioned that the Board's inspections program would inform its enforcement activities.[42] Such entwinement is therefore a feature of Sarbanes-Oxley—not a flaw or a reason not to adopt a negligence standard.

One commenter also appeared to interpret the Proposal as the Board suggesting that having multiple people with overlapping responsibility for a firm's QC system is an obstacle to investor protection or enhanced audit quality and that a single individual needs to be held accountable for a QC violation in the absence of reckless behavior. That was not the Board's intent; rather, the Board meant simply what it said: When there are multiple individuals involved in the QC function, it could be that no individual's conduct rose to the level of recklessness despite a firm's QC failure, thus allowing persons who negligently, directly, and substantially contribute to a QC failure to avoid individual accountability under Rule 3502.[43]

Moreover, the Board did not mean to imply that a single person "needs" to be held individually accountable in all circumstances for negligence contributing to a firm's QC failure.[44] The Board exercises discretion about whom to charge and what charges to bring, and

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comply with applicable professional standards and the firm's standards of quality."); QC 1000 Release at 70-71 (setting forth, in QC 1000.05, the objective of a firm's QC system).

[42] *See, e.g.*, Section 104(c)(3) of Sarbanes-Oxley (requiring the Board, "in each inspection," to "begin a formal investigation or take disciplinary action, if appropriate, with respect to any [potential] violation [identified during an inspection], in accordance with this Act and the rules of the Board").

[43] *See* 2023 Proposing Release at 9.

[44] Comment Letter from PricewaterhouseCoopers LLP at A4 (Nov. 2, 2023).

even in the absence of a charge, the *potential* to be held individually liable for contributory negligence may increase the amount of care and attention dedicated to QC by responsible individuals. Indeed, while reflecting only a modest change, the Board anticipates that the amendment will have a positive impact on audit quality as a result of its deterrent effect.

Another comment letter posited that a negligence standard would place an unfair burden on national office partners responsible for a firm's QC functions and engagement quality review partners, who the comment letter asserted typically do not have the authority to establish firm strategies or allocate resources. This commenter expressed concern that the Board would pursue enforcement actions against a single individual when a firm's partners collectively are responsible for the strategy and resource allocation decisions that led to a firm's violation. Regardless of whether collective responsibility is uniformly the practice, the Board should not be precluded from exercising its discretion to pursue a Rule 3502 charge against an individual who failed to exercise reasonable care and competence, even in cases involving a firm's strategy or resource-allocation decisions that led to a QC failure.

In addition to the QC context, Rule 3502 also arises in sole-proprietorship cases, in which the sole owner and sole partner of a firm causes the firm to commit a violation. Yet for some types of violations, there is not always sufficient evidence of reckless behavior. A negligence standard thus would promote greater accountability by the sole proprietor and prevent that person from being shielded from individual liability under Rule 3502.

One commenter sought clarity regarding how Rule 3502 might be applied to sole proprietors. The Board notes that examples include instances in which firms fail to obtain an

engagement quality review[45] or fail to file (or file timely) required PCAOB forms.[46] In each scenario, the respective primary violations can be committed only by a firm because the obligations are imposed solely on the firm,[47] yet a sole proprietor of a firm could negligently, directly, and substantially contribute to the firm's violation of the relevant PCAOB rules and standard.

Another commenter identified independence violations as a common type of case not mentioned above and for which the commenter believes that a negligence standard of contributory liability would promote greater individual accountability. The Board agrees.[48] Another commenter identified a data compilation regarding cases and fact patterns that the commenter said could be a resource in confirming and validating the change to Rule 3502.[49]

3. Advancing the Board's Investor-Protection Mandate

In the Board's 2022-2026 Strategic Plan, the Board expressed a rejuvenated focus on the PCAOB's investor-protection mandate and stated its intent "to modernize and streamline our existing standards . . . where necessary to meet today's needs."[50] The Board also expressed an

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[45] *E.g.*, *In re Jack Shama*, PCAOB Release No. 105-2024-004 (Jan. 23, 2024); *In re Robert C. Duncan Accountancy Corp.*, PCAOB Release No. 105-2022-010 (June 22, 2022); *In re Tamba S. Mayah, CPA*, PCAOB Release No. 105-2021-007 (Sept. 13, 2021).

[46] *See, e.g.*, *In re Jeffrey T. Gross, Ltd.*, PCAOB Release No. 105-2019-016 (July 23, 2019) (primary violation of PCAOB Rule 3211 relating to Form AP).

[47] *See* AS 1220, *Engagement Quality Review*; PCAOB Rule 2200, *Annual Report* (Form 2 filing rule); PCAOB Rule 2203, *Special Reports* (Form 3 filing rule); PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants* (Form AP filing rule).

[48] Indeed, as the Board has previously stated, Rule 3502 is "essential to the proper functioning of the Board's independence rules." 2004 Proposing Release at 19; *see* 2005 Adopting Release at 14.

[49] The resource is available at https://wp.nyu.edu/compliance_enforcement/category/artificial-intelligence. PCAOB staff's review indicates that what the commenter referred to as qualitative data mainly consists of blog posts written on a wide array of legal issues and news articles that are much broader in scope, cannot be analyzed readily in their entirety, and are not directly relevant to the Board's analysis.

[50] PCAOB, Strategic Plan 2022-2026, at 10, *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/strategic-plan-2022-2026.pdf?sfvrsn=b2ec4b6a_4/.

intent to "engag[e] in vigorous and fair enforcement that promotes accountability and deterrence," including by "tak[ing] a more assertive approach to bringing enforcement actions" and "hold[ing] accountable" those who commit "violations that result from negligent conduct."[51] The amendment to Rule 3502 is consistent with those goals.

When Congress enacted Sarbanes-Oxley, it empowered the Board to promulgate and adopt certain standards and rules, to inspect registered firms for compliance with those standards and rules, and to enforce compliance by firms and their associated persons. Among the tools that Congress provided to the Board for enforcement is the ability to impose certain sanctions for negligent conduct, including single instances of negligence.[52] That liability threshold serves a dual function: It incentivizes auditors to conduct their work knowing that reasonable care is the standard for assessing it (i.e., deterrence), and it allows the Board to publicly discipline auditors who were found to have not exercised an appropriate degree of care (i.e., accountability).[53] Each of those functions—one *ex ante* to auditors' conduct and the other *ex post*—goes to the core of the Board's mission of protecting investors and promoting high-quality audits.

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[51] *Id.* at 3, 13; *see also id.* at 8 ("[W]e are focused on aggressively pursuing all statutory legal theories for charging respondents and remedies available in executing our enforcement program, which is central to protecting investors and promoting the public interest.").

[52] *See* Sections 105(c)(4) & (c)(5) of Sarbanes-Oxley; *Rules on Investigations and Adjudications*, PCAOB Release No. 2003-015, at A2-58 (Sept. 29, 2003), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_005/release2003-015.pdf?sfvrsn=35827b4_0 ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act."). The Board received multiple comments regarding its authority to pursue enforcement proceedings based on single instances of negligence, and the Board addresses those comments below.

[53] *See* Honigsberg, *supra*, at 1899 ("Individual accountability could provide a counterweight to the current incentive structure. . . . [A]udit partners do not internalize the full consequences of an audit failure. Promoting individual brands will better address this inefficiency and reduce externalities by causing audit partners to internalize these failures."); *see also* Gina-Gail S. Fletcher, *Deterring Algorithmic Manipulation*, 74 Vand. L. Rev. 259, 268-69 (2021) ("[I]f the applicable laws are narrow, only capturing the most blatant misconduct, wrongdoers may not be deterred from breaking the law. . . . [D]eterrence is effective if regulators have strong, suitable tools to enforce the regime and market actors know whether they are violating the law.").

The current formulation of Rule 3502, however, stops short of deploying the Board's authority to sanction negligent conduct to the fullest extent by requiring at least reckless conduct before an associated person can be held secondarily liable. The amendment that the Board has adopted to Rule 3502's liability standard removes this constraint and makes the rule both a more effective deterrent and a more effective enforcement tool, and in so doing, better aligns the rule with Sarbanes-Oxley.[54]

Several commenters stated that it is clear and understandable how the amendment to Rule 3502 advance the Board's statutory mandate to protect investors, including by promoting the twin goals of accountability and deterrence. One such commenter remarked that a negligence standard "may be needed" to enhance accountability to investors,[55] while another noted that such standard "fall[s] squarely" within the scope of the Board's mission and "clearly and unambiguously advances" the Board's cause.[56] Still another opined that the amendment would ensure consistency between the liability standard and investor expectations and that "it makes no sense" to have differing standards for firms and individuals.[57]

As to deterrence, multiple commenters stated that the amendments should result in auditors being more likely to comply with their respective legal requirements. One commenter further opined that a negligence standard "sends a strong message" to auditors regarding the requisite level of care that they should be applying in their work.[58]

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[54] *See* PCAOB, Strategic Plan 2022-2026, at 10 ("Effective auditing, attestation, quality control, ethics, and independence standards advance audit quality and are foundational to the PCAOB's execution of its mission to protect investors.").

[55] Comment Letter from Council of Institutional Investors at 5 (Oct. 26, 2023).

[56] Comment Letter from Better Markets at 8.

[57] Comment Letter from Center for American Progress at 2 (Nov. 3, 2023).

[58] Comment Letter from Better Markets at 5.

Other commenters expressed a different view of the amendments relative to investor protection. One commenter stated that, should the amendment discourage certain individuals from accepting important QC roles for fear of being held liable, the public's interest would not be served by having less cautious or less qualified individuals fill those roles. Another opined that the amendments would incentivize high-quality talent to avoid the audit profession, which could lead to lower audit quality, increased audit fees, and a large number of delistings. As certain other commenters pointed out and as the Board observed in the Proposal, however, auditors already are subject to liability and disciplinary schemes that encourage them to comply—and not just avoid reckless noncompliance—with applicable statutory, regulatory, and professional standards.

Still another commenter expressed uncertainty about how a change to negligence will achieve further investor-protection benefits. This commenter remarked that the Board currently has means to hold accountable individuals who are negligent in various contexts and that investors are best protected when noncompliance is avoided in the first place. While the Board agrees that avoiding noncompliance in the first instance promotes audit quality and benefits investors, the Board views the addition of another enforcement tool to deter negligent conduct (including conduct that currently is beyond the Board's reach), and to hold accountable those who engage in such conduct, as a complement to—not mutually exclusive from—avoiding noncompliance.

Beyond deterrence and accountability, multiple commenters remarked that the amendments should enhance investors' confidence, both in audits and in the information provided in companies' financial statements. Some commenters noted that a change to a negligence standard would protect investors by encouraging auditors to be more careful about

their work and positively affecting capital-market efficiency. Another commenter offered several additional downstream investor-protection benefits, including that as audit quality improves, the likelihood of auditors being subjected to meritorious litigation, and the risks and costs to investors resulting from that litigation (as well as misstatements and omissions in audited financial statements), should be reduced.

DISCUSSION OF THE AMENDMENT

As discussed above, the Board has amended PCAOB Rule 3502 by changing the liability standard from recklessness to negligence. The details of the amendment are discussed in the following subsections.

A. Text of the Amended Rule and the Negligence Standard Generally

The Board has amended Rule 3502's liability standard as proposed by deleting the phrase "knowing, or recklessly not knowing" (and certain ancillary surrounding text) and inserting elsewhere into the rule the phrase "knew or should have known" (and certain ancillary surrounding text). The outgoing phrase describes conduct that amounts to at least recklessness,[59] whereas the incoming phrase sets a negligence standard using "classic negligence language."[60] Consequently, the Board is changing the standard for contributory liability from an "extreme departure from the standard of ordinary care"[61] (recklessness) to "the failure to exercise reasonable care or competence" (negligence).[62]

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[59] *See* 2005 Adopting Release at 12 n.23.

[60] *In re KPMG Peat Marwick LLP*, SEC Release No. 34-43862 (Jan. 19, 2001) ("Ordinarily, the phrase 'should have known' . . . is classic negligence language."), *pet. for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109 (D.C. Cir. 2002); *see also Erickson Prods., Inc. v. Kast*, 921 F.3d 822, 833 (9th Cir. 2019) ("'[S]hould have known' . . . is a negligence standard. To say that a defendant 'should have known' of a risk, but did not know of it, is to say that he or she was 'negligent' as to that risk."); *KPMG*, 289 F.3d at 120 ("knew or should have known" is language that "virtually compel[s]" a negligence standard).

[61] *Marrie*, 374 F.3d at 1204 (citation and quotation marks omitted).

[62] *S.W. Hatfield*, SEC Release No. 34-69930, at 35 n.169 (citation and quotation marks omitted).

Such a change addresses the incongruity and related issues noted above. Specifically, it aligns the requisite mental states for liability of a registered firm and for liability of an associated person whose conduct directly and substantially contributed to the firm's violation.[63] In so doing, the modification should better incentivize associated persons to exercise the appropriate level of care, thus promoting investor protection.

Numerous commenters remarked that a change to negligence is appropriate, and with limited exception, commenters remarked that the proposed language to effectuate that change—which the Board has adopted—is clear and understandable.

One commenter called the proposed rule text ("knew or should have known") "overly vague and broad" and asserted that, in contrast to an accountability framework that sets forth clear expectations, the proposed rule does not provide notice of specific conduct that may lead to a violation.[64] As the Proposal explained (and as repeated above), however, the "knew or should have known" phrasing is "classic negligence language," and negligence is "the failure to exercise reasonable care or competence."[65] Indeed, one commenter remarked that such language is "familiar in the American legal system."[66] Moreover, as discussed in the 2005 Adopting Release and the Proposal (and as discussed below), the Board has delineated through its explanation of "directly and substantially" the nexus and magnitude that an auditor's conduct must have to a firm's primary violation to be actionable. The Board is thus satisfied that such a well-known

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[63] However, the sanctions to which a contributory actor may be subject upon being found to have violated Rule 3502—including whether the Board may impose any of the heightened sanctions in Section 105(c)(5) of Sarbanes-Oxley—depend on the associated person's conduct and not that of the firm that commits the primary violation.

[64] Comment Letter from RSM US LLP at 1 (Nov. 3, 2023).

[65] 2023 Proposing Release at 13 & n.45.

[66] Comment Letter from Center for Audit Quality at 11 (Nov. 2, 2023).

standard in the law, supplemented by additional parameters that have been in place for nearly two decades, is neither vague nor overly broad.

Several commenters sought clarity over how the adopted text of Rule 3502 ("knew or should have known"), as well as the definition of negligence ("failure to exercise reasonable care or competence"), would interact with other standards of conduct applicable to auditors, and in particular the obligation of exercising due professional care under then-proposed (now-adopted) AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*.[67] To be sure, due professional care and reasonable care and competence are largely overlapping concepts.[68] However, the Board wishes to emphasize three points.

First, while there may be overlap, AS 1000 does not apply to all conduct for which the Board has enforcement authority[69]; thus, there is a need for a separate rule with a negligence standard. Second, because Rule 3502 includes the "directly and substantially" modifier, it will not always be the case that conduct that violates the obligation of due professional care also violates Rule 3502; thus, Rule 3502 is not duplicative of AS 1000, even if conduct violating the latter may also violate the former in certain circumstances. Third, Rule 3502—located within the "Ethics and Independence" section of the Board's rules regarding professional practice standards—reflects an overarching ethical obligation, and the Board believes it appropriate to

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[67] See General Responsibilities of the Auditor in Conducting an Audit and Amendments to PCAOB Standards, PCAOB Release No. 2024-004, at 30-39 (May 13, 2024) ("AS 1000 Release") (subject to Commission approval); see also AS 1015, Due Professional Care in the Performance of Work.

[68] *See* AS 1000 Release at A1-3 ("due professional care" includes "acting with reasonable care and diligence"); *see also* QC 1000 Release at 81 ("We are adopting this provision [QC 1000.10] with modifications to align with the descriptions of due professional care and professional skepticism being adopted in AS 1000.").

[69] *See* AS 1000 Release at 30-31 (delineating the parameters of "all matters related to the audit" to which AS 1000's requirement to exercise due professional care applies).

codify that general obligation, even if it overlaps with more specific provisions in particular professional standards.

A substantial number of commenters did not appear to support the change. In general, these commenters stated that they do not believe that negligence is an appropriate standard for assessing conduct and compliance on complex audit engagements, which commenters said require a wide range of judgments. For instance, one commenter opined that what could be labeled as a "violation" of professional standards instead may be only a difference of opinions between accountants about a particular pronouncement(s). That commenter further opined that, by proposing a negligence standard, the Board misunderstands the nature of audits. Several other commenters opined that it is bad policy to penalize errors in judgment and for the PCAOB to second-guess auditors' good-faith decisions in situations involving the application of professional judgment.

As noted above, however, firms and associated persons already are subject to a negligence standard for their primary violations, including for single instances of negligence that violate professional standards.[70] The amendment to Rule 3502 therefore affects only an incremental (albeit important) change, and only for contributory conduct. Given the Board's nearly two decades of experience distinguishing isolated, good-faith errors in professional judgment from conduct that warrants disciplinary action, as well as the modest estimated increase in Rule 3502 cases that would result from the amendment, the Board does not anticipate that a change in the liability standard for contributory conduct will be used to sanction isolated, good-faith errors in professional judgment—let alone be wielded as a "blunt" or "draconian"

[70] *See, e.g.*, *In re Sassetti, LLC*, PCAOB Release No. 105-2024-018 (Mar. 28, 2024); *In re Berkower, LLC*, PCAOB Release No. 105-2024-016 (Mar. 28, 2024).

instrument, as one commenter suggested[71]—including with respect to less senior engagement team members.[72] The amendment focuses on unreasonable conduct; it does not impose strict liability.[73]

One commenter opined that a Rule 3502 charge could cause associated persons to "lose their livelihood" due to "career-ending penalties" under the Proposal.[74] Several other commenters expressed a similar concern about the negligence threshold and the potential collateral effects and impacts on auditors' careers. While the Board appreciates that disciplinary orders have consequences—as they should—research suggests that auditors remain gainfully employed following a culpability finding.[75] And in all events, the Board emphasizes that it is not the Board's intent to pursue, through Rule 3502 charges, what one commenter described as "foot-faults" or "unintentional slips, pure errors of judgment, and innocuous errors on 'technicalities.'"[76] Nor do the Board's standards require that auditors exercise "perfect judgment

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[71] Comment Letter from U.S. Chamber of Commerce at 2 (Nov. 7, 2023).

[72] To iterate what the Board said in 2005, Rule 3502 is not "a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful." 2005 Adopting Release at 14.

[73] "Strict liability is imposed upon a defendant without proof that he was at fault. In other words, when liability is strict, neither negligence nor intent must be shown." Dobbs' Law of Torts § 437.

[74] Comment Letter from RSM US LLP at 1, 2.

[75] *See* J. Krishnan, M. Li, M. Mehta & H. Park, *Consequences for Culpable Auditors*, *available at* https://ssrn.com/abstract=4627460. In their working paper studying audit professionals subject to Commission or PCAOB enforcement proceedings between 2003 and 2019, the authors make three key findings:

First, a substantial number of culpable auditors remain gainfully employed by their firms one year after the enforcement event (26% of Big 4 and 43% of non-Big 4 culpable auditors). Second, culpable individuals leaving Big 4 firms primarily move to the corporate sector and secure senior or mid-level executive positions at private firms. By contrast, culpable auditors departing from non-Big 4 firms tend to join other non-Big 4 public accounting firms, often as partners. Third, . . . the large majority of culpable auditors do not engage in liquidity-increasing real estate transactions around enforcement.

[76] Comment Letter from U.S. Chamber of Commerce at 9, 10.

at all times," as one commenter put it,[77] to avoid an enforcement proceeding (under Rule 3502 or otherwise).[78]

Some commenters expressed concern over the notion that, as a result of the amendment, the Board would be able to pursue conduct that is not itself a violation but that merely contributes to a violation. One commenter characterized this as a "significant change from current PCAOB enforcement policy,"[79] but in fact it is no change at all; under the current version of Rule 3502, the Board can bring charges for conduct that is not itself a primary violation. The amendment merely changes the standard for when an individual's contributory conduct becomes actionable; it does not alter whether the contributory conduct must be an independent violation apart from the firm's underlying primary violation.

Several commenters expressed concern regarding a negligence standard in Rule 3502 in light of the current regulatory environment—specifically amidst the Board's other standard-setting projects, including the then-proposed (now-adopted) quality control standard, QC 1000. These commenters opined that new requirements in proposed and adopted other standards may put auditors at greater risk of violating Rule 3502, including based on the introduction or modification of key concepts and their interrelation to negligence.

The Board appreciates that audits, especially of large enterprises, have the potential to be quite complex and can require input from various individuals, including individuals not on the

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[77] Comment Letter from RSM US LLP at 3.

[78] *See* AS 1015.03, *Due Professional Care in the Performance of Work* (quoting a treatise describing the obligation of due care as: "[N]o man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment." (citation omitted)); AS 1000 Release at 31 ("We continue to believe that the description of due professional care in the final standard is consistent with the description in AS 1015.03 (and the reference in the current standard to the legal treatise, *Cooley on Torts*), which uses the terms 'reasonable care and diligence' and 'good faith and integrity but not infallibility' to describe due care.").

[79] Comment Letter from U.S. Chamber of Commerce at 2.

engagement team. QC systems likewise can be quite complex and require input from numerous people. And as in 2005, "[t]he Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs."[80] But complexity is not a reason to allow negligent auditors—individuals who by definition have acted *unreasonably*—to contribute directly and substantially to firms' violations without consequence. Indeed, as one commenter noted, the complexity of audits and the current environment in which companies operate—which is rapidly changing and subject to emerging risks—*supports* amending Rule 3502 because audited financial statements are becoming increasingly important.

The Board also recognizes that it recently has adopted amendments to several standards[81] and has proposed amendments to other standards[82] and to certain PCAOB rules.[83] This is consistent with the Board's Strategic Plan, which states: "We expect to propose and adopt numerous amendments and new standards over the coming years, in accordance with our standard-setting and research agendas. We also plan to evaluate certain existing standards to determine whether they are outmoded."[84] Many of the newly adopted standards, moreover, have staggered effective dates, and thus auditors will not be required to come into compliance with

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[80] 2005 Adopting Release at 14.

[81] See generally Amendments Related to Aspects of Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form, PCAOB Release No. 2024-007 (June 12, 2024) (subject to Commission approval); QC 1000 Release; AS 1000 Release; The Auditor's Use of Confirmation, and Other Amendments to PCAOB Standards, PCAOB Release No. 2023-008 (Sept. 28, 2023); Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm, PCAOB Release No. 2022-002 (June 21, 2022).

[82] See, e.g., Proposed Auditing Standard – Designing and Performing Substantive Analytical Procedures and Amendments to Other PCAOB Standards, PCAOB Release No. 2024-006 (June 12, 2024); Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments, PCAOB Release No. 2023-003 (June 6, 2023).

[83] See, e.g., Proposing Release: Firm Reporting, PCAOB Release No. 2024-003 (Apr. 9, 2024); Firm and Engagement Metrics, PCAOB Release No. 2024-002 (Apr. 9, 2024); Proposals Regarding False or Misleading Statements Concerning PCAOB Registration and Oversight and Constructive Requests to Withdraw from Registration, PCAOB Release No. 2024-001 (Feb. 27, 2024).

[84] PCAOB, Strategic Plan 2022-2026, at 10.

each of them at the same time.[85] And in all events, as firms make efforts to comply with new standards, it necessarily follows that individuals who could be subject to Rule 3502 also would be making such efforts because firms can act only through their natural persons.

The Board does not intend for any of its new or revised standards, either alone or in conjunction with the amendment the Board has adopted, to "create[ ] a trap for the unwary," as one commenter opined.[86] Far from it, the Board's standard-setting agenda seeks to modernize standards in a way that promotes high-quality audits through compliance in the first instance. Enforcement proceedings promote this same *ex ante* focus on compliance insofar as they serve as a deterrent to other auditors from engaging in the same or similar misconduct.

Finally, some commenters expressed concern about whether an associated person could be liable for negligence under Rule 3502 in situations where a primary violation by a firm requires a standard higher than negligence. One commenter remarked that holding an associated person liable in such circumstances would be "unprecedented (and unlawful)" and stated that the Board should consider specifically exempting violation-causing conduct when a primary violation involves intentional conduct.[87] Another commenter sought clarity from the Board on the issue and asked whether the Board believes that individual liability in such a scenario would be appropriate. Although the Board will continue to evaluate whether to bring Rule 3502 charges on a case-by-case basis, when the firm's primary violation requires more than

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[85] *See* PCAOB Release No. 2022-002, at 58 (effective for audits of financial statements for fiscal years ending on or after December 15, 2024); PCAOB Release No. 2023-008, at 96 (effective for audits of financial statements for fiscal years ending on or after June 15, 2025); AS 1000 Release at 96 (with limited exception, effective for audits of financial statements for fiscal years beginning on or after December 15, 2024); QC 1000 Release at 378 (effective December 15, 2025); PCAOB Release No. 2024-007, at 61 (effective for audits of financial statements for fiscal years beginning on or after December 15, 2025).

[86] Comment Letter from U.S. Chamber of Commerce at 10.

[87] Comment Letter from RSM US LLP at 3.

negligence, the Board does not anticipate charging individuals for negligently contributing to such violations.[88]

B. Retention of "Directly and Substantially"

As proposed, the Board has decided to retain the "directly and substantially" modifier to describe the connection between a contributory actor's conduct and a registered firm's primary violation.[89] Thus, for conduct to "directly" contribute to a primary violation, it must "either essentially constitute[ ] the violation"—in which case the conduct necessarily is a direct cause of it[90]—or be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation"; but it need not "be the final step in a chain of actions leading to the violation."[91] Moreover, "directly" does not excuse an associated person who negligently "engages in conduct that substantially contributes to a violation, just because others also contributed to the violation, or because others could have stopped the violation and did not."[92] Nor would it necessarily excuse an associated person's conduct when another actor engages in intentional misconduct that might otherwise break the chain of causation—in particular where the associated person's

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[88] *See Howard v. SEC*, 376 F.3d 1136, 1141 (D.C. Cir. 2004) ("Although we held in *KPMG, LLP v. SEC*, that the 'knew or should have known' language in § 21C embodied a negligence standard for purposes of that case, it does not necessarily follow that negligence is the standard" where "scienter [is] an element of the primary violations."); *KPMG Peat Marwick*, SEC Release No. 34-43862 ("We hold today that negligence is sufficient to establish 'causing' liability under Exchange Act Section 21C(a), at least in cases in which a person is alleged to 'cause' a primary violation that does not require scienter.").

[89] *See* 2005 Adopting Release at 13. As discussed above, the "directly and substantially" modifier was added in response to commenters' concerns that a negligence standard might sweep too broadly. *See also* 2005 Adopting Release at 13. Because the Board is retaining "directly and substantially," as explained herein, the guardrails that the Board put in place in 2005 in response to such concerns remain in Rule 3502.

[90] *Cf. Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980) ("[C]ommon law agency principles, including the doctrine of respondeat superior, remain viable in actions brought under the Securities Exchange Act and provide a means of imposing secondary liability for violations of the Act independent of § 20(a). The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.").

[91] *See* 2005 Adopting Release at 13.

[92] *Id.*

conduct is at least negligent and created the situation for the other actor to engage in intentional misconduct, and where the associated person realized or should have realized the potential for, and likelihood of, such third-party intentional misconduct.[93]

For its part, "substantially" continues to require that the associated person's conduct "contribute[ ] to the violation in a material or significant way," though it "does not need to have been the sole cause of the violation."[94] The Board stresses that Rule 3502 is not intended to "reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation."[95]

Commenters generally encouraged the Board to retain the "directly and substantially" modifier, including one commenter remarking that the Board's reasons for retaining it "remain valid."[96] Multiple commenters, moreover, stated that these terms are clear and understandable. One commenter posited that the Board should not retain "directly and substantially" as part of Rule 3502.

Several commenters sought additional clarity around the terms "directly and substantially." For instance, one commenter noted that the terms are not defined in Rule 3502

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[93] *See* Restatement (Second) of Torts § 448 ("The act of a third person in committing an intentional [violation] is a superseding cause of harm to another resulting therefrom, although the actor's negligent conduct created a situation which afforded an opportunity to the third person to commit such a [violation], unless the actor at the time of his negligent conduct realized or should have realized the likelihood that such a situation might be created, and that a third person might avail himself of the opportunity to commit such a [violation].").

[94] 2005 Adopting Release at 13.

[95] *Id.*; *see also id.* at 14 (the Board does not "seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation"). One commenter opined that the distinction between obligations placed on individuals and firms, respectively, should not be disturbed insofar as there may be instances where it is appropriate for a firm to be sanctioned for a violation but where no particular individual played a sufficient role in that violation. This commenter urged the Board to not use Rule 3502 to "collapse this distinction." Comment Letter from Center for Audit Quality at 9. The Board agrees—there are indeed instances where it is appropriate to sanction a firm but not any individual(s) (under Rule 3502 or otherwise). The amendment the Board has adopted does nothing to collapse that distinction: It changes only the actionable standard of conduct, but does nothing to alter the nexus and magnitude requirements of "directly and substantially," i.e., it does not alter the requisite sufficiency of an individual's role relative to a firm's violation.

[96] Comment Letter from Ernst & Young LLP at 4 (Nov. 3, 2023).

and claimed that the purported lack of clarity will make the rule inoperable. This commenter suggested that the Board instead import a more established legal doctrine of causation. Another commenter called the terms "subjective" and asked for a clearer articulation of them,[97] and another asked whether the terms "will be applied differently moving forward."[98]

Having considered all commenters' views, the Board is satisfied that the modifier "directly and substantially" is sufficiently clear and operable and believes that no further delineation of the terms is needed at this time. The Board notes that, going back to the 2005 Adopting Release, the explanation of "directly and substantially" includes concepts from established legal principles (e.g., "directly" includes circumstances where an individual's conduct is a "reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the [firm's] violation").

The Board further notes that, based on the amended rule text, "directly and substantially" would apply only to the sufficiency of the connection between an associated person's conduct and a firm's violation. Thus, to be liable under Rule 3502, a person must have known, or should have known, that an act or omission by them would contribute—but not that it would *directly and substantially* contribute—to a firm's violation.

One commenter remarked that the Board failed to explain its intention behind this aspect of the amendment and that the wording creates potential ambiguities and unfairness. The Board, however, sees it differently—by eliminating the need for any inquiry into individuals' mental states regarding the manner in which their conduct contributes to the firm's violation, the Board

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[97] Comment Letter from Accounting & Auditing Steering Committee of the Pennsylvania Institute of Certified Public Accountants at 5 (Nov. 2, 2023).

[98] Comment Letter from Audit and Assurance Services Committee of the Illinois CPA Society at 3 (Nov. 2, 2023).

believes that the rule has the potential to be applied more uniformly (and thus more fairly). Moreover, if an associated person knew or should have known that his or her conduct would contribute to a violation in *any* way, then that individual should not be able to evade liability simply because the individual did not know the extent of the nexus and magnitude of such contribution. But in all events, the Board iterates that, absent conduct "directly and substantially" contributing to a firm's violation, an individual's actions or omissions are not subject to discipline under Rule 3502.

Two commenters opined that the Proposal suggested that the Board was open to a tertiary liability theory, in which a first associated person's conduct contributes to the conduct of a second associated person, which in turn contributes to a registered firm's violation. But as those commenters also recognized, the rule still would require the first person's conduct to directly and substantially contribute to *the firm's* violation.[99] Thus, contrary to those commenters' concerns, the definition of "directly" is not stretched beyond what it would be if there were no second person involved, let alone beyond common usage of the word.

Finally, some commenters suggested other phrases or concepts to incorporate into the rule to modify "contribute." One commenter called for limiting liability to "egregious actions."[100] Such a standard, however, more aptly describes conduct that is reckless (as opposed

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[99] *See* 2023 Proposing Release at 17 n.65; *e.g.*, *In re Shandong Haoxin Certified Public Accountants Co., Ltd*., PCAOB Release No. 105-2023-045, at ¶65 (Nov. 30, 2023) (multiple individuals violated Rule 3502 in connection with the same primary violation by the firm through different (though related) contributory conduct).

[100] Comment Letter from Accounting & Auditing Steering Committee of the Pennsylvania Institute of Certified Public Accountants at 5.

to negligent),[101] which would be contrary to what the Board intends for the amendment to accomplish.

That same commenter expressed the view that the negligence standard should not apply to a professional who spends only a de minimis amount of time on an engagement, and further suggested that the Board add language to clarify that liability would only extend to a professional having a substantive level of participation on the engagement. Another commenter similarly suggested that the Board require that an associated person's conduct be a "substantial factor" in bringing about the firm's violation.[102] The Board, however, believes that the contours of "substantially" (in "directly and substantially") suffice to help ensure that Rule 3502 is applied only to those individuals with a substantive level of participation or responsibility on an engagement with respect to a firm's violation in connection with an audit. And as the Board previously has expressed—in the 2005 Adopting Release, in the Proposal, and above—Rule 3502 is not intended to reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation.

C. No New Liability Standard in Light of the Commission's Authority

As explained in the Proposal, associated persons already are subject to potential liability—including money penalties—for negligently contributing to registered firms' violations of numerous laws and rules governing the preparation and issuance of audit reports via the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, Section 21C of the Exchange Act authorizes the Commission to institute cease-and-desist proceedings against any "person that

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[101] *See, e.g.*, *In re Gately & Assocs., LLC*, SEC Release No. 34-62656, at 18 (Aug. 5, 2010) ("Recklessness can be established by an 'egregious refusal to investigate the doubtful and to see the obvious.'" (citation omitted)).

[102] Comment Letter from RSM US LLP at 7.

is, was, or would be a cause of [a] violation [of the Exchange Act or any rule or regulation thereunder], due to an act or omission the person knew or should have known would contribute to such violation,"[103] and Section 21B further authorizes the Commission to "impose a civil penalty" upon finding that such person "is or was a cause of [such] violation."[104] Section 3(b)(1) of Sarbanes-Oxley, in turn, provides that "[a] violation by any person of . . . any rule of the Board shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder." Thus, the amendment to Rule 3502's liability threshold does not subject auditors to any new or different standard to govern their conduct in light of the Commission's authority.[105]

Numerous commenters seemed to disagree with that proposition for several reasons. Some commenters pointed out that the Commission cases cited in footnote 52 of the Proposal, while each a proceeding under Section 21C of the Exchange Act, were also proceedings under Commission Rule of Practice 102(e), which requires either "[a] single instance of highly unreasonable conduct that results in a violation" or "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards."[106] Sanctions are not available

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[103] 15 U.S.C. 78u-3(a); *see also* 15 U.S.C. 77h-1(a), 80a-9(f)(1), 80b-3(k)(1).

[104] 15 U.S.C. 78u-2(a)(2). The Commission's Section 21B authority to impose civil penalties for violations in Section 21C cease-and-desist proceedings was added in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Pub. L. 111-203.

[105] Nor does the Commission's authority to sanction associated persons' negligent contributory conduct detract from the proposed amendment's deterrent effect. As previously noted, as an increase in the number of regulators on the lookout for the same or similar violative conduct increases the likelihood of that conduct being detected and, consequently, the likelihood that the conduct would be sanctioned. *See* Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. Chi. Legal F. 1, 12 (2010) ("One of the most powerful deterrents to misconduct is an increased threat of prosecution. . . . A 'can do' accountant is less likely to provide questionable opinions if there is a substantial certainty that he will be caught and punished."); *see also* Fletcher, *supra*, at 268 ("Certainty of punishment"—including "the possibility of detection, apprehension, conviction, and sanctions"—is one of two "primary factors" that drive deterrence.).

[106] 17 CFR 201.102(e); *see In re David S. Hall, P.C.*, SEC Initial Decision Release No. 1114 (Mar. 7, 2017) (ALJ Op.), *decision made final*, SEC Release No. 34-80949 (June 15, 2017); *In re Gregory M. Dearlove, CPA*, SEC Release No. 34-57244 (Jan. 31, 2008); *In re Philip L. Pascale, CPA*, SEC Release No. 34-51393 (Mar. 18, 2005).

under Rule 102(e) when an auditor engages in a single instance of unreasonable (but not highly unreasonable) conduct.[107] Thus, certain commenters said that the cases were not "on par" with what the Board intends through the amendment to Rule 3502.[108]

To be sure, those commenters are correct that the cases cited in footnote 52 of the Proposal involve proceedings under Commission Rule 102(e), as well as under Section 21C. Commenters, however, did not appear to contest that the Commission has the authority to bring proceedings for single acts of ordinary negligence under Section 21C, including for civil money penalties (authorized by Section 21B), *without also proceeding under Commission Rule 102(e)*.[109] Rather, commenters instead suggested only that the Commission rarely exercises such authority in practice. While that may be the case, the Board's point nonetheless remains: The amendment to Rule 3502's liability threshold does not subject auditors to any new or different standard to govern their conduct.

The Commission release cited by certain commenters when advancing the contrary argument makes this point abundantly clear. In it, the Commission stated that a single act of negligence "may result in a violation of the federal securities laws" and that "the person committing such an error, though not subject to discipline under Rule 102(e), would be exposed

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[107] *See Amendment to Rule 102(e) of the Commission's Rules of Practice*, SEC Release No. 34-40567 (Oct. 26, 1998) ("[T]he Commission is not adopting a standard that reaches single acts of simple negligence.").

[108] Comment Letter from Center for Audit Quality at 7; Comment Letter from Moss Adams LLP at 3 (Nov. 3, 2023). One commenter observed that the Commission proposed but ultimately declined to adopt an ordinary negligence standard for contributory conduct by accountants under Rule 102(e). But as that commenter also recognized, the Commission did so while expressly acknowledging that an ordinary negligence standard in Rule 102(e) would have been duplicative of authority that it already possessed. *See* SEC Release No. 34-40567 ("Moreover, the Commission possesses authority, wholly independent of Rule 102(e), to address and deter such errors through its enforcement of provisions of the federal securities laws that impose liability on persons, including accountants, for negligent conduct."). The Board, by contrast, lacks ability to pursue contributory negligent conduct based on the current formulation of Rule 3502.

[109] Indeed, civil money penalties are not available under Commission Rule 102(e)—only censure or denial (temporary or permanent) of the privilege of appearing or practicing before the Commission. 17 CFR201.102(e). Thus, the Commission would not need to meet Rule 102(e)'s "highly unreasonable conduct" standard to impose a civil money penalty for a single act of negligence under Section 21B of the Exchange Act.

to the sanctions available under [such] other provisions."[110] The Commission noted elsewhere in its release that a single act of ordinary negligence "could have legal consequences."[111]

One commenter suggested that Section 21C proceedings are an inapt analog for charges under Rule 3502 because Section 21C was intended to quickly enjoin conduct that may lead to violations, but was not designed to be a sanctions-imposing provision. Whether that was the original intent of Section 21C,[112] Section 21B now indisputably allows for sanctions (in the form of monetary penalties) in a proceeding under Section 21C when an auditor or any other person was negligent in causing violations by others. Indeed, much like Section 21B's direct-violation provision, the text of the secondary-violation provision in Section 21B expressly contemplates the imposition of a penalty based on conduct that *already* occurred.[113]

This commenter also posited that, in addition to a primary violation, Section 21C also requires a finding of harm to the public that was in part caused by a contributory negligent act. While that may be the case for issuance of a temporary order pursuant to Section 21C(c), no such

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[110] SEC Release No. 34-40567 at n.28; *see also id.* at n.38 ("In other instances, the federal securities laws expressly subject auditors to liability without requiring intentional misconduct. . . . [S]ection 21C of the Exchange Act imposes liability when a person is a 'cause' of a violation 'due to an act or omission the person knew or should have known would contribute to such violation.'").

[111] *Id.* at n.47.

[112] The commenter's cited authority does not appear to support that view. *See* Andrew M. Smith, *SEC Cease-and-Desist Orders*, 51 Admin. L. Rev. 1197, 1226 (1999) ("The legislative history of the [statute that includes Section 21C] is not clear as to whether Congress intended to require the SEC to find a reasonable likelihood of future violation before imposing a cease-and-desist order, although a strong argument can be made that Congress did not intend to require the SEC to make such a finding. In addition, most, if not all, of the proponents and architects of cease-and-desist authority, and many who have commented on the [relevant statute] and its predecessor legislative proposals, believe that such a finding is not necessary.").

[113] 15 U.S.C. 78u-2(a)(2)(B) ("In any proceeding instituted under [Section 21C] against any person, the Commission may impose a civil penalty, if the Commission finds, on the record after notice and opportunity for hearing, that such person . . . is *or was* a cause of the violation of any provision of this chapter, or any rule or regulation issued under this chapter." (emphasis added)); *see also* Smith, *supra*, at 1199 ("[Section 21C's] plain language—'has violated'—appears to authorize the SEC to base a cease-and-desist order upon a *single past violation*, without any showing that the violator is likely to break the law in the future." (emphasis added)).

finding is required for imposition of a monetary penalty under Section 21B.[114] And regardless, although harm is not an element of proof for a Rule 3502 violation, inherent in any proceeding under Rule 3502 is the foundational principle that the Board is bringing the proceeding and imposing sanctions "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[115]

Another commenter remarked that in a Commission proceeding for ordinary negligence under Section 21C (and not also for highly unreasonable conduct under Rule 102(e)), the Exchange Act limits what sanctions the Commission can impose, and in the commenter's view, the Commission lacks the authority to impose certain sanctions that the Board can impose. But while the available sanctions for a single act of negligence might be different in a proceeding under Rule 3502 compared with one under Section 21C—indeed, the Commission can seek certain sanctions that the Board cannot[116]—Sarbanes-Oxley *does* place express limits on what sanctions the Board can impose.[117] In the Board's view, that the limitations on sanctions in the

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[114] *Compare* 15 U.S.C. 78u-3(c)(1), *with id.* 78u-2(a)(2). In any event, it would appear that harm to the public interest is sufficient, but not *required*, for a temporary restraining order under Section 21C, as that provision allows the Commission to enter a temporary restraining order "[w]henever the Commission determines that the alleged violation or threatened violation . . . is likely to result in significant dissipation or conversion of assets, significant harm to investors, *or* substantial harm to the public interest." *Id.* 78u-3(c)(1) (emphasis added).

[115] Section 101(a) of Sarbanes-Oxley. As the Commission has recognized, moreover, even "unreasonable, or negligent, accounting or auditing errors . . . could undermine accurate financial reporting." SEC Release No. 34-40567.

[116] The Commission's authority is more expansive in other ways, as well. For example, as noted in the Proposal, the Commission is not limited to holding accountable auditors for contributory conduct with respect to primary violations committed only by registered firms; rather, the Commission also may hold accountable auditors who cause violations by any other person, including issuers. *See* 2023 Proposing Release at 9 n.33. Additionally, while Rule 3502 applies only to associated persons of registered firms, the Commission's authority under Section 21C is not so limited; it applies to "any person," including nonaccounting professionals. 15 U.S.C. 78u-3(a); *see also id.* 78c(a)(9) (defining "person").

[117] *See* Section 105(c)(5) of Sarbanes-Oxley. One commenter sought clarity with respect to footnote 48 of the Proposal, and specifically the circumstances under which the Board would be permitted to impose heightened sanctions. The Board takes this opportunity to clarify that, although the amendment to Rule 3502 allows the Board to sanction single instances of negligent contributory conduct, the heightened sanctions referenced in Section 105(c)(5) of Sarbanes-Oxley—specifically, those sanctions listed in subparagraphs (A) through (C) and (D)(ii) of Section 105(c)(4)—would *not* be available for a Rule 3502 violation absent a finding that the individual

Exchange Act and in Sarbanes-Oxley, respectively, might not be the same in all respects does not render the Board's enforcement authority "unprecedented."[118]

D. Authority for the Amendment

Several commenters expressed doubt regarding the Board's statutory authority for the amendment in two respects: They questioned whether the Board has the authority to sanction single acts of ordinary negligence as a general matter (i.e., in cases of direct violations or otherwise), and they questioned the Board's authority to promulgate a contributory liability rule at the negligence standard. In general, these commenters asserted that the Board's authority in these respects is either unclear or rests on questionable interpretations of Sarbanes-Oxley. One commenter further opined that the Proposal ignores congressional intent and that the Board's authority is "not as settled as the Proposal assumes,"[119] and still another comment letter posited that Sarbanes-Oxley is clear that in the absence of repeated negligence, sanctions should not be imposed.

Although the Board believes that its authority in both respects is well-settled for reasons the Board has previously explained,[120] the Board nonetheless addresses these commenters' views.

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who violated Rule 3502 acted at least recklessly or committed repeated acts of negligence each resulting in a violation of an applicable statutory, regulatory, or professional standard.

[118] Comment Letter from Center for Audit Quality at 8. This commenter also sought to cast as inappropriate a negligence standard for Rule 3502 in light of the mental state required for aiding and abetting liability. The Board agrees with the commenter that aiding and abetting generally requires knowing conduct, which is why the Board has not relied on that theory of liability—in 2004, in 2005, in the Proposal, or now—as an analog or basis for Rule 3502. *See, e.g.*, 2005 Adopting Release at 11 n.20 ("Rule 3502, of course, differs from an aiding-and-abetting cause of action in important respects. Among other things, the rule does not apply whenever an associated person causes another to violate relevant laws, rules and standards. Rather, Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated.").

[119] Comment Letter from U.S. Chamber of Commerce at 2.

[120] *See* 2004 Proposing Release at 18; 2005 Adopting Release at 10-12; *see also* 2023 Proposing Release at 12 n.43.

1. Authority to Sanction Single Acts of Negligence Generally

The text of Section 105 of Sarbanes-Oxley plainly permits the Board to impose liability for single acts of negligence. Specifically, Section 105(c)(4) authorizes the Board to impose an array of sanctions—listed in subparagraphs (A) through (G)—upon finding that a registered firm or associated person engaged in violative conduct, without reference to the level of culpability required but "subject to applicable limitations" in Section 105(c)(5). Section 105(c)(5), in turn, provides that "[t]he sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of [Section 105(c)(4)] shall only apply to [ ] intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct each resulting in a violation of the applicable statutory, regulatory, or professional standard." Section 105(c)(5) thus does not restrict the Board's authority to impose for single acts of negligence certain sanctions—those in subparagraphs (D)(i) and (E) through (G) of Section 105(c)(4).

The Board has long recognized this grant of authority,[121] as did multiple commenters. One commenter agreed that the Board has had authority to bring enforcement proceedings for negligence "[s]ince the PCAOB's creation,"[122] and another posited that Congress "clearly" intended for the Board to sanction associated persons for negligent conduct.[123] Still another

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[121] Two decades ago, the Board stated:

> The Act *plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act*. Section 105(c)(5) of the Act provides that the Board may impose the more severe sanctions authorized by section 105(c)(4) only in cases that involve intentional or knowing conduct (including reckless conduct) or repeated instances of negligent conduct. Implicit in that provision is that *a violation based on a single instance of negligent conduct is sufficient to warrant a disciplinary proceeding to impose lesser sanctions*.

PCAOB Release No. 2003-015, at A2-58-59 (emphases added); *see also id.* at A2-76 ("[S]ection 105(c)(5) of the Act requires scienter or repeated negligence for imposition of the most severe sanctions. The Act does not limit the standard that must be met for imposition of other sanctions."); 2005 Adopting Release at 12 n.23.

[122] Comment Letter from North American Securities Administrators Association, Inc. at 1 (Nov. 13, 2023).

[123] Comment Letter from Center for American Progress at 3.

asserted that Sarbanes-Oxley "empowers" the Board to sanction associated persons in instances "when their conduct was not intentional or reckless."[124] Indeed, this latter commenter opined that the Proposal created a "misimpression" that associated persons currently can *only* be sanctioned for intentional or reckless misconduct.[125] This of course was not the Board's intent.

Other commenters, however, took the opposite view. One comment letter opined that, when read together, the provisions of Sections 105(c)(4) and (c)(5) discussed above make clear that unless negligent conduct is repeated, sanctions and penalties "should not be applied."[126] If Congress had intended for *all* sanctions listed in Section 105(c)(4) to be unavailable absent reckless conduct or repeated acts of negligence, however, then it would have had no reason to make the specific carve-outs that it did in Section 105(c)(5); there would be no point to them. Such an interpretation thus runs contrary to both Section 105(c)(5)'s text and the bedrock principle of statutory construction to not read a statute in a way that renders language superfluous.[127]

2. Authority for a Negligence-Based Contributory-Liability Rule

Congress intended to grant to the Board "plenary authority" to establish or adopt ethics standards.[128] To that end, Section 103(a)(1) of Sarbanes-Oxley mandates that the Board

> shall, by rule, establish . . . and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, such ethics standards, and such independence standards to be used by registered public

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124 Comment Letter from Ernst & Young LLP at 2.

125 *Id.*

126 Comment Letter from Eight Accounting Professors (Cannon, et al.) at 4 (Nov. 2, 2023).

127 *See, e.g.*, *FCC v. NextWave Personal Cmmc'ns Inc.*, 537 U.S. 293, 302 (2003) ("[E]ven § 525(a) itself contains explicit exemptions for certain Agriculture Department programs. These latter exceptions would be entirely superfluous if we were to read § 525 as the Commission proposes—which means, of course, that such a reading must be rejected."); *see also TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) ("[W]ere we to adopt [respondent's] construction of the statute, the express exception would be rendered insignificant, if not wholly superfluous." (citation and quotation marks omitted)).

128 S. Rep. 107-205, at 8.

> accounting firms in the preparation and issuance of audit reports . . . as may be necessary or appropriate in the public interest or for the protection of investors.[129]

As the Board twice recognized nearly two decades ago—once when it proposed Rule 3502 and again when the Board adopted it—a contributory liability rule merely codifies auditors' longstanding ethics obligations.[130]

Some commenters nonetheless expressed doubt about whether the statutory authority to regulate ethical conduct equates to a statutory authority to sanction negligent conduct. In doing so, one such commenter appeared to interpret the Proposal's discussion of the Commission's authority under Section 21C of the Exchange Act to mean that the Board was relying on that provision as authority for the amendment. The Board, however, did not rely (and is not relying) on Section 21C of the Exchange Act as a source of authority for its negligent contributory-liability standard; rather, the Board agrees with the commenter that such provision applies only to the Commission. The Proposal's discussion of Section 21C instead was meant to show that, by adopting a negligence threshold in Rule 3502, the Board would not be subjecting auditors to any new standard to govern their contributory conduct.[131]

As the Board previously explained, "an associated person's ethical obligation is not merely to refrain from knowingly causing a violation but also to act with sufficient care to avoid

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[129] *See also* Section 101(c)(2) of Sarbanes-Oxley.

[130] 2004 Proposing Release at 18; *see* 2005 Adopting Release at 9. Beyond codifying auditors' ethics obligations, Rule 3502 is also "essential to the proper functioning of the Board's independence rules." 2004 Proposing Release at 19; *see also* 2005 Adopting Release at 14. As the Board previously explained:

> For example, Rule 3521 provides, in part, that a registered firm is not independent of its audit client if the firm provides that audit client with a service for a contingent fee. When an associated person causes . . . the registered firm to provide that service for a contingent fee, Rule 3502 would allow the Board to discipline the associated person for that conduct.

2005 Adopting Release at 14.

[131] 2023 Proposing Release at 14 (discussing Section 21C and concluding: "Thus, the proposed amendment to Rule 3502's liability threshold would not subject auditors to any new or different standard to govern their conduct.").

negligently causing a violation."[132] Such obligation has deep historical roots. For instance, the AICPA's Code of Professional Conduct at the time that Sarbanes-Oxley was enacted (and still today) made it an "act discreditable to the profession"—and therefore a violation of its ethics rules[133]—for a member accountant to "*permit[ ] or direct[ ] another* to make[ ] materially false and misleading entries in the financial statements or records of an entity" "*by virtue of his or her negligence*."[134] Just the same if a member were to "*permit[ ] or direct[ ] another* to sign[ ] a document containing materially false and misleading information" "*by virtue of his or her negligence*."[135]

Congress clearly had in mind the AICPA Code of Professional Conduct when it authorized the Board to promulgate ethics standards. The AICPA had a prominent presence during the drafting of Sarbanes-Oxley and in the run up to its passage,[136] and beyond Congress empowering the Board to write its own ethics standards, it also empowered the Board to "adopt as its rules[ ] . . . any portion of any statement of auditing standards or *other professional standards*" and to "modify, supplement, revise, or subsequently amend, modify, or repeal, in

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[132] 2005 Adopting Release at 9.

[133] The AICPA's *Ethics Rulings* are a body of decisions made by the AICPA's professional ethics division's executive committee that "summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances." Introduction, Code of Professional Conduct (as Adopted January 12, 1988), *available at* https://us.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014december14codeofprofessionalconduct.pdf; *see also* AICPA Code of Professional Conduct § 0.500.01 (updated June 2020) ("The code is the only authoritative source of AICPA ethics rules and interpretations." (italics omitted)).

[134] AICPA Code of Professional Conduct, ET § 501.05(a), *Negligence in the Preparation of Financial Statements or Records* (emphases added), *recodified at* Section 1.400.040.01.

[135] *Id.* § 501.05(c) (emphases added).

[136] During committee hearings for Sarbanes-Oxley, the Senate heard testimony from five individuals who were serving, or previously had served, in leadership roles within the AICPA (including the AICPA's then-current Chair and its former Chair), and also relied on data provided by the AICPA. *See* S. Rep. 107-205, at 3-4, 61, 63; *see also* H.R. Rep. No. 107-414, at 19 (2002) (noting that the AICPA's then-President and CEO provided testimony to a House of Representatives committee on a related bill).

whole or in part, any portion of any [such] statement."[137] In other words, Congress authorized the Board to adopt (and later amend or modify) parts of the AICPA's Code of Professional Conduct as the Board's ethics standards, and at the time of Sarbanes-Oxley's enactment, that Code included prohibitions on negligent contributory conduct.

One commenter cited a provision of the AICPA Code of Professional Conduct that has a "knowingly" standard for contributory conduct (Section 0.200.020.04). This commenter also cited the Board's then-proposed (now-adopted) EI 1000, *Integrity and Objectivity*, to note that the definition of "integrity" in that standard includes "[n]ot knowingly or recklessly misrepresenting facts," without reference to negligence.[138] However, this commenter did not acknowledge that the AICPA Code also has contributory-conduct provisions at the negligence standard, as discussed above.

Certain commenters compared the Board's authority for a contributory negligence standard in Rule 3502 to private plaintiffs' inability to bring suit under Section 10(b) of the Exchange Act[139] for aiding and abetting securities fraud. To be sure, in *Central Bank of Denver*, the U.S. Supreme Court held that "there is no private aiding and abetting liability under § 10(b)" "[b]ecause the text of § 10(b) does not prohibit aiding and abetting."[140] But that holding regarding an implied private right of action has little bearing on the Board's authority for the amendment.

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[137] Section 103(a)(3) of Sarbanes-Oxley (emphasis added). In 2003, the Board adopted parts of the AICPA Code of Professional Conduct as its interim ethics standards, *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006, at 10 (Apr. 18, 2003), and the Commission approved such adoption "as consistent with the requirements of [Sarbanes-Oxley]," *Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002*, SEC Release No. 34-47745 (Apr. 25, 2003).

[138] QC 1000 Release at A4-1.

[139] 15 U.S.C. 78j.

[140] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

The Board draws its authority for the amendment from different text in a different statute. As explained above, Congress empowered the Board to promulgate ethics standards pursuant to Section 103(a) of Sarbanes-Oxley, which is distinct from any congressional grant of authority to the Commission, including those in Sections 10(b) or 21C of the Exchange Act.[141] There is no analogous statutory mandate for the Commission to "establish . . . ethics standards" in the area of auditors' professional responsibility.

The Board, however, indisputably *does* have such a mandate in Section 103(a)(1) of Sarbanes-Oxley,[142] and with that distinct mandate comes distinct authority.[143] Indeed, as the Commission recognized when approving the Board's adoption of Rule 3502 in 2006, "the rule is within the scope of the PCAOB's authority, particularly its authority to establish ethical standards."[144] Section 103(a)(1), moreover, is an enabling (or authorizing) statute that permits

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[141] Section 105 of Sarbanes-Oxley also supplies authority to adopt the proposed amendment. *See* 2005 Adopting Release at 12; 2023 Proposing Release at 12 n.43. As the Board previously explained, "Section 105 authorizes the Board to investigate and, when appropriate, discipline registered firms *and* their associated persons," and because (1) "[c]ertain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm," and (2) "[s]uch firms . . . can only act through the natural persons that comprise them," it follows that (3) "[w]hen one or more of those associated persons has caused that firm to" commit a violation, "it is appropriate, and consistent with the Board's duty to discipline registered firms and their associated persons under Section 101(c)(4) of the Act, that the Board be able to discipline the associated person for that misconduct." 2005 Adopting Release at 12.

[142] One commenter remarked that Section 103 "is not untethered" from the rest of Sarbanes-Oxley. Comment Letter from U.S. Chamber of Commerce at 4. The Board agrees: Section 103 tethers *directly* to Section 101(c)(2), which mandates that the Board "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards . . . in accordance with section 7213 [103] of this title." Indeed, doing so is an express "Dut[y] of the Board" under Section 101(c). Section 101(c)(2) is thus another source of authority for the Board's amendment.

[143] Nor does Section 103(a) of Sarbanes-Oxley include the telltale terms of a statute that requires a mental state higher than negligence, as does Section 10(b) of the Exchange Act. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) ("Section 10(b) makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance' in contravention of Commission rules. The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."); *id.* at 199 ("The argument simply ignores the use of the words 'manipulative,' 'device,' and 'contrivance' [are] terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.").

[144] Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules, SEC Release No. 34-53677, at 9 (Apr. 19, 2006).

the Board to establish standards to govern the preparation and issuance of audit reports "as may be necessary or appropriate in the public interest," which text provides broad rulemaking authority.[145]

So, too, is Section 101(g)(1) of Sarbanes-Oxley—yet another source of authority for the amendment. That provision authorizes the Board to promulgate rules to "provide for . . . the exercise of its authority, and the performance of its responsibilities under this Act," which include "enforc[ing] compliance" with applicable laws, rules, and standards; "conduct[ing] investigations and disciplinary proceedings"; and "impos[ing] appropriate sanctions where justified."[146] Section 101(g)(1) thus empowers the Board to implement the Board's "ultimate purposes" under Sarbanes-Oxley of "protect[ing] the interests of investors and further[ing] the public interest in the preparation of informative, accurate, and independent audit reports."[147] The amendment, and Rule 3502 generally, do precisely that.

STATEMENT REGARDING THE PROPOSED AMENDMENT TO CLARIFY THE RELATIONSHIP BETWEEN CONTRIBUORY ACTOR AND PRIMARY VIOLATOR

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[145] *See, e.g.*, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 377-78 & n.5 (1999) (construing a provision allowing the FCC to "prescribe such rules and regulations as may be necessary in the public interest to carry out" the relevant statute as a "general grant of rulemaking authority" sufficient for the FCC to promulgate the regulations at issue); *Metrophones Telecommc'ns, Inc. v. Global Crossing Telecommc'ns, Inc.*, 423 F.3d 1056, 1068 (9th Cir. 2005) ("Given the reach of the [FCC's] rulemaking authority under § 201(b)"—which granted to the FCC the "broad power to enact such 'rules and regulations as may be necessary in the public interest to carry out the provisions of this Act'"—"it would be strange to hold that Congress narrowly limited the Commission's power to deem a practice 'unjust or unreasonable.'"); *Brown v. Azar*, 497 F. Supp. 3d 1270, 1281 (N.D. Ga. 2020) ("[W]hen an agency is authorized to 'prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of the Act,' Congress' intent to give an agency broad power is clear."), *appeal dismissed as moot*, 20 F.4th 1385 (11th Cir. 2021) (mem.).

[146] Sections 101(c)(4) and (6) of Sarbanes-Oxley.

[147] Section 101(a) of Sarbanes-Oxley; *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 780 (1968) ("We are, in the absence of compelling evidence that such was Congress' intention, unwilling to prohibit administrative action imperative for the achievement of an agency's ultimate purposes."); *see Doe v. FEC*, 920 F.3d 866, 870-71 (D.C. Cir. 2019) ("When an agency's 'empowering provision'" permits the agency "'to make, amend, and repeal such rules … as are necessary to carry out the provisions of'" the statute, "the courts will sustain a regulation that is 'reasonably related' to the purposes of the legislation." (citations omitted)).

As noted above, in addition to proposing a change in Rule 3502's liability standard, the Proposal also contemplated amending Rule 3502 to provide that an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation (i.e., that an associated person of one registered firm can contribute to a primary violation of another registered firm).[148] Specifically, the Board proposed changing the word "that" to "any" immediately before the reference to the registered public accounting firm that commits the primary violation. After due consideration, the Board has decided not to adopt any changes to Rule 3502 to implement this aspect of the Proposal, for two primary reasons.

First, as the Proposal explained, the Board's rules already contemplate that associated persons can be associated with more than one registered firm at the same time.[149] Specifically, PCAOB Rule 1001(p)(i)'s definition of an "associated person" provides that if a firm reasonably believes that one of its associated persons is primarily associated with another registered firm, then that person is excluded from the definition of an "associated person," but only "for purposes of completing a registration application on Form 1, Part IV of an annual report on Form 2, or Part IV of a Form 4 to succeed to the registration status of a predecessor." For all other purposes, that carveout does not apply, thus underscoring that, in the context of Rule 3502's reference to an "associated person," a person can be associated with two or more registered firms at once.

Second, an individual who "directly and substantially" contributes to a firm's violation (consistent with the meaning of that phrase in Rule 3502, as described above) in all instances likely also will have "participate[d] as agent *or otherwise on behalf of* such [ ] firm in *any*

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148 *See* 2023 Proposing Release at 16-17.

149 *See id.* at 10 n.36.

activity of that firm" "*in connection with* the preparation or issuance of *any* audit report," and thus be an "associated person" of that firm.[150] In the Board's view, this definition of "associated person," in combination with the notion that a person can be associated with multiple firms at the same time, renders unnecessary the proposed change from "that" to "any" in Rule 3502.

The Board appreciates commenters' feedback on this aspect of the Proposal. As one commenter surmised, this aspect of the Proposal was aimed at providing for equal accountability by associated persons as firm structures evolve. Based on the two points noted above, however, the Board believes that such accountability currently exists.[151] It was not the Board's intent through this aspect of the Proposal to deter collaboration or the sharing of perspectives between firms. And, to the extent that commenters believe that this aspect of the Proposal would exacerbate their concerns with respect to a negligence standard, the Board's decision not to adopt any amendment in this regard should help to alleviate those concerns.

EFFECTIVE DATE

If the amendment to PCAOB Rule 3502 is approved by the Commission, then (as proposed) the Board intends that it would become effective 60 days from the date of Commission approval.[152] In that regard, the Board anticipates that conduct occurring more than 60 days after Commission approval would be subject to Rule 3502, as amended, but that conduct occurring prior to, or within 60 days after, Commission approval would not be subject to the amendment to Rule 3502.

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150 *See* Section 2(a)(9) of Sarbanes-Oxley (emphases added); PCAOB Rule 1001(p)(i).

151 Beyond these two points, one commenter opined that "in most, if not all, cases," an auditor's direct and substantial contribution to a primary violation by a firm with which the auditor is *not* associated also would have at least negligently, directly, and substantially contributed to a primary violation by a firm with which the auditor *is* associated. Comment Letter from Ernst & Young LLP at 4. This proposition further underscores the point that no clarifying amendment is needed given the current regulatory framework.

152 *See* 2023 Proposing Release at 31.

Commenters expressed mixed views regarding the effective date. One commenter agreed that 60 days after Commission approval is appropriate, and another stated that it did not disagree with the Board's basis for an effective date 60 days after Commission approval. Another commenter stated that it could not comment on an appropriate effective date because the Board should redeliberate and repropose amendments to Rule 3502. Other commenters encouraged the Board to delay the effectiveness until the Board more fulsomely assesses the costs of the amendment and considers the amendment's impact on the profession and audit quality.

Several commenters suggested that the Board delay the effectiveness of any amendment to Rule 3502 to provide for time to gauge the impact of other then-pending proposals, including QC 1000 and AS 1000 (both of which have since been adopted). In general, these commenters opined that the impact of the amendment to Rule 3502 could depend on how the amendment interacts with, and the potential unintended consequences of, changes to other professional standards. Another commenter encouraged the Board to delay the effectiveness of the amendment for medium-sized and smaller firms, including those in non-U.S. jurisdictions, to appropriately understand the amendment's ramifications and to respond accordingly.

The Board recognizes that it is in various stages of the process of modernizing several of its standards and rules to protect the interests of investors and further the public interest. Those updates (both adopted and proposed) reflect that, over the years, audits and the audit industry have evolved, and the Board's standards and rules should as well.[153] The Board also appreciates that its revised standards and rules may require adjustment by individuals and firms, which is

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[153] *See* PCAOB, Strategic Plan 2022-2026, at 10 ("[A]s important as [auditing, attestation, quality control, ethics, and Independence] standards are, some of them were written by the audit profession prior to the PCAOB's establishment and have not been updated since we adopted them in 2003 on what was intended to be an interim basis. The world has changed since 2003, and our standards must adapt to keep up with developments in auditing and the capital markets. We intend to modernize and streamline our existing standards and to issue new standards where necessary to meet today's needs.").

why each of those standards also includes (or proposes to include, in the case of proposals) a delay in its respective effective date following the date of Commission approval.[154] The notion that multiple standards are being modernized in parallel, however, is not a basis for permitting individuals—regardless of the size of the firm(s) with which they are associated—to negligently, directly, and substantially contribute to firms' primary violations. And as noted above, as firms make efforts to comply with new standards, it necessarily follows that individuals who could be subject to Rule 3502 also would be making such efforts (because firms can act only through their natural persons).

Accordingly, having considered the comments and for the reasons above, the Board continues to believe that 60 days after Commission approval is an appropriate effective date for the amendment to Rule 3502. That period provides sufficient time for associated persons to familiarize themselves with the applicable legal standards and to increase their diligence as necessary and appropriate, which enhances audit quality and therefore serves the interests of the public and better protects investors.

D. Economic Considerations and Application to Audits of Emerging Growth Companies

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[154] *See* PCAOB Release No. 2022-002, at 58 (effective for audits of financial statements for fiscal years ending on or after December 15, 2024); PCAOB Release No. 2023-008, at 96 (effective for audits of financial statements for fiscal years ending on or after June 15, 2025); AS 1000 Release at 96 (with limited exception, effective for audits of financial statements for fiscal years beginning on or after December 15, 2024); QC 1000 Release at 378 (effective December 15, 2025); PCAOB Release No. 2024-007, at 61 (effective for audits of financial statements for fiscal years beginning on or after December 15, 2025); *see also* PCAOB Release No. 2024-006, at 61 (contemplating effectiveness for audits of fiscal years beginning on or after December 15 in the year of approval by the Commission); PCAOB Release No. 2024-003, at 89 (proposing effective dates of 90 days after Commission approval for certain aspects and no earlier than March 31, 2026, or one year after Commission approval, whichever is later, for other aspects); PCAOB Release No. 2024-002, at 186 (proposing phased effective dates beginning no earlier than October 1 in the year after Commission approval); PCAOB Release No. 2024-001, at 63 (proposing an effective date of six months after Commission approval to comply with certain aspects); PCAOB Release No. 2023-003, at 94 (contemplating effectiveness for audits of fiscal years beginning in the year after approval by the Commission, or if Commission approval occurs in the fourth quarter of a calendar year, effectiveness for audits of fiscal years beginning two years after the year of Commission approval).

The Board is mindful of the economic impacts of its rulemaking. This section describes the baseline for evaluating the economic impacts of the amendment to Rule 3502, the need for rulemaking, its expected economic impacts (including benefits, costs, and potential unintended consequences), and reasonable alternatives considered. Due to data limitations, much of the economic analysis is qualitative; however, it incorporates quantitative information, including PCAOB enforcement data and academic and industry research, where feasible.

The Board sought information relevant to the economic analysis throughout this rulemaking and has carefully considered the comments submitted, including the data and studies suggested by the commenters.

A. Baseline

Section C above describes the important components of the baseline against which the amendment's economic impacts are considered, including the current formulation of Rule 3502 and the Board's implementation experience. The Board discusses below the Board's enforcement activities. Table 1 presents PCAOB enforcement data on Rule 3502 charges from 2009-2024.[155] This table provides historical information on how frequently individuals have been charged under the current formulation of Rule 3502.

[155] Table 1 contains data through April 30, 2024. The Board brought the first Rule 3502 charge in 2009 for conduct committed after the effective date of Rule 3502 in April 2006.

Table 1. Number and Incidence of Rule 3502 Charges, 2009-2024

Year	Cases with Rule 3502 Charges (A)	Firms Sanctioned (B)	Incidence of Rule 3502 Charges C = A / B
2009	2	5	40%
2010	0	2	0%
2011	2	6	33%
2012	3	4	75%
2013	5	10	50%
2014	2	20	10%
2015	17	37	46%
2016	14	30	47%
2017	15	42	36%
2018	8	13	62%
2019	8	19	42%
2020	2	13	15%
2021	3	14	21%
2022	6	30	20%
2023	5	43	12%
2024	4	20	20%
Total	96	308	31%

Source: Settled and Adjudicated Disciplinary Orders Reported by the Board to the Public Pursuant to Section 105(d) of Sarbanes-Oxley, *available at* https://pcaobus.org/oversight/enforcement/enforcement-actions

Column A shows the number of cases in which associated persons were found to have violated Rule 3502 (includes settled and adjudicated cases); column B shows the number of cases in which registered firms were sanctioned (for any violation); and column C is the ratio of the two, expressed as a percentage to reflect the proportion of firm cases when an associated person was charged with Rule 3502 by the Board.

From 2009 through April 30, 2024, there have been a total of 96 cases with Rule 3502 violations. At an average of six per year, the number of Rule 3502 cases was highest in 2015 at

17 and lowest in 2010, when no Rule 3502 violations were found.[156] The 96 cases represent 31 percent of the total number of cases in which the Board sanctioned firms for violations from 2009-2024. The data presented in the table does not predict how many Rule 3502 violations the Board might find because of the amendment; it indicates that in over two-thirds of the cases in which a firm was sanctioned, no contributory actor was held accountable under Rule 3502.[157]

Commenters suggested alternative means of assessing the baseline for this amendment. Some commenters suggested that the Board consider the Commission's enforcement data. However, PCAOB enforcement data is a more relevant comparison because this data is limited to cases brought by the PCAOB, offering a more precise perspective for understanding the baseline of the amendment. Although the Commission's enforcement data is valuable, it is impacted by various factors, including the Commission's case mix, prosecutorial discretion, resource allocation decisions, and enforcement priorities. While the Commission and the PCAOB coordinate enforcement efforts as required by Sarbanes-Oxley, their respective mandates are separate from each other. Given these separate mandates, inclusion of the

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[156] Column Year refers to the year the firms were sanctioned. Column A reflects Rule 3502 cases involving sanctions of one or more respondents as one instance. Some firms were sanctioned in different years than associated persons were sanctioned for the corresponding Rule 3502 violations. In such cases, Rule 3502 violations by associated persons are counted in the same year the firms were sanctioned. Therefore, column A can be interpreted as a subset of cases in Column B.

[157] One commenter asserted that Table 1 in the Proposal did not illuminate whether the cases without Rule 3502 charges would have merited or supported a Rule 3502 charge for individual negligence had that option been available, and suggested that the PCAOB perform that analysis, even if for a shortened period of 5 years. Another commenter also suggested that this analysis does not indicate cases where a Rule 3502 charge would have been inappropriate or where the absence of charges was supported by the Board's exercise of prosecutorial discretion. However, the Board notes that staff has already performed an analysis of that nature for the immediately preceding two years, which forms the basis of the estimated increase in the number of cases discussed below. *See also* 2023 Proposing Release at 24-25 (providing estimate for 2022). Performing an analysis for additional older years may be potentially less robust, given the extremely fact-based nature of the evaluation; staff recollections of whether all of the available investigatory evidence could have supported a negligence claim are naturally less reliable for older matters; and relevant staff may have since departed the PCAOB.

Commission's data herein would not contribute to a fuller understanding of the PCAOB's historical practices.

Other commenters suggested that, rather than the comparison provided in Table 1 of individual Rule 3502 cases to firm cases, a more relevant comparison would be PCAOB enforcement proceedings against firms to PCAOB enforcement proceedings against individuals (under Rule 3502 and otherwise). One of these commenters acknowledged, however, that such a comparison would not shed meaningful light on the need for the proposed change, and the Board agrees. Because contributory liability under Rule 3502 is distinct from primary liability, aggregating individual liability for all types of violations would not contribute to an understanding of the PCAOB's historical application of Rule 3502. Column A in Table 1 focuses on contributory liability only and therefore more clearly illuminates the baseline of the PCAOB's use of Rule 3502 as currently formulated.

Another commenter suggested conducting a survey regarding the resulting internal impact of PCAOB enforcement proceedings at the firm level on associated individuals. While a well-designed survey may provide additional insights, the Board believes that staff analysis based on PCAOB enforcement activities provides a sufficiently reliable basis for assessing the need for and scope of the amendment to Rule 3502.[158]

B. Need

This section discusses the problem the amendment intends to address and how the amendment addresses the problem.

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[158] Further, the suggested survey would have shed light on firms' internal disciplinary measures taken against associated individuals, which, as discussed below, are important but not equivalent in effect to public proceedings.

1. Problems to Be Addressed

The need for the amendment arises from a current gap in the PCAOB's regulatory framework. Specifically, as described in detail in section C above, the gap in the PCAOB's regulatory framework relates to a misalignment between the liability standard for firms that commit violations resulting from an associated person's conduct and the liability standard for the associated person who contributes directly and substantially to the firm's violation. Under the current formulation of Rule 3502, while firms can be held accountable by the PCAOB for violations due to negligence, individuals can be held liable for their contributory conduct only if their conduct was at least reckless, a more stringent standard than negligence. That is, Rule 3502's current formulation places negligent individual contributors to firms' violations beyond Rule 3502's reach.

The gap discussed above creates regulatory inefficiency and undermines the PCAOB's regulatory objectives, including furthering the public interest in the preparation of informative, accurate, and independent audit reports. Inefficiency arises under the current regulatory framework because the PCAOB cannot hold individuals accountable for negligent contributory conduct while the Commission can, and therefore the PCAOB would have to refer one part of a broader case to the Commission to take action (as it deems appropriate) against the negligent individual. If the Commission decided to move forward with a separate case against the individual, Commission staff may need to familiarize themselves with the case, potentially reinterview witnesses, and undertake (as needed) additional investigative steps. This could result in delays and, given that these activities would relate to substantially the same set of facts that the PCAOB is seeking to establish with respect to the firm, would render duplicative the PCAOB's prior work in these areas, thereby creating inefficiencies. Moreover, if the

Commission chooses not to pursue the case (for example, due to resource constraints or competing priorities), the individual's negligent conduct may go unsanctioned.[159] This lack of individual accountability could hinder the effectiveness of the PCAOB's enforcement proceedings and may lead to under-deterrence among individuals within the industry, as they observe only the firm being penalized without consequences for the individuals responsible for the negligent conduct.

2. How the Amendment Addresses the Need

The amendment to Rule 3502 addresses the need by aligning the liability standards for firms and associated persons. It changes the liability standard for individual contributory conduct from recklessness to negligence. Doing so closes the regulatory gap described above and allows the Board to hold individuals accountable when they directly and substantially contribute to a firm's violation if their contributory act or failure to act was negligent but not reckless. By closing the gap, the amendment eliminates the obstacles in the public enforcement framework and helps improve regulatory efficiency.

The amendment does not result in a novel expansion of liability to reach conduct that is currently not subject to enforcement, as the Commission already has authority to discipline associated persons who negligently cause a firm's violation. Instead, it merely provides the PCAOB with the ability to hold individuals accountable similar to the Commission.

Some commenters agreed that the amendment would address the regulatory gap within the existing framework. However, other commenters challenged the need for the amendment.

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[159] *See, e.g.,* Samuel B. Bonsall IV, Eric R. Holzman & Brian P. Miller, *Wearing out the Watchdog: The Impact of SEC Case Backlog on the Formal Investigation Process,* 99 Acct. Rev. 81, 81 (2024) ("We find that higher office case backlog decreases the likelihood of an investigation into a restating firm. . . . Backlog also impacts pursued investigations, leading to more prolonged investigations, a lower Accounting and Auditing Enforcement Releases likelihood, and smaller SEC penalties. Our evidence suggests that busyness undermines the SEC's investigation process.").

Some commenters asserted that the PCAOB already has tools for disciplining individuals and that the absence of Rule 3502 charges does not imply a lack of individual accountability. To be sure, the PCAOB currently has the authority to hold individuals accountable for violations of rules that contemplate individual responsibility, and the Board actively brings cases to hold individuals accountable for wrongdoing. But Rule 3502 is a distinct authority that creates and enforces a distinct obligation, and currently, the PCAOB is unable to hold individuals accountable under that rule when they act unreasonably but not recklessly. The amendment thus is not "duplicative," as some commenters suggested,[160] and the Board's analysis therefore centers on the need to close this particular regulatory gap to give the PCAOB the appropriate tool for these sets of circumstances.

Other commenters asserted that the PCAOB's need was not sufficient to justify the amendment to Rule 3502 that these commenters considered profound, with its attendant costs and consequences. Certain of these commenters suggested that any change in auditor behavior that the PCAOB hopes to accomplish has already been accomplished by the Commission's ability to bring cases for negligent conduct, and that therefore the PCAOB has not shown a convincing need. As discussed in section C above, the amendment to Rule 3502 is not a significant shift in the liability landscape. Rather, it allows the PCAOB to discipline associated persons for negligently contributing to firms' violations, which is misconduct that the Commission currently can pursue. The Board recognizes, however, that this incremental increase in the PCAOB's enforcement capability may in turn generate certain incremental effects on auditor behavior, as discussed further below.

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[160] Comment Letter from U.S. Chamber of Commerce at 7; Comment Letter from Center for Audit Quality at 6.

Some commenters also asserted the absence of adequate evidence to support the need for the amendment. However, the comments received did not offer data that can be used to supplement the analysis meaningfully, and the Board is not aware of additional data or quantitative analysis that could be performed. Thus, as noted at the outset, the Board has performed limited quantitative analysis where possible but relies largely on qualitative analysis to inform this rulemaking.

One comment letter noted that the PCAOB's current inspection program is effective in enhancing audit quality, citing academic research to support that view.[161] While the Board acknowledges that the PCAOB's inspection program plays a vital role in enhancing audit quality, the PCAOB's enforcement program plays a distinct but complementary role in holding firms and associated persons accountable for violations, and thereby sanctioning and deterring unlawful conduct. The amendment aims to fill a gap in that latter program by helping to ensure that individuals negligently contributing to a firm's violations are held accountable and that the integrity of the audit process is strengthened. The continued persistence of a high rate of audit deficiencies also suggests that, while the inspections and enforcement processes may be effective at enhancing audit quality, as the commenter describes, additional efforts are needed, including through this rulemaking.[162]

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[161] For example, the commenter cited Lindsay M. Johnson, Marsha B. Keune & Jennifer Winchel, *U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination*, 36 Contemp. Acct. Res. 1540, 1557 (2019) ("Overall, participants described substantial modifications in their audit approach in response to inspection findings and the anticipation of inspections. These modifications are consistent with auditors and their firms actively working to comply with PCAOB expectations . . . ."). This behavioral study examined auditors' observations and behaviors in response to the PCAOB inspection process, focusing on factors such as perceived power and trust in the regulatory body.

[162] *See, e.g.*, *PCAOB Report: Audits with Deficiencies Rose for Second Year in a Row to 40% in 2022* (July 25, 2023), *available at* https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-report-audits-with-deficiencies-rose-for-second-year-in-a-row-to-40-in-2022.

In general, commenters did not introduce arguments or data that caused the Board to rethink its assessment of the need: there is a regulatory gap, the gap is small because the Commission already has the ability to bring negligence-based secondary-liability cases, but the gap can nonetheless result in regulatory inefficiencies or an incremental absence of deterrence and accountability, respectively. The amendment would close this gap, yielding the economic impacts discussed further below.

C. Economic Impacts

This section discusses the expected benefits and costs of the amendment and potential unintended consequences.

A critical component of the Board's assessment of the economic impacts of this amendment is the Board's assessment of the likely number of PCAOB enforcement cases that would be brought under the amended rule. For the Proposal, staff examined enforcement matters from 2022 to assess the potential increase in recommended cases had Rule 3502 included the proposed amendment. Staff estimated two to three instances in 2022 where the amendment could have prompted staff to recommend a Rule 3502 charge.[163] Staff also indicated that, based on its expertise, that number would be broadly consistent with other years.

For this release, staff updated its analysis to include an additional year (2023); for 2023, staff also believes that, had negligence been the standard in Rule 3502, two or three instances could have prompted staff to recommend a Rule 3502 charge.[164] The Board continues to note

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[163] *See* 2023 Proposing Release at 25. This is an estimate of cases in which staff would likely have recommended Rule 3502 charges against natural persons. Because Rule 3502 charges can be brought against associated persons, which include both natural persons and legal entities, it is possible that the estimate could be higher if it were to include potential additional cases against legal entities. However, due to the complexity of the fact patterns presented in such cases, staff could not estimate the number of additional cases that would have been brought against such entities. Additionally, although the Proposal's estimate included the second aspect of the Proposal, staff has confirmed that the estimate remains appropriate without that aspect.

[164] Staff were limited in the ability to perform further analysis given the intensively fact-specific nature of investigatory and charging decisions. Further, the availability (or unavailability) of potential charges can

that this estimate may vary to the extent that there are modifications to other Board standards or changes in enforcement priorities.

This analysis influenced, and continues to influence, the Board's assessment of the likely benefits, costs, and potential unintended consequences of the amendment—namely, that auditors are already held to a contributory negligence standard, that the change here is only adding the PCAOB as an enforcer, and that this change therefore would have meaningful but incremental benefits. As discussed further below, it would result in more efficient enforcement in specific cases, and it may prompt individuals to exercise the appropriate level of care and to make firms more efficiently allocate resources, which would raise audit quality. It would also have some incremental anticipated costs, and unintended consequences that parallel the anticipated costs, including litigation, liability, and opportunity costs, and potential inefficiencies in terms of self-protective behavior.

One commenter agreed with the Board's expectation that the economic impact will be modest while others challenged this analysis. They took issue with the estimate of only a few additional cases for 2022 resulting from the amendment, questioning the basis and relevance of this prediction. Based on extensive experience, staff believes that this number is a fair average representation across other years and provides an estimate of the additional cases resulting from the Board pursuing charges under the amendment. In fact, as discussed above, staff updated its analysis to include data from 2023 and that analysis generated an estimate of two to three

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itself shape the investigatory process. Finally, determining whether all the available facts and circumstances would have supported a staff recommendation against an individual for negligent contributory conduct also depends on an intimate familiarity with the entire investigatory file as it pertains to that individual's conduct and the relevant standard of care. As recollections fade over time, a case-specific analysis of what charges could have been supported becomes less reliable. Other staff have moved to different roles within the PCAOB or departed the organization entirely. The Board therefore focused its analysis on the most recent time period where relevant staff members are available and their knowledge is the freshest, and then confirmed staff's view of whether it has any reason to believe that this time period would not be representative of the broader trend.

additional cases in 2023, consistent with that for 2022. Overall, the estimation approach espoused here (with respect to both 2022 and 2023) applies expert judgment to the PCAOB's recent case data to offer a pragmatic perspective.[165]

Moreover, the PCAOB has existing authorities to bring charges against individuals—both for primary violations and for at least reckless contributory conduct;[166] the amendment therefore would close a gap regarding one particular type of conduct (negligent contributory conduct) rather than supplanting these other forms of accountability. Staff's estimate of two to three additional cases thus appears objectively reasonable.

In terms of the potential variability in the future of other standards, including QC 1000 and AS 1000, commenters took issue with the uncertainty that poses. But standards and regulatory priorities are always evolving in a bid to keep pace with developments in the relevant environments (e.g., developments within the regulated industry, legal developments, etc.). Indeed, there could be benefits to amending Rule 3502 in tandem with other standards if it means that individuals, in determining how their registered firm should implement the new standards, are more sharply aware of the standard of care that is expected of them and can design their firm's implementation strategies accordingly. Moreover, if the Board assumes that the number of Rule 3502 cases increases more significantly in the future because the facts and circumstances of those matters show that individuals are failing to act reasonably under newer PCAOB

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[165] An alternative approach would involve providing an upper bound of the number of cases, i.e., the total number of firm cases that were brought each year. This can be easily derived from Table 1. However, not every firm case would be associated with individual contributory liability, and some cases would involve individual primary liability too. Therefore, the Board declined to engage in this alternative approach and rather relied on staff's expertise in terms of providing a more pragmatic perspective on the additional number of cases under the amendment.

[166] Here, the Board agrees with commenters who pointed out that the PCAOB has alternative means of bringing charges against individuals.

requirements, and thereby contributing to firms' violations of other standards, then the Board expects that both the benefits and costs of Rule 3502 would be higher.[167]

Some commenters posited that the amendment would represent a profound change in liability and have significant impacts on the profession and far-reaching unintended consequences. As previously discussed, the amendment does not effectuate a fundamental shift in the liability landscape, but rather aligns the PCAOB's secondary liability standard with that of the Commission. And thus, as discussed below, the Board has assessed that there would be recognizable but not significant benefits, or costs, attributable to enhanced compliance with other PCAOB rules and standards.

The Board has considered this discrepancy between commenters' assertions of the significance of the amendment and the Board's analysis of the amendment's incremental effect. This discrepancy could be the result of unstated assumptions on commenters' parts:

- One possibility is that commenters are aware of (but do not acknowledge expressly) a more significant deficit in associated persons failing to act reasonably, which the Board has not detected through its oversight, such that there will be considerably more opportunities for enforcement under the amended rule than the Board has assumed in its analysis. In that case, the Board would expect to see more cases potentially being brought, with more benefits from enhanced compliance with PCAOB standards, and more costs from the actions that individuals would take to come into compliance and demonstrate the reasonableness of their actions if challenged.

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[167] Conversely, if the number of additional cases declines over time due to changes in auditor behavior in response to the Rule 3502 enforcement risk, this may translate into an increase in benefits discussed below.

- Another possibility is that commenters believe that the PCAOB would exercise its discretion under the amended rule irresponsibly—choosing to pursue cases against individuals over differences in reasonable judgments, or cases where an individual had only a remote connection to, or was responsible for only a small fraction of, the decision-making process that led to a firm's violation—and thus they believe that the unintended consequences (e.g., self-protective behaviors) would be more significant than staff estimates. The Board does not believe that commenters' concerns are warranted. As described, the Board intends to deploy its prosecutorial discretion responsibly, informed by the recommendations of its staff, and any sanctions imposed by the Board are subject to de novo review by the Commission,[168] all of which guides the Board's exercise of discretion in determining what matters to pursue.

The Board discusses these points in more detail below.

1. Benefits

This subsection presents the expected benefits of the amendment, particularly enhancements in regulatory efficiency and individual accountability, as well as positive impacts on capital markets. Several commenters agreed with the Board's analysis, while others disagreed with certain aspects of the Board's assessment of the benefits. The Board discusses these in more detail below.

One commenter asserted that the benefits discussion in the Economic Analysis section of the Proposal is high-level and lacks application of the specifics of the amendment. The benefits

[168] *See* Section 107(c) of Sarbanes-Oxley; *see also, e.g., S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 2-3.

discussions—in the Proposal and in this release—however, touch upon a crucial aspect of the amendment, which involves expanding the PCAOB's enforcement authority to discipline associated persons for negligently contributing to violations of a firm. While the discussion may appear broad, it is intended to highlight the overarching benefits of this expansion, including enhancing individual accountability, strengthening investor protection, and promoting greater adherence to applicable laws, rules, and professional standards.

The following sections discuss regulatory efficiency and individual accountability and expected impacts on capital markets.

i. Regulatory Efficiency and Individual Accountability

The amendment can improve regulatory efficiency by enabling the PCAOB to bring a case involving negligence against a firm and the responsible relevant associated person(s), rather than referring part or all of the case to the Commission or charging only the firm. Under the status quo, the Commission (as well as other authorities such as a state board of accountancy), but not the PCAOB, can bring such cases. By contrast, the PCAOB can only sanction the firm and defer to the Commission to take action against the negligent individual (as the Commission deems appropriate).

By enabling the PCAOB to address violations by a firm and contributory violations by its associated persons concurrently, the amendment ensures that individuals who fail to meet their responsibilities with reasonable care are held accountable. This method of reinforcing individual accountability and facilitating improvement among practitioners elevates overall audit quality, benefiting both firms and investors by reducing the likelihood of negligent conduct.

a. Effects on Associated Persons

Enabling the PCAOB to hold individuals accountable can lead to more deterrence among all individual associated persons. Currently, individuals may act inappropriately if they discount the likelihood of public sanction because the PCAOB lacks the ability to bring charges for negligent contributory conduct, although they may not be able to avoid sanction by the Commission or private sanction by their firms. However, the imposition of a firm's disciplinary action against individuals depends on the detection and investigation of the individuals' misconduct. Detection, in turn, may depend on the frequency and efficacy of external review processes, e.g., PCAOB inspections. Additionally, without a noncompete agreement, a firm cannot prevent a partner from associating with a different registered public accounting firm and performing issuer or broker-dealer audit work, or from becoming employed by an issuer or broker-dealer in an accountancy or financial management capacity; in contrast, a PCAOB sanction may do so.[169] Finally, a firm cannot suspend an individual's CPA license, but a PCAOB sanction can lead to collateral consequences with relevant state accountancy authorities.[170]

Because of the reasons discussed above, adding the PCAOB as an additional enforcer may increase auditors' perception that negligent conduct may be detected, investigated, and effectively sanctioned; doing so therefore can provide additional deterrence against misconduct,

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[169] *See* Section 105(c)(7) of Sarbanes-Oxley.

[170] *See, e.g.*, N.Y. State Rules of the Board of Regents § 29.10(f); *see also* Section 105(d)(1) of Sarbanes-Oxley (requiring the Board to report disciplinary sanctions it imposes to, among others, "any appropriate State regulatory authority or any foreign accountancy licensing board with which [a sanctioned] firm or person is licensed or certified").

Also, a firm may expel a partner, but such an action is unlikely to be public (e.g., a private settlement may contain nondisclosure and antidisparagement clauses) and thereby is less likely to be an effective deterrent to associated persons of other firms as compared to a public sanction. Similarly, a firm may be able to inflict a private financial penalty (e.g., through a claw-back or forfeiture of paid-in capital or deferred compensation). However, a firm may not have effective provisions in its partnership agreements or may view enforcing those clauses as uneconomical if forced to litigate them as a contractual dispute.

even though the risk of liability resulting from the additional deterrence is not a large one insofar as the Commission currently has the authority to discipline associated persons for negligently causing a firm's violations. Academic literature also suggests that public authorities' sanctioning tools (e.g., public censure, fines, associational prohibitions) deter future misconduct more effectively than private reprimands by a firm.[171]

By increasing individual accountability and the potential for liability, the amendment can provide incremental deterrence against future violations and, hence, enhance incentives for individuals to perform important roles with reasonable care. Individuals that exercise reasonable care, in turn, may contribute to better compliance practices in their firms. This change is expected to lead to more diligent adherence to professional standards. In fact, in support of the amendment, one commenter contended that the heightened level of deterrence would reduce the risk of substandard audits by encouraging auditors to adhere to professional standards and regulations to avoid liability.

The amendment's effect as a deterrent to auditor misconduct generated different viewpoints from commenters. Some commenters indicated that reducing the liability threshold from recklessness to negligence would deter misconduct, lead to more careful work by auditors, and enhance audit quality. These commenters also indicated the proposed change in liability would boost public confidence, increase investors' confidence in financial statements, and

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[171] See, e.g., John T. Scholz, Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory, 60 Law & Contemp. Probs. 253, 265 (1997). Scholz states:

> When corporations have the means of punishing subordinates for illegal behavior, punishing the corporation rather than individuals responsible for wrongdoing may serve to strengthen the corporation's private enforcement system. Criminal prosecution of individuals will be necessary, however, whenever the potential gains to the individual from illegal behavior far exceed the worst punishment the firm could impose.

See also Michelle Hanlon & Nemit Shroff, *Insights Into Auditor Public Oversight Boards: Whether, How, and Why They "Work",* 74 J. Acct. & Econ. 1, 4 (2022) ("We find that the majority of respondents think that POB [Public Oversight Board] inspectors have greater authority (enforcement options) than peer-reviewers and that the culture at POBs is more conducive to detecting auditing deficiencies.").

strengthen the financial markets. One commenter suggested that improvements in audit quality will reduce financial misstatements and omissions as well as auditor litigation risk and costs to investors resulting from such litigation. This is consistent with the Board's analysis presented here.

By providing incremental deterrence and, hence, enhancing individual auditors' incentives in the performance of their audits, the amendment can improve audit quality. Academic literature suggests that auditors' incentives to perform high-quality audits can increase with greater enforcement.[172] Furthermore, in general, academic research provides evidence that enforcement proceedings have a deterrent effect[173] and can potentially improve audit quality of non-sanctioned entities that are aware of sanctions imposed on others.[174] Other related literature also discusses the role of regulation in providing auditors with incentives for improving audit quality.[175]

By contrast, one commenter asserted the amendment does not deter conduct because penalties are not an effective method to deter one-time mistakes, inadvertence, and errors in

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[172] *See, e.g.,* Ralf Ewert & Alfred Wagenhofer, *Effects of Increasing Enforcement on Financial Reporting Quality and Audit Quality*, 57 J. Acct. Res. 121, 123 (2019) ("Our main finding is that auditing and enforcement are complements in a low-intensity enforcement regime but can become substitutes in a strong regime. The auditor's incentives to perform a high-quality audit increase with greater enforcement because the expected penalty rises, and they decrease with lower anticipated earnings management.").

[173] *See* Robert H. Davidson & Christo Pirinsky, *The Deterrent Effect of Insider Trading Enforcement Actions,* 97 Acct. Rev. 227, 227 (2022) ("Insiders who have witnessed [a Commission] enforcement action have a lower probability for future conviction than their unexposed peers.").

[174] *See, e.g.,* Phillip Lamoreaux, Michael Mowchan & Wei Zhang*, Does Public Company Accounting Oversight Board Regulatory Enforcement Deter Low-Quality Audits?* 98 Acct. Rev. 335, 339 (2023) ("We find that audit firm responses to PCAOB enforcement only occur following sanctions of like-sized firms. That is, small firm responses only follow sanctions of small firms and large firm responses only follow sanctions of large firms. Specifically, following the PCAOB sanction of a small audit firm, the likelihood of misstatement is 2.2 percentage points lower for clients of competing non-sanctioned small audit firm offices in the same [Metropolitan Statistical Area]. In contrast, following PCAOB sanctions of a large audit firm, the likelihood of misstatements decreases by 2.6 percentage points for clients of non-sanctioned audit offices within the sanctioned audit firm.").

[175] *See, e.g.*, A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 Lewis & Clark L. Rev. 19, 19 (2006) ("Audit quality is promoted by three incentives: reputation, regulation, and litigation.").

judgement. Another commenter expressed a concern that the PCAOB did not explain how the amendment would result in Rule 3502 becoming a more effective deterrent than the current formulation of Rule 3502. Other commenters expressed skepticism that the amendment will incentivize individuals or change behavior. One commenter expressed concern that the amendment may not incentivize the negligent or reckless auditors as intended because those individuals may be the least risk averse. The Board considered these commenters' perspectives as well as academic research noted above that suggests enforcement proceedings have a deterrent effect.[176] The Board believes that there is sufficient support for the Board's belief that the amendment would enhance deterrence (albeit incrementally) and that the deterrence would lead to benefits.

One commenter stated that the Proposal implied that "the discipline imposed by a firm (whether financial penalty or even expulsion) is less likely to be an effective deterrent to others'" misconduct compared to public sanction, but that there was a lack of evidence in the Proposal to support such a claim.[177] Unlike internal disciplinary measures, public sanctions are visible to everyone, including potential clients and employers.[178] This public visibility may result in all

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[176] See, e.g., Ralf Ewert & Alfred Wagenhofer, Effects of Increasing Enforcement; Robert H. Davidson & Christo Pirinsky, The Deterrent Effect of Insider Trading Enforcement Actions; Lamoreaux, et al., Does Public Company Accounting Oversight Board Regulatory Enforcement Deter Low-Quality Audits?

[177] Comment Letter from National Association of State Boards of Accountancy at 2 (Oct. 24, 2023). Another commenter expressed that the firm's approach to prevent and respond to instances of negligence in response to inspection findings may impact the individual more, as the firm's actions may more directly dictate an individual's future. But as discussed above, while the Board acknowledges that the PCAOB's inspection program plays a vital role in enhancing audit quality, the PCAOB's enforcement program plays a distinct but complementary role in holding firms and associated persons accountable for violations, and thereby punishing and deterring unlawful conduct. In other words, there is a distinction to be made between firm's quality control and private sanctions deterring misconduct.

[178] On one hand, if a person receiving a private sanction remains an associated person of the same firm, such a firm may have incentives (e.g., to win new business or keep existing business) not to disclose the private sanction to clients, prospective clients, or the public, or may have agreed not to do so. On the other hand, if a person receiving a private sanction leaves the firm, whether as part of the sanction or voluntarily, and then seeks, for example, to join a new firm (or an issuer or broker-dealer in an accountancy or financial management capacity),

associated individuals exercising greater care while carrying out their responsibilities. Therefore, as discussed in more detail above, the Board believes that public discipline can enhance the deterrence effect beyond what internal discipline can achieve, making it a key tool for enforcing accountability and upholding high standards in the audit profession.[179]

b. Effects on Firms

Some firms choose to invest in staffing and resources voluntarily to comply better with regulatory requirements. Yet, competitive pressures from other firms that prefer not to make similar investments may lead these firms to reconsider their investment decisions. With the amendment, however, all firms lacking adequate staffing and resources would now face enhanced possibility of sanctions of their associated persons, prompting them to make additional investments. This change is expected to improve audit quality by counteracting underinvestment of staffing and resources, thereby reducing noncompliance by audit firms. This collective uplift mitigates any single firm's competitive concerns and promotes broader societal benefits by fostering a more robust and reliable compliance environment resulting in improved overall audit quality.

Individual auditors, perceiving greater litigation and liability risks, are likely to change their behavior and take their professional responsibilities more seriously, ensuring that their actions are objectively reasonable under the circumstances. This shift in individual behavior can

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the prior firm might not disclose details about the sanction to the new prospective firm or employer, whether per nondisclosure or anti-disparagement provisions or as a matter of general policy.

Furthermore, the sufficiency of private sanctions is hard to square with the PCAOB's authority to discipline *formerly* associated persons of firms, as provided by Section 929F of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Section 2(a)(9)(C) of Sarbanes-Oxley. If a private sanction (i.e., expelling the associated person from the firm) were sufficient, Congress presumably would not have given to the PCAOB the power to impose a public sanction against an individual who is no longer associated with a registered firm.

[179] See, e.g., Scholz, Enforcement Policy and Corporate Misconduct 265.

lead to greater compliance by firms with their respective legal requirements, including auditing standards, quality control standards, and ethics and independence standards, which were enacted to promote audit quality and investor interests. In other words, by preventing individual negligence, the amendment can also mitigate firm negligence, as individuals' actions directly impact firm actions, such as implementing better quality control systems.[180] One commenter agreed that the amendment will result in firms being more likely to comply with their respective legal requirements.

ii. Capital Market Impact

As explained above, the amendment can introduce an incremental deterrent effect, which could lead to improvements in audit quality. Increased audit quality can improve financial reporting quality and enhance investors' confidence in the information provided in companies' financial statements. Because auditors have a responsibility to provide reasonable assurance about whether the financial statements are free of material misstatement, higher audit quality could increase the likelihood that the auditor would discover a material misstatement or would qualify its audit opinion when a material misstatement exists and is not corrected by management. If a Commission registrant were to include such a qualified audit opinion in a filing with the Commission, then Commission staff may deem the registrant's filing to be deficient.[181] Furthermore, a qualified audit opinion may evoke negative market reactions. For these reasons, higher audit quality could incentivize issuers to take steps to ensure their financial

[180] Quality control systems play a fundamental and widespread role in overall audit quality. These systems are essential in ensuring the audit process adheres to professional standards. A robust quality control system can help firms to detect and address factors that compromise audit quality.

[181] *See* 17 CFR 210; *see also Financial Reporting Manual* § 4220, Division of Corporation Finance, SEC, *available at* https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

statements are free of material misstatement. Issuers could take these steps proactively, prior to the audit, or in response to adjustments requested by the auditor.

Financial statements that are free of material misstatement are of higher quality and more useful to investors. In particular, more reliable financial information allows investors to improve the efficiency of their capital allocation decisions. Investors may also perceive less risk in capital markets generally, leading to an increase in the supply of capital.[182] An increase in the supply of capital could increase capital formation while also reducing the cost of capital to companies.[183] A reduction in the cost of capital reflects a welfare gain because it implies investors perceive less risk in the capital markets.

Commenters agreed that the amendment will enhance investors' confidence both in audits and in the information provided in companies' financial statements, as well as have an incremental positive effect on capital-market efficiency.

2. Costs

This section discusses the expected costs of the amendment. Because the amendment is expected to lead to an increase in the number of enforcement cases by the PCAOB, the Board discusses costs to firms and individuals, and costs to issuers.

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[182] *See, e.g.,* Hanwen Chen, Jeff Zeyun Chen, Gerald J. Lobo & Yanyan Wang, *Effects of Audit Quality on Earnings Management and Cost of Equity Capital: Evidence from China*, 28 Contemp. Acct. Res. 892 (2011); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. Acct. Res. 385 (2007).

[183] Cost of capital is the rate of return investors require to compensate them for the lost opportunity to deploy their capital elsewhere. Equivalently, cost of capital is the discount rate investors apply to future cash flows. Cost of capital depends on, among other factors, the riskiness of the underlying investment. Accordingly, the rate of return required by equity holders—cost of equity capital—and the rate of return required by debt holders—cost of debt capital—may differ to the extent equity and debt securities expose investors to different levels of risks. For theoretical discussion on the link between the greater availability of information to investors and cost of capital, see, for example, Richard A. Lambert, Christian Leuz & Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Rev. Fin. 1, 16-18 (2012); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. Fin. 1553, 1571 (2005); and William Robert Scott & Patricia C. O'Brien, *Financial Accounting Theory* 412 (Prentice Hall 3d ed. 2003).

The Board's assessment of the degree of the anticipated costs is affected by the Board's estimate of the number of additional cases to be brought, as discussed at the outset of this section. As discussed there, the amendment is expected to result in a slight increase in the number of PCAOB enforcement cases (two to three per year) due to the changed liability threshold. Any additional cases due to the amendment will involve legal costs, which could result in substantial costs for the firms and individuals involved. Staff could not provide an estimate for the per-case cost; however, the small number of incremental cases could limit the aggregate cost of the amendment, in particular, when the total number of issuers and broker-dealers is taken into account.

i. Costs to Firms and Individuals

With the anticipated increase of enforcement proceedings of two to three per year, certain firms will incur direct and indirect costs with respect to those proceedings as a result of the amendment. These costs include legal costs and broader financial and operational impacts.

Direct costs include increased hours and resources (including attorneys, experts, and other personnel) to prepare for, respond to, and defend against investigations and charges—actual or anticipated. The Board expects that, in most cases, the costs of defending associated persons who have negligently contributed to a firm's violation will be borne by the firm.[184] The direct defense costs can be grouped into two categories based on the stage of the matter:

- First, during the investigative stage, staff works to determine whether it is likely that a primary violation occurred and if so, whether an individual directly and

[184] That is, the Board believes that the firm would have advancement and indemnification agreements in place with relevant firm personnel. In certain circumstances, it is possible that an individual respondent that is found liable would have to reimburse the firm (or the firm's insurer) for defense costs, but the extent and nature of that obligation depends on the facts and circumstances as applicable to the terms and conditions of the indemnification and insurance agreements.

substantially contributed to the violation. Because this inquiry already takes place (albeit to determine whether someone acted recklessly rather than negligently), the incremental resource cost to firms at the investigative stage will not be significant.

- Second, staff works to determine whether the individual acted negligently and notifies the potential respondent of that determination. After this point, the direct costs of the amendment to firms may increase more significantly.[185] Staff lacks sufficient data to reliably estimate the costs of each matter because the costs depend on numerous factors, including the duration of the matter,[186] the complexity of the matter (e.g., a complex audit case versus a simpler case of noncompliance with PCAOB filing requirements), the number and nature of counsel and expert witnesses retained, and so forth.[187]

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[185] One commenter expressed concern that the PCAOB's investigations and enforcement could become at least marginally more costly given enforcement requirements of the negligence criteria. The Board agrees; there could be incremental costs to the PCAOB of pursuing negligence-based cases. The Board expects these would be generally proportional to the costs discussed above for potential individual respondents (e.g., both sides may need to hire expert witnesses to litigate whether conduct met the standard of care). Another comment letter expressed doubt that the firm would cover an individual's defense costs if the individual chose to mount a defense that involved attributing responsibility to the firm. The Board believes that in these circumstances, it is more likely that the firm would nonetheless have to continue abiding by its advancement and indemnification obligations, but that the firm might then have to retain separate counsel for the individual, which would increase the overall costs as discussed (given an increase in complexity and number of counsel).

[186] As set out in the PCAOB rules, a PCAOB enforcement case has numerous stages where the proceedings might halt. For example, a persuasive Rule 5109(d) submission may convince the staff not to recommend proceedings; the Board may determine not to institute proceedings under Rule 5200; the Hearing Officer might dismiss the matter; the matter might end with a Hearing Officer's initial decision; or the initial decision might be appealed to the Board, the Commission, or the courts. The longer the litigation, the greater the costs (e.g., attorney fees, expert witness fees, and opportunity costs).

[187] These factors make it impracticable to construct a quantitative estimate of the anticipated cost—there is no "typical" case that the Board could use to construct an estimate that would be extensible across the two to three cases per year anticipated here. While the Board requested information about costs, including relevant data, commenters did not provide specific data about defense costs that would permit the Board to construct a quantified estimate. The Board's analysis therefore continues to be qualitative in nature.

Apart from these direct defense costs, if the individual is adjudicated as having acted negligently and a sanction is imposed, the individual would incur potential financial costs of having been found liable for failing to act with reasonable care and thereby contributing to the firm's violation. To the extent that there are civil money penalties, they would be assessed against the individual.[188]

A firm that has indemnification agreements in place that would compel it to bear the financial burden of defending or indemnifying associated persons may choose to purchase insurance to help alleviate the contingent financial burden. If so, it would have to buy insurance in the market, and the pricing of such insurance may depend on the risks of loss identified by the underwriting process. Or a firm may self-insure against such liabilities, in which case the amount held in reserve or reinsurance may vary based on anticipated losses.

There may also be opportunity costs as enforcement proceedings distract individuals from their everyday responsibilities. The opportunity costs relate to diversion from engagement tasks and other work.

Further, an individual may incur reputational costs, such as adverse employment or career events. Commenters asserted that the effects of the Proposal would include causing harm to individuals' careers (e.g., by being removed from issuer client service roles or being demoted) and collateral consequences (e.g., follow-on proceedings by state boards of accountancy or disciplinary measures by other regulators) consistent with having been found to have violated the Board's standards, and hence the federal securities laws. The Board agrees and recognizes that

[188] If not foreclosed from doing so, individuals might seek to have their firm bear these financial costs pursuant to indemnification agreements, insurance agreements, or otherwise. However, such agreements or arrangements might not cover civil money penalties.

these costs could exist in any proceeding brought under the amendment.[189] While the Board may consider the relevant facts and circumstances in determining the sanction it believes appropriate in the public interest, the Board recognizes that additional consequences beyond the sanctions imposed in the case frequently occur. The Board acknowledges that these consequences could be significant to the individual against whom they are imposed. However, the Board also believes that these consequences would not be significant in the aggregate, taking into account the number of associated persons across all registered firms and in light of the anticipated number of additional proceedings likely to be brought as a result of the amendment.

Certain commenters raised concerns about the potential increase in legal costs for firms. In particular, they noted the increased legal liability that associated persons might face under the amendment, which may result in higher costs of firms defending their associated persons and liability insurance for firms. Other commenters voiced concerns about the potential for increased state-level investigations and disciplinary proceedings against individuals, which could lead to the suspension or revocation of professional licenses. However, another commenter asserted the amendment's contributory negligence standard would better align the PCAOB's liability approach with the majority of the states' liability approach, which does not limit individual liability for negligent conduct.

The Board agrees that the amendment could increase legal and liability insurance costs, as well as the number of state investigations. Those incremental costs, however, would not be significant based on the two to three additional cases expected per year.

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[189] *See* J. Krishnan, M. Li, M. Mehta & H. Park, *Consequences for Culpable Auditors*, *available at* https://ssrn.com/abstract=4627460.

Several commenters highlighted that the amendment could significantly increase audit firms' litigation risk and legal liability for small firms. They indicated that increased costs, encompassing defense expenditures and opportunity costs, are expected to disproportionately affect small firms, which may lack the resources and market influence to offset these expenses. The commenters cautioned that small firms with a limited capacity to absorb these costs or demand higher fees could face significant challenges.

The Board acknowledges that litigation risk and legal liability involve costs, and those costs may have a greater impact on small firms, where direct costs and distractions are less absorbable by firms' other activities or personnel. For example, small firms are especially vulnerable to increases in legal costs, as small firms may disproportionately bear the burden of insuring against the risk. However, the Board believes certain features of the market and this amendment would limit these effects.

First, smaller firms typically have simpler supervisory structures that may make it easier for these firms to supervise their partners to help to ensure that partners are acting with reasonable care.[190] They also may be less impacted by the concern raised by other commenters that responsibility for firm compliance could be divided up among many individuals, with accountability for any one act of negligence being more difficult to establish. Second, in assessing insurance costs, the Board distinguishes between market-wide effects (i.e., a market-wide increase in directors & officers or professional liability coverage) and specific-firm effects (i.e., a specific firm experiencing an increase in the cost of insurance if it has a specific claim brought against its associated persons). The Board believes the market-wide effects are likely to

[190] The Board acknowledges that smaller firms may have fewer resources to invest in dedicated supervisory structures. However, given that their respective QC systems oversee a smaller number of engagements, the same level of resources may not be necessary for the firm to nonetheless obtain reasonable assurance that their personnel comply with applicable professional standards and regulatory requirements.

be smaller: Again, the Commission already has the authority to bring negligence-based cases, and the staff has estimated that the amendment would result in an average of two to three more cases per year. The Board believes it less likely that the amendment or resulting incremental claims experience would cause a significant shift in underwriters' perception of risk and thus the availability or pricing of insurance for smaller firms in general. However, the Board acknowledges that the impact on a specific firm that is involved in a specific matter could be more significant; an increase in its individual claims experience could cause an increase in the cost of coverage and/or retention amounts in the future or make it more difficult to secure acceptable coverage.

In addition to the direct costs described above, the amendment could result in indirect costs as individuals adjust their behavior and put forth additional effort to ensure they do not contribute to a firm's violation through their negligence. However, to the extent that these indirect costs are incurred to bring previously negligent conduct up to a level of reasonable care, these costs are properly allocable to the underlying law, rule, or standard that the firm is alleged to have violated, as those provisions each assume a level of costs necessary for the firm to comply.

One commenter expressed concerns about a requirement in the Proposal that involves the application of "directly and substantially" only to the sufficiency of the connection between an associated person's conduct and a firm's violation. The commenter asserted that this is an important change from the present rule, under which an alleged violator must know (or recklessly not know) not only that they are contributing to a violation, but also that the contribution is direct and substantial. The Board notes that its analysis, which includes staff estimate of two to three additional cases per year based on the Proposal, takes into account the

application of "directly and substantially" only on the sufficiency of the connection between the associated person's conduct and a firm's violation. The Board does not believe that this change would be a significant driver of costs to individuals or firms in the aggregate.[191]

ii. Costs to Issuers (Audit Fees)

To the extent that firms pass on some of the costs to their audit clients, the amendment could result in audit fee increases to cover firms' compliance costs related to the amendment. Consistent with this notion, academic studies find that increased enforcement intensity can lead to temporary increases in audit fees for some issuers.[192] Further academic research provides evidence that audit fees increase with the auditor's assessment of business risk, which includes risk of regulatory sanctions, among others.[193] The findings indicate that the increases in audit fees are due to the increase in the number of audit hours, but not hourly rates.

3. Potential Unintended Consequences

The following discussion describes potential unintended consequences that the Board considered and, where applicable, factors that mitigate the adverse effects, such as the steps the Board has taken or the existence of countervailing forces.

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[191] Nor would it be a significant contributor to costs in particular cases; indeed, it might save costs by avoiding effort seeking to establish the reasonableness of the individual's belief as to the directness and substantialness of the participation or lack thereof where a direct and substantial connection in fact has already been established.

[192] Annita Florou, Serena Morricone & Peter F. Pope, *Proactive Financial Reporting Enforcement: Audit Fees and Financial Reporting Quality Effects*, 95 Acct. Rev. 167, 167 (2020) ("We examine the costs and benefits of proactive financial reporting enforcement by the U.K. Financial Reporting Review Panel. Enforcement scrutiny is selective and varies by sector and over time, yet can be anticipated by auditors and companies. We find evidence that increased enforcement intensity leads to temporary increases in audit fees and more conservative accruals. However, cross-sectional analysis across market segments reveals that audit fees increase primarily in the less-regulated AIM segment, and especially those AIM companies with a higher likelihood of financial distress and less stringent governance. On the contrary, less reliable operating asset-related accruals are more conservative in the Main segment and, in particular, those Main companies with stronger incentives for higher financial reporting quality. Overall, our study indicates that financial reporting enforcement generates costs and benefits, but not always for the same companies.").

[193] *See, e.g.,* Timothy B. Bell, Wayne R. Landsman & Douglas A. Shackelford, *Auditors' Perceived Business Risk and Audit Fees: Analysis and Evidence*, 39 J. Acct. Res. 35 (2001).

i. Self-Protective Behavior

The Board recognized in the Proposal that auditors might engage in self-protective behavior.[194] Specifically, while the threat of enforcement action can motivate individuals to act in a manner consistent with their legal obligations, it can also result in excessive monitoring and self-protective behavior, leading to an inefficient allocation of time and resources. The effect on audit quality may change as the degree of intervention increases. Individuals may spend more time on a task than is necessary to accomplish it at the appropriate level of care. Similarly, individuals may excessively document the nature of their task performance to demonstrate compliance in a future proceeding. Time spent on unproductive, self-protective activities may detract from other important obligations and directly impact audit quality.

Many commenters echoed this concern and emphasized the potential significance of this issue, including that its effects may discourage effective collaboration between and among accountants, especially in complex audits. Some of these commenters expressed concern that moving to a negligence standard for contributory liability would lead to sanctions of professionals who make judgments in good faith. A few commenters asserted that emphasizing every error an auditor makes will encourage auditors to focus on defensive auditing—which could result in a decrease in audit quality. These commenters' concerns center on the prospect that increased liability risk could lead auditors to prioritize self-protective measures (e.g., overemphasizing compliance documentation) and excessive monitoring over more important audit tasks, particularly in small- and mid-sized firms with limited resources. Another comment letter raised concerns about the impact of coercive enforcement strategies on audit practices,

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[194] *See* 2023 Proposing Release at 26.

suggesting that such strategies could lead to defensive behaviors rather than genuine quality improvements.

The Board notes that the compliance and documentation requirements in applicable professional standards are designed to sufficiently demonstrate compliance, thus mitigating the need for excessive, unproductive documentation.[195] Furthermore, the possibility of such self-protective behavior is not new. As discussed above, the Commission currently can initiate enforcement proceedings against individuals for negligent contributory conduct.[196] And, as commenters have pointed out, the PCAOB currently possesses a robust enforcement regime covering negligent primary conduct. Therefore, the risk of litigation and sanctions is already a factor in the current regulatory environment, driving the existing need for individuals to act with reasonable care and to be able to demonstrate their compliance. Thus, while the Board acknowledges some inefficient behavior could result from the amendment, consistent with the incremental increase in deterrence that the Board posits above, the Board continues to believe that the likelihood that the amendment would drive significant increases in self-protective behavior is low.

ii. Lack of Available Personnel or Compensation Enhancements

As recognized in the Proposal, excessive risk of enforcement action could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals.[197] Alternatively, auditors

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[195] See, e.g., AS 1215, Audit Documentation.

[196] Also, as discussed in section C above, the AICPA's Code of Professional Conduct makes certain negligent contributory acts by individuals an "act discreditable to the profession." *See* AICPA Code of Professional Conduct, ET § 501.05(a), *Negligence in the Preparation of Financial Statements or Records*, *recodified at* Section 1.400.040.01.

[197] *See* 2023 Proposing Release at 26.

may seek to offset the increased risk by demanding higher compensation for taking certain roles or responsibilities, which could have downstream effects on audit fees.

Many commenters remarked about the amendment's potential negative impact on the accounting and audit workforce. These commenters highlighted an existing "talent crisis," especially affecting small- and mid-sized firms. They noted that the amendment's threshold for sanctionable conduct and resulting increased liability risks could intensify the crisis. The commenters contended that the amendment might discourage talented individuals at various career stages from engaging in PCAOB-regulated work, potentially leading to lower audit quality, higher fees, and public company delisting. The commenters identified fear of punitive action and a culture of defensive auditing as factors that could deter newcomers from entering the profession and prompt experienced auditors to leave, further jeopardizing the talent pipeline. In addition, the commenters argued that the amendment would affect the on-the-job nature of auditors' learning. Many of the same commenters also raised concerns that a shift to a negligence standard might discourage experienced auditors from accepting essential roles due to the fear of increased liability for good faith judgments. According to these commenters, a negligence standard could dissuade risk-averse and diligent professionals integral to a firm's quality control system, thus affecting auditors' development, training, and monitoring. One commenter added that this amendment in combination with other recent proposed standards may exacerbate the talent crisis problem.

Some commenters cited literature to support their concerns that there has been a steady decline in the number of accounting graduates and that this is partly due to the regulatory environment making the profession unappealing.[198] While the cited studies indicate a decline in

[198] *See* Association of International Certified Professional Accountants, *2023 Trends Report* (2023), *available at* https://www.aicpa-cima.com/professional-insights/download/2023-trends-report; *see also* Center for

the number of accounting graduates and professionals or a waning interest in the accounting profession, they do not expressly point out regulatory oversight as a reason for the decline. Rather, according to one of these studies, the 150 CPA credit hour requirement as well as relatively low starting salaries are the two main reasons for not choosing accounting as a major among college students who considered accounting.[199]

The Board acknowledges the commenters' concerns about the amendment's potential impact on auditing personnel. However, the lack of available auditing personnel is likely the result of the interplay between numerous factors in the labor market. On the supply side, a notable decline in the number of entry-level auditors, as evidenced by a significant decrease in the number of new CPA candidates, suggests a waning interest among entry-level professionals in auditing careers.[200] A study found that for graduates who have already completed the 150 CPA credit hour requirement, finding the time to study for the CPA exam and the overall rigor of the exam are the most significant challenges to licensure.[201] Other contributing factors may include the retirement of baby boomers and a lack of diversity in the profession.[202]

Audit Quality and Edge Research, *Increasing Diversity in the Accounting Profession Pipeline: Challenges and Opportunities* (2023) ("CAQ–Edge Report"), *available at* https://thecaqprod.wpenginepowered.com/wp-content/uploads/2023/07/caq_increasing-diversity-in-the-accounting-profession-pipeline_2023-07.pdf.

[199] *See* CAQ–Edge Report at 7; *see also* Daniel Aobdia, Qin Li, Ke Na & Hong Wu, *The Influence of Labor Market Power in the Audit Profession,* Social Science Research Network (SSRN) (2024), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4732093 ("[W]e confirm that audit offices in more concentrated labor markets have greater labor market power and exercise it in the form of higher skill requirements and greater required effort from their auditors, at similar or slightly lower wages.").

[200] According to the *2023 Trends Report*, the number of new CPA candidates decreased from 48,004 in 2016 to 30,251 in 2022.

[201] *See* CAQ–Edge Report at 15.

[202] See Drew Niehaus, Fixing the Crisis in Accounting: Five Steps to Attracting Tomorrow's CPAs, CPA Journal (Nov. 2022), and Mark Maurer, Job Security Isn't Enough to Keep Many Accountants from Quitting, Wall St. J. (Sept. 22, 2023), available at https://www.wsj.com/articles/accounting-quit-job-security-675fc28f.

On the demand side, as the economy grows, businesses evolve, and more companies go public, the demand for auditors will increase.[203] Furthermore, technological advancements and the integration of digital tools into business processes have created a need for auditors with expertise in cybersecurity, blockchain, and data analytics.[204] Taking into account the current state of supply of and demand for auditors, attracting talent likely would depend primarily on factors under firms' control, such as auditor compensation, especially given that college students have cited low starting salary as one of the main hurdles to choosing accounting as a major.

Thus, while the Board acknowledges the potential for this amendment to affect the market for audit services, the Board disagrees with commenters' assessment of the magnitude of these risks. First, the Board continues to believe that the Board is not establishing a novel burden on individuals to refrain from acting negligently and thereby contributing to a firm's violation; instead, the Board is merely providing a mechanism for the PCAOB to discipline individuals who fail to meet that standard. The effect is, therefore, the incremental probability of PCAOB enforcement. However, this increased probability is not so novel and significant that it would be expected to impact noticeably the market for associated persons' services. Second, firms have a tool at their disposal—adjusting compensation—that could tend to increase the

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[203] *See* Bureau of Labor Statistics, *Occupational Outlook Handbook: Accountants and Auditors, available at* https://www.bls.gov/ooh/business-and-financial/accountants-and-auditors.htm#tab-6 ("In general, employment growth of accountants and auditors is expected to be closely tied to the health of the overall economy. As the economy grows, these workers will continue being needed to prepare and examine financial records. In addition, as more companies go public, there will be greater need for public accountants to handle the legally required financial documentation. The continued globalization of business may lead to increased demand for accounting expertise and services related to international trade and international mergers and acquisitions.").

[204] *See, e.g.,* Najoura Elommal & Riadh Manita, *How Blockchain Innovation Could Affect the Audit Profession: A Qualitative Study,* 37 J. Innovation Econ. & Mgmt. 37, 38 (2022) ("According to Alles (2015), the use of advanced technologies and blockchain by audit clients would be the catalyst for the adoption of these technologies by auditors. Blockchain, associated with other digital technologies, could change the audit process by modifying the way in which the auditor accesses data, collects evidence, and analyzes data (Rozario, Thomas, 2019). Auditors have the choice only to integrate these technologies and to change their organization and their process at the risk of losing their legitimacy in the audit market.").

supply of these services as needed, although there may be short-term displacements. The increased cost of labor may be absorbed by firms or passed to issuers and investors through increased audit fees.

iii. Reduced Competition in the Audit Market

The amendment to Rule 3502 could disproportionately impact small- and medium-sized firms if they are less able to bear the cost of defending their personnel. As discussed above, these costs include attorney fees to defend associated persons against charges and distracting personnel from generating income from the performance of client services. In an extreme case, a firm might not be able to sustain its practice considering the negative impact; more broadly, less profitable firms may perceive that the risk of such costs is too significant compared to their existing net profit from issuer and broker-dealer audit work and, therefore, decide to exit those markets. This result could further consolidate the market for issuer and broker-dealer audit services.

Several commenters asserted that the amendment could reduce competition in the audit market. They noted that the increase in liability could discourage firms, especially non-U.S. firms, from participating in U.S. issuer and broker-dealer audits. One commenter argued that the amendment "may inadvertently create barriers" for smaller firms and those servicing emerging industries by elevating the risk profile of conducting audits.[205] Another commenter asserted that there has been a decline in PCAOB-registered firms auditing issuers and broker-dealers due to regulatory burdens.

The likelihood that defense costs cause substantial changes in the relevant markets is lowered by three factors. First, a firm may already defend against an allegation of negligent

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[205] Comment Letter from Chamber of Digital Commerce at 1 (Nov. 2, 2023).

primary conduct (brought using the PCAOB's current authority) such that, in any additional cases brought under the amended rule, defending individuals facing a charge of negligent contributory conduct would likely involve common sets of facts and legal theories and could be done more efficiently (i.e., at lower additional cost) as compared to a wholly novel proceeding. Second, a firm may already defend an individual against an allegation of primary violations, involving common sets of facts and legal theories related to an allegation against a firm. Third, the Commission's existing authority to sanction associated persons for negligent contributory conduct means that firms' profitability calculations should already factor in the risk of defending personnel against charges of this nature, albeit with a modestly greater frequency in light of the amended rule. Thus, in addition to the firm's defense, the incremental cost of defending an individual may not be as significant as it appears at first glance. [206]

While the Board agrees that there has been a decline in the number of firms performing audits of public companies, the Board notes that firms may decide to cease providing audits for any number of reasons, mostly strategic in nature.[207] While the amendment could lead some firms to exit the issuer audit market because of increased risk of higher expected litigation expenses (thus reducing competition), this exit might involve low-quality auditors and lead to better matching between auditors and clients.[208] While the amendment may induce market

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[206] One commenter stated that the assertions in the Proposal that defense costs would be lowered by an increase in the volume of cases to defend is not based in fact. It appears that the nature of the Board's assertion was misinterpreted; as discussed above, the Board believes that individuals and firms will incur additional litigation costs to defend against charges brought under the amended rule. However, the Board has considered the nature of those costs and how they would relate to the way that staff might investigate and make recommendations regarding these cases, and the frequency of those charges, and the Board believes that those factors diminish the size of the expected increase—i.e., while costs will go up, they will go up less than if firms needed to defend a wholly new class of charges.

[207] Michael Ettredge, Juan Mao & Mary S. Stone, *Small Audit Firm De-registrations from the PCAOB-Regulated Audit Market: Strategic Considerations and Consequences*, Social Science Research Network (SSRN) (2022), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3572291.

[208] One study suggests that PCAOB inspections incentivize low-quality auditors to exit the market, resulting in an overall improvement in audit quality. *See* Mark L. DeFond & Clive S. Lennox, *The Effect of SOX on*

shifts, the resulting landscape could be characterized by a higher concentration of more capable and compliant audit firms, mitigating the negative impacts on the competitive landscape.

iv. Other Distortions/Inefficiencies

One commenter expressed concern that the amendment could change the dynamics of the settlement negotiation process during enforcement cases and "tip the scale" in the PCAOB's favor.[209] The commenter further contended that the PCAOB may pursue weaker cases, which would divert its resources to less meritorious cases, while another commenter asserted its belief that the PCAOB will appropriately exercise its prosecutorial discretion. Some commenters asserted that the amendment could have negative effects on the PCAOB's inspections program. One commenter noted that the amendment could cause firms to be particularly reluctant to provide services to novel industries.

The Board emphasizes that the amendment is designed to enhance regulatory oversight and accountability, not to unfairly "tip the scale" against firms and their associated persons. The PCAOB is committed to using its enforcement resources efficiently, and the Board emphasizes that enforcement proceedings are based on substantive evidence and legal principles, thereby helping to maintain the integrity and effectiveness of the PCAOB's overall enforcement process to protect investors' interests. Moreover, the Board believes that enhancements to the PCAOB's enforcement program will serve as a natural complement to the inspections program; even today, with a primary liability regime based on negligence, the vast majority of inspection deficiencies do not result in enforcement proceedings. The Board does not anticipate that the incremental

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Small Auditor Exits and Audit Quality, 52 J. Acct. & Econ. 21, 39 (2011) ("We conclude that while the PCAOB inspections are intended to improve audit quality primarily through the remediation of poor audit practices, they also improve audit quality by incentivizing the lower quality auditors to exit the market.").

[209] Comment Letter from U.S. Chamber of Commerce at 12.

effects of the amendment to Rule 3502 will prompt significant changes in the nature of the inspections process that has developed over time.

The amendment is intended to strengthen the PCAOB's ability to address instances of negligence that may harm investors or undermine the integrity of the audit process, ensuring a more effective and transparent regulatory framework. On balance the Board believes that the amendment will enhance audit quality, not diminish it. Enhancements in audit quality will also benefit emerging industries: while the amendment does not specifically target these industries, it is precisely because these industries operate in evolving regulatory and legal frameworks that they may benefit from more thorough and diligent auditing practices. Therefore, the Board believes that, rather than deterring firms from engaging with innovative sectors, the amendment can serve to enhance the quality and effectiveness of audits in these industries, ultimately benefiting both participants in the emerging industries and investors.

D. Alternatives Considered

The Board considered two alternatives to the amendment, as discussed below.[210]

1. Alternative Articulations of the Standard of Liability

Rather than amending Rule 3502 as done, the Board considered rewriting Rule 3502 to mirror the language in the cease-and-desist provisions of the Exchange Act, 15 U.S.C. 78u-3(a).

The primary benefit of such an approach would be to facilitate interpretive alignment with the scope of the Commission's causing-liability regime, which may provide associated persons with more clarity on the nature of the legal risk. However, for more than a dozen years, the Board has developed a distinguishable body of practice under Rule 3502 through its

[210] As discussed in section C above, the Proposal considered amending Rule 3502 to provide that an associated person that negligently contributes to a firm's violation need not be an associated person of the firm that commits the primary violation. The Board decided not to adopt this aspect of the Proposal.

enforcement program—including via the rule-based requirement that any contribution to a primary violation be "direct[ ] and substantial[ ]"—and the amended rule will maintain that familiar practice while narrowly adjusting only the standard of liability.

In response to comments, the Board also considered other potential liability standards, including whether to adopt a framework that would require a showing of multiple acts of negligence to hold an individual liable for contributory conduct at the negligence level. Commenters noted that because Section 21C proceedings are usually brought in conjunction with Rule 102(e) proceedings, the Commission often pursues a multiple acts of negligence or a heightened form of negligence theory. Commenters also discussed their belief that it would be inequitable or inappropriate for the Board to hold individuals liable for one-time errors.

However, as discussed in section C above, while the Commission often chooses to bring Section 21C and Rule 102(e) matters together, nothing requires it to do so. Similarly, under the amendment, the Board may choose to bring a case that has repeated acts of negligence, so that an appropriate remedial sanction can be imposed. Or, in appropriate facts and circumstances, it may choose to bring a case that involves a single act of negligence. This optionality thus mirrors that available to the Commission under Section 21C. Requiring multiple instances of negligence, moreover, would not fully close the regulatory gap noted above, would not give the Board authority that is co-extensive with the Commission, and would not fully achieve the efficiency benefits that the amendment seeks to achieve.

2. Removing Additional Barriers to Contributory Liability

The Board also considered an alternative that would expand the Board's ability to hold persons liable for contributing to firm violations by changing the "directly and substantially" modifier that describes the relationship of an associated person's contribution to a firm's primary

violation, including removing it altogether. This is currently an element of proof required for the Board to find a violation of Rule 3502.

Removing "directly and substantially" would enable the Board to use Rule 3502 to hold accountable any individual who took part in any way in the chain of events leading to a firm's violation, even if only remotely. The relationship between contributory conduct and the primary violation could be a discretionary factor to consider in bringing a proceeding in the first instance and when determining the appropriate sanction.

This alternative could improve audit quality by ensuring that all individuals with relevant professional responsibilities are appropriately motivated to perform their responsibilities with reasonable care. However, this could exacerbate the costs and unintended consequences discussed above in conjunction with the amendment. Therefore, this alternative might lead to excessive motivation for auditors to increase defensive efforts that do not contribute to audit quality (e.g., excessive self-protective measures in anticipation of future litigation).

The amended rule maintains the criteria of nexus and magnitude ("directly and substantially") for an associated person's contribution to a firm's violation, although it does not require proof that the individual knew or was negligent in not knowing that their conduct would be a direct and substantial contributor. These requirements appropriately specify the conduct the Board considers actionable for "contributing" to a primary violation, as outlined above. This approach tailors the incentives to individuals with the most direct responsibility for firm compliance. In other words, the amendment continues to focus on individuals most likely influenced by increased litigation risk leading to improved firm compliance and audit quality. Conversely, individuals who are less involved would experience lower benefits in relation to costs and unintended consequences.

3. Nonenforcement Alternatives Suggested by Commenters

Several commenters asserted that an alternative to the amendment is for the Board to provide auditors with additional guidance, training, and tools illustrating successful and problematic practices. Commenters indicated that this could be achieved through enhanced communication, such as issuing interpretive guidance and publishing observations from enforcement activities, to educate auditors and to help them better understand accountability expectations for associated persons, or through implementing a real-time consultation process similar to the Commission's. One commenter also expressed appreciation of the PCAOB's Spotlight series that is published to help users of financial statements better understand the PCAOB's activities and observations.

Although the Board agrees that these alternative approaches are beneficial, devoting additional resources to activities buttressing these approaches, without addressing the existing regulatory gap, would not yield the benefits discussed above that are associated with providing the PCAOB with the appropriate tool to hold individuals accountable for failing to act reasonably and contributing directly and substantially to a firm's violation. An increase in the number of regulators that can pursue negligent contributory conduct increases the likelihood of the conduct being detected and deterred through a range of sanctions that can be imposed by the PCAOB, including training.

One commenter suggested an alternative to the amendment could be to adopt standards addressing the roles of individuals involved in designing and monitoring firms' systems of quality control. The commenter believes this approach would provide predictability in enforcement of PCAOB standards and would more effectively accomplish the PCAOB's goals. While addressing the conduct of individuals involved in designing and monitoring a firm's

system of quality control is important, the scope of the amendment, and Rule 3502 generally, are broader than quality control.[211] As discussed previously, the amendment aims to address a specific gap in the PCAOB's regulatory framework related to liability standards for firms and associated persons, ensuring a more consistent and effective regulatory framework.

SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES

The amendment does not impose additional requirements on emerging growth company (EGC) audits. Accordingly, the Board believes that Section 103(a)(3)(C) of Sarbanes-Oxley does not apply. Nevertheless, the discussion of benefits, costs, and potential unintended consequences above generally applies to the audits of EGCs, and the Board includes this analysis for completeness.

Under Section 104 of the Jumpstart Our Business Startups Act (JOBS Act), rules adopted by the Board after April 5, 2012, generally do not apply to the audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act, unless the Commission "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[212] As a result of the JOBS Act, the rules and related amendments to PCAOB standards adopted by the Board are generally subject to a separate determination by the Commission regarding their applicability to audits of EGCs.

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[211] QC 1000, if approved by the Commission, would provide clear expectations for certain individuals serving in quality control roles. QC 1000 and Rule 3502 may overlap in some but not all circumstances because Rule 3502 applies to individuals more broadly than just quality control roles.

[212] *See* Pub. L. No. 112-106 (Apr. 5, 2012). Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act, also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the issuer's financial statements (auditor discussion and analysis) do not apply to an audit of an EGC. The amended Rule 3502 falls outside these two categories.

To inform consideration of the application of auditing standards to audits of EGCs, Board staff prepares a white paper annually that provides general information about the characteristics of EGCs.[213] As of November 15, 2022, PCAOB staff identified 3,031 companies that self-identified with the Commission as EGCs and filed audited financial statements in the 18 months preceding that date.[214]

EGCs are likely to be newer public companies, which may increase the importance to investors of the external audit to enhance the credibility of management disclosures. All else equal, the benefits of the higher audit quality resulting from the amendment may be more significant for EGCs than for non-EGCs, including improved efficiency of capital allocation, lower cost of capital, and enhanced capital formation. By increasing the likelihood that associated persons are held accountable for their negligent contributory roles in firm violations, the amendment to Rule 3502 aims to bolster investor confidence in the audit process. Because investors who lack confidence in a company's financial statements may require a larger risk premium that increases the cost of capital to companies, the improved audit quality resulting from applying the amendment to EGC audits could reduce the cost of capital to those EGCs.[215]

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[213] For the most recent EGC report, see *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2022* (February 20, 2024), *available at* https://pcaobus.org/resources/other-research-projects ("EGC White Paper").

[214] The EGC White Paper uses a lagging 18-month window to identify companies as EGCs. Please refer to the "Current Methodology" section of the EGC White Paper for details. Using an 18-month window enables staff to analyze the characteristics of a fuller population in the EGC White Paper, but may tend to result in a larger number of EGCs being included for purposes of the present EGC analysis than would alternative methodologies. For example, an estimate using a lagging 12-month window would exclude some EGCs that are delinquent in making periodic filings. An estimate as of the measurement date would exclude EGCs that have terminated their registration or exceeded the eligibility or time limits. *See id*.

[215] For a discussion of how increasing reliable public information about a company can reduce risk premiums, see David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. Fin. 1553, 1573 (2004) ("These findings suggest an important role for the accuracy of accounting information in asset pricing. Here, greater precision directly lowers a company's cost of capital because it reduces the riskiness of the asset to the uninformed.").

The amendment could impact competition in an EGC product market if the costs disproportionately affect the EGCs relative to their competitors. However, as discussed above, the costs associated with the amendment are expected to be small, particularly given the Commission's existing authority to sanction associated persons for single acts of contributory negligence. Therefore, the amendment's impact on competition, if any, is expected to be limited. Overall, the amendment is expected to enhance audit quality and increase the credibility of financial reporting by EGCs, thereby fostering efficiency.

Some commenters agreed that the amendment should apply to audits of EGCs and that doing so would benefit such audits. One commenter remarked that there was no reason not to apply the amendment to audits of EGCs and that the principles, standards, and scope of enforcement against violations involving contributory negligence should be the same regardless of the scale and size of the entity and of the firm. Another commenter posited that excluding EGCs from the application of the amendment would be inconsistent with protecting the public interest.

As previously discussed, one commenter suggested that the amendment would have a greater impact on smaller firms with fewer resources to defend personnel and navigate an uncertain liability environment, and consequently, these firms are more likely to cease auditing entities that require PCAOB-registered auditors. The Board agrees that the amendment may have a greater impact on smaller firms to the extent that their individual auditors are investigated under the amended rule, and the firms are unable to absorb the direct costs and distractions. This would, in turn, impact EGCs because they are more likely than non-EGCs to engage small

firms.[216] The Board believes that the amendment should apply uniformly to audits of EGCs to maintain high standards of audit quality and uphold investor protection across all entities.

Considering these comments and the reasons explained above, the Board will request that the Commission determine, to the extent that Section 103(a)(3)(C) of the Sarbanes-Oxley applies, that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the amendment will promote efficiency, competition, and capital formation, to apply the amendment to audits of EGCs.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 45 days of the date of publication of this notice in the *Federal Register* or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

(A) By order approve or disapprove such proposed rules; or

(B) Institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's internet comment form (https://www.sec.gov/rules/pcaob); or

[216] Staff analysis indicates that, compared to exchange-listed non-EGCs, exchange-listed EGCs are approximately 2.6 times as likely to be audited by a firm that is not affiliated with the largest global networks, and approximately 1.3 times as likely to be audited by a triennially inspected firm. Source: EGC White Paper and S&P.

- Send an e-mail to rule-comments@sec.gov. Please include PCAOB-2024-04 on the subject line.

Paper comments:

- Send paper comments in triplicate to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to PCAOB-2024-04. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (https://www.sec.gov/rules/pcaob). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. Do not include personal identifiable information in submissions; you should submit only information that you wish to make available publicly. We may redact in part or withhold entirely from publication submitted material that is obscene or subject to copyright protection. All submissions should refer to PCAOB-2024-04 and should be submitted on or before [INSERT DATE 21 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*].

By the Commission.

Vanessa A. Countryman

Secretary.

PCAOB
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PROPOSED AMENDMENTS TO PCAOB RULE 3502 GOVERNING CONTRIBUTORY LIABILITY

PCAOB Release No. 2023-007
September 19, 2023

PCAOB Rulemaking
Docket Matter No. 053

Summary: The Public Company Accounting Oversight Board (PCAOB or "Board") is proposing to amend in two respects PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, the Board's rule governing the liability of associated persons who contribute to a registered public accounting firm's primary violation. First, the Board is proposing to change from recklessness to negligence the standard of conduct for associated persons' contributory liability. Second, the Board is proposing to amend the rule to provide that an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation (i.e., that an associated person of one firm can contribute to a primary violation of another firm).

Public Comment: Interested persons may submit written comments to the Board. Comments should be sent by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. Comments also may be submitted by mail to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 053 in the subject or reference line and should be received by the Board by November 3, 2023.

Board Contacts: James Cappoli, Acting General Counsel, Office of the General Counsel (202/591-3105, cappolij@pcaobus.org);
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I. EXECUTIVE SUMMARY

Through the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), Congress established the Board in the wake of a series of high-profile corporate collapses that laid bare auditor misconduct and the need for a new type of oversight of the public accounting industry.[1] As part of its comprehensive, multipronged approach to such oversight, Congress authorized the Board to investigate, bring charges against, and sanction (when appropriate) registered public accounting firms and associated persons[2] thereof for violations of the laws, rules, and standards that Congress charged the Board with enforcing.[3] That enforcement authority covers a wide array of auditor conduct, including negligent conduct.

Congress also authorized the Board to promulgate rules and standards to govern auditor conduct.[4] To that end, in 2005, the Board codified auditors' longstanding obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly*

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[1] Pub. L. No. 107-204, 15 U.S.C. § 7201 *et seq.*; *see* S. Rep. No. 107-205, at 3 (2002) ("The purpose of [Sarbanes-Oxley] is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years."). As the Senate Report notes, "the frequency of financial restatements by public companies ha[d] dramatically increased" in the run up to the passage of Sarbanes-Oxley. S. Rep. No. 107-205, at 15; *see id.* ("From 1990-97, the number of public company financial restatements averaged 49 per year, but jumped to an average of 150 per year in 1999 and 2000.").

[2] An associated person is "any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor or entity that, in connection with the preparation or issuance of any audit report . . . (1) shares in the profits of, or receives compensation in any other form from, that firm; or (2) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." PCAOB Rule 1001(p)(i). The definition of an "associated person" does not include persons engaged only in clerical or ministerial tasks. *See id.*

[3] *See* Sections 105(b) & (c) of Sarbanes-Oxley.

[4] *See id.* § 103(a)(1); *see also, e.g.*, *id.* § 101(c)(2), (c)(4), (c)(6) & (g)(1).

Contribute to Violations.[5] For well over a decade now, the Board has brought enforcement proceedings against associated persons pursuant to Rule 3502.

Yet Rule 3502's current formulation contains an incongruity that places negligent contributors to firms' violations beyond the rule's reach. That incongruity stems from the fact that registered firms, like any legal entity, can act only through natural persons. It logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person's negligence.

Rule 3502, however, at present requires a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who contribute to firms' negligence-based violations. Put another way, Rule 3502 requires a showing of more than negligence by individuals for the Board to sanction conduct resulting in negligence by firms. Thus, under the current Rule 3502, associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not. As a result, the Board believes that the proposed Rule 3502 would address this incongruity, and therefore better protect investors and promote quality audits.

Rule 3502 also conditions contributory (or secondary) liability on the relationship between the firm that commits a violation and the individual[6] that contributes to that violation by requiring that the individual be an associated person of that firm. Given the complexity of many contemporary audits and the multiple firms involved in them, we are proposing to amend the rule to apply to individuals' contributions to primary violations committed by "any" registered public accounting firm.

For these reasons, the Board is proposing to amend Rule 3502 in two ways. First, the Board is proposing to change from recklessness to negligence the liability standard for associated persons' contributory conduct. Second, the Board is proposing to amend the rule to provide that an individual contributing to a registered firm's primary violation need not be an associated person of the firm that commits the violation so long as the individual is an associated person of some registered firm. As explained in greater detail herein, the Board

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[5] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005) ("2005 Adopting Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf ("The Board proposed [Rule 3502] to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit [ ] violations.").

[6] For ease of reference, this release sometimes refers to associated persons who are the contributory actors for purposes of Rule 3502 as "persons" or "individuals." The Board notes, however, that both natural persons and entities can be associated persons, and therefore Rule 3502 charges can be brought against both natural persons and entities, consistent with the meaning of the term "person associated with a registered public accounting firm." *See supra* footnote 2.

believes, based on its experience, that these proposed amendments would better align Rule 3502 with the scope of the Board's enforcement authority under Sarbanes-Oxley, thus further advancing the Board's mission of investor protection.

II. BACKGROUND

PCAOB Rule 3502 provides grounds for secondary liability when an associated person of a registered firm acts at least recklessly to directly and substantially contribute to a violation by that firm of a law, rule, or standard that the Board is charged with enforcing. Although the rule as adopted in 2005 incorporated a recklessness standard, the rule as proposed in 2004 required that individuals only negligently contribute to a firm's violation to be subject to liability.[7] Whereas negligence "is the failure to exercise reasonable care or competence,"[8] recklessness requires "an extreme departure from the standard of ordinary care for auditors" that "is either known to the actor or is so obvious that the actor must have been aware of it."[9] Indeed, Sarbanes-Oxley characterizes "reckless conduct" as a subspecies of "intentional or knowing conduct,"[10] whereas negligence is an "objective" standard that is not measured by "the intent of the accountant."[11]

The Board is now proposing that negligence be the liability standard for actionable contributory conduct under Rule 3502. And for good reason: The proposed negligence standard is based on the Board's extensive experience with Rule 3502 since the rule's adoption nearly two decades ago, it aims to shore-up a gap in the PCAOB's regulatory framework that can lead to anomalous results, and it advances certain objectives in the Board's 2022-2026 Strategic Plan in furtherance of the Board's overall mission.

In the first subsection below, we review the Board's 2004 proposal and 2005 adoption of Rule 3502. Then, we detail the reasons for the proposed amendments to modernize and strengthen the rule.

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[7] *See Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2004-015, at 18 & n.40 (Dec. 14, 2004) ("2004 Proposing Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2004-12-14_Release_2004-015.pdf.

[8] *In re S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 35 n.169 (July 3, 2013) (citation and quotation marks omitted).

[9] *Marrie v. SEC*, 374 F.3d 1196, 1203 (D.C. Cir. 2004) (citation and quotation marks omitted); *see also* 2005 Adopting Release at 13 ("[T]he phrase 'knew, or was reckless in not knowing' is a well-understood legal concept, and the Board intends for the phrase to be given its normal meaning.").

[10] *See* Section 105(c)(5)(A) of Sarbanes-Oxley.

[11] *In re Melissa K. Koeppel, CPA*, PCAOB File No. 105-2011-007, at 166 (Dec. 29, 2017) (quoting *In re Kevin Hall, CPA*, SEC Release No. 34-61162, at 12 (Dec. 14, 2009) (quotation marks omitted)).

A. History of Rule 3502

As part of a package of proposed ethics and independence rules, the Board proposed PCAOB Rule 3502 in 2004.[12] In issuing the proposal, the Board observed that "[w]hile certain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm, the firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm."[13] Accordingly, through Rule 3502, the Board sought to "codify that obligation" and "make it clear that the obligation is enforceable by the Board."[14] Using language "intended to articulate a negligence standard," the proposed version of Rule 3502 subjected associated persons to potential contributory liability if they "knew or should have known" that an act or omission by them would contribute to a firm's primary violation.[15] And although not stated expressly, the 2004 Proposing Release implied that the individual contributing to a violation must be an associated person of the firm that commits the primary violation.[16]

Following a notice-and-comment period,[17] the Board adopted Rule 3502 with two modifications from the proposal. First, while affirming its authority to promulgate a negligence-

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[12] *See generally* 2004 Proposing Release at 18-19. As proposed (and adopted), Rule 3502 was entitled *Responsibility Not to Cause Violations*. *See id.* at A-4; 2005 Adopting Release at A-5. Shortly after adoption, however, the Board changed the title of the rule to its current title, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*. The Board made the change "[a]fter discussions with the SEC" and "to avoid any misperception that the rule affects the interpretation of any provision of the federal securities laws." *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-020, at 2 (Nov. 22, 2005), *available at* https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket017/2005-11-22_release_2005-020.pdf?sfvrsn=69338fcd_0. In so doing, however, the Board clarified that "[t]he rule, as amended, should be interpreted and understood to be the same as the rule adopted by the Board." *Id.*

[13] 2004 Proposing Release at 18.

[14] *Id.*

[15] *Id.* at 18 n.40; *see id.* at A-4 (proposed rule text).

[16] *See id.* at 18 ("[T]he firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm").

[17] "Several commenters supported the rule as proposed and noted that they saw the rule as essential to the Board's ability to carry out its disciplinary responsibilities under the Act," 2005 Adopting Release at 9, while others did not fully endorse it. Their objections were based principally on the view that negligence might be an ill-suited liability standard "in light of the complex regulatory requirements with which auditors must comply" and out of concern that such standard "would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards." *Id.* at 9, 13. Certain commenters "also questioned the Board's authority to adopt the proposed rule, or at least the proposed rule with a negligence standard." *Id.* at 9.

based contributory liability rule,[18] the Board revised the liability standard from negligence to recklessness, which the Board at that time believed would "strike[ ] the right balance in the context of th[e] rule."[19] Second, the Board modified "contribute"—the verb that describes the connection between the associated person's conduct and the firm's primary violation—with "directly and substantially."

The latter modification was made due to commenters expressing concern that, because of the collaborative nature of accounting work, each individual involved in formulating a decision or other action that ultimately leads to a firm violation could be held liable for causing the violation.[20] The Board explained that the addition of "directly" means, among other things, that an associated person's conduct must "either essentially constitute[ ] the [firm's] violation" or be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation." But, the Board clarified, "directly" does not place outside the scope of Rule 3502 contributory conduct "just because others also contributed to the violation, or because others could have stopped the violation and did not." "Substantially," the Board explained, means that associated persons' conduct must "contribute[ ] to [a] violation in a material or significant way," though it need not be "the sole cause of the violation."[21]

Finally, the 2005 Adopting Release clarified expressly what the 2004 Proposing Release implied regarding the relationship between associated persons who contribute to a violation and the firms that commit the violations: "Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated."[22]

B. Reasons for the Proposed Amendments

As the Board previously recognized, when an associated person causes a firm to commit a violation, such conduct "operates to the detriment of the protection of investors."[23] The following subsections explain why the proposed modifications to Rule 3502 are appropriate in furtherance of the Board's mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

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18 *See id.* at 12 n.23; *see also infra* footnote 43.

19 2005 Adopting Release at 13; *see id.* at 12 & n.23.

20 *See id.* at 9, 13.

21 *Id.* at 13.

22 *Id.* at 11 n.20.

23 2005 Adopting Release at 10.

1. Aligning Rule 3502 With the Board's Enforcement Authority

As the Board previously has explained, a registered firm "can only act through the natural persons who serve as its agents, including its associated persons."[24] Accordingly, "a natural person's actions may render both the [firm] primarily liable and the natural person secondarily liable."[25] Yet under the current formulation of Rule 3502, there exists an incongruity between the respective requisite mental states for liability of a registered firm resulting from an associated person's conduct and for liability of the associated person: A firm can commit a primary violation of certain laws, rules, or standards by acting *negligently*, but an associated person who directly and substantially contributed to that violation must have acted at least *recklessly* to be secondarily liable.

This incongruity has the potential to dissuade associated persons from exercising the appropriate level of care in their audit work. They may not exercise reasonable care (the standard for negligence) if they know that they cannot be held individually liable by the PCAOB for a firm's primary violation unless an act or omission by them amounts to an "an extreme departure from the standard of ordinary care for auditors" (the standard for recklessness).[26] The proposed modification to Rule 3502's liability standard from recklessness to negligence is intended to close this regulatory gap, which should incentivize associated persons to be more deliberate and careful in their actions. Indeed, "accountability frequently improves outcomes."[27]

In addition to the discrepancy in liability standards, uncertainty may exist with respect to the enforceability of Rule 3502, as it pertains to *who* can violate the rule. Currently, to be subject to potential liability under Rule 3502, an associated person of a registered public accounting firm must at least recklessly, directly, and substantially "contribute to a violation by *that* registered public accounting firm," meaning the firm of which the individual is an

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[24] 2004 Proposing Release at 18; *see* 2005 Adopting Release at 12 ("[Registered] firms . . . can only act through the natural persons that comprise them, many of whom are 'associated persons' subject to the Board's ethics standards and disciplinary authority.").

[25] *In re Timothy S. Dembski*, SEC Release No. 34-80306, at 13-14 n.35 (Mar. 24, 2017) (quoting *SEC v. Koenig*, 2007 WL 1074901, at *7 (N.D. Ill. Apr. 5, 2007)).

[26] *Marrie*, 374 F.3d at 1204; *see* Russell G. Pierce & Eli Wald, *The Relational Infrastructure of Law Firm Culture and Regulation*, 42 HOFSTRA L. REV. 109, 129 (2013) (explaining how rules from the legal industry's governing body that would restrict lawyers' limited liability "will encourage lawyers to devote more energy to maintaining the quality of the firm because they could potentially face personal liability for poor quality services"); *see also* Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 VAND. L. REV. 1871, 1885 (2019) (arguing that "existing deterrence mechanisms have failed to produce optimal audit quality" and "are ineffective").

[27] Honigsberg, *supra* footnote 26, at 1902.

associated person—and only that firm.[28] Yet it's possible that an associated person of a registered firm—who by virtue of that designation is subject to the Board's enforcement authority[29] and is required to comply with all applicable standards that the Board is charged with enforcing[30]—could contribute to a second firm's violation in such a way that there may be doubt as to the application of current Rule 3502. In such circumstance, regardless of the individual's degree of departure from the standard of reasonable care (i.e., even if the individual acted intentionally or recklessly), there may be uncertainty as to the availability of a charge under Rule 3502 against the individual due to the nature of the individual's relationship with the firm committing the primary violation (although other charges potentially might be available).

Questions:

1. Are the regulatory concerns discussed above clear and understandable?

2. Are there other regulatory concerns related to the current formulation of Rule 3502? If so, what are they and how should the Board address them, if at all?

3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms?

2. The Board's Implementation Experience

Although the Board viewed Rule 3502's recklessness liability threshold as "strik[ing] the right balance in the context of th[e] rule" at the time of the rule's adoption in 2005, the threshold had not yet been tested in practice by the PCAOB, and experience has shown that it prevents the Board from executing its investor-protection mandate to the fullest extent that Congress authorized in Sarbanes-Oxley.

In the instances in which the Board has instituted proceedings against firms for negligence-based violations, the Board has not been able to charge Rule 3502 violations against the individuals that contributed to those firms' violations. Although the decision not to bring charges against individuals varies case-by-case and is at the Board's discretion, it remains that the Board has been legally barred by the current formulation of Rule 3502 from holding

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[28] PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (emphasis added).

[29] *See* Section 101(c)(6) of Sarbanes-Oxley.

[30] *See* PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*.

accountable under Rule 3502 individuals who negligently, directly, and substantially contributed to the firms' violations, given the absence of reckless conduct.[31]

The Board's interactions with Rule 3502 in various contexts supply experience-based reasons for the proposed amendment to the liability standard. For example, when dealing with the design and implementation of firm quality control (QC) policies and procedures under applicable QC standards, the Board has observed that registered firms that commit a QC violation often have multiple individuals with overlapping QC responsibility but that no single individual was reckless in failing to act, and thus no individual can be held personally accountable for the firm's QC failure. And yet, individuals with QC responsibility at a firm are often in some of the most important, decision-making roles within the firm because a compliant QC system serves as the backstop to ensure that all *other* professional standards are followed.[32]

In addition to the QC context, Rule 3502 also arises in sole-proprietorship cases, in which the sole owner and sole partner of a firm causes the firm to commit a violation. Yet for some types of violations, there is not always sufficient evidence of reckless behavior. A negligence standard thus would promote greater accountability by the sole proprietor and prevent that person from being shielded from individual liability under Rule 3502.

Regarding the other aspect of the proposal, contributory liability for an associated person who directly and substantially contributes to a firm's primary violation shouldn't be contingent upon the individual's formal role or relationship with that firm, so long as the individual is an associated person of *any* registered firm.[33] To be sure, an individual who "directly and substantially" contributes to a firm's violation (consistent with the meaning of that phrase[34]) in all instances likely also will have "participate[d] as agent *or otherwise on behalf of* such [ ] firm in *any* activity of that firm" "*in connection with* the preparation or issuance of

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[31] As the 2005 Adopting Release notes, however, Rule 3502 "is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons." 2005 Adopting Release at 14 n.25.

[32] *See* QC § 20.03, *System of Quality Control* ("A firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.").

[33] Indeed, the U.S. Securities and Exchange Commission ("Commission") has even broader secondary-liability authority—it may hold accountable auditors for causing primary violations not only by firms, but by any other person, including issuers. *See, e.g.*, *In re James Fitts, CPA*, SEC Release No. 34-97259 (Apr. 6, 2023); *In re Steven C. Avis, CPA*, SEC Release No. 34-95071 (June 8, 2022); *see also infra* pages 13-14 (discussing the Commission's secondary-liability regime).

[34] *See* 2005 Release at 13; *see also infra* pages 14-15.

any audit report," and thus be an "associated person" of that firm.[35] Moreover, PCAOB rules acknowledge that an individual can be an associated person of multiple registered firms at the same time.[36] The Board, however, believes that amending the rule to provide that a contributory violator need not be an associated person of the registered firm that commits the primary violation would eliminate any doubt about which individuals are within proposed Rule 3502's scope.

The Board also notes—as it has observed through its oversight activities—that varied roles and creative work arrangements for certain personnel are becoming increasingly common in the industry.[37] In light of these arrangements, the Board believes that amending the rule as described above would clarify that associated persons of *any* registered firm are potentially subject to liability under proposed Rule 3502, regardless of an individual's formal role or relationship with the firm that commits the primary violation.

Question:

4. Are there common types of cases or fact patterns not discussed above in which a negligent standard of liability would be particularly useful to promote greater individual accountability under Rule 3502?

3. Advancing the Board's Investor-Protection Mandate

In the Board's 2022-2026 Strategic Plan, the Board expressed a rejuvenated focus on the PCAOB's investor-protection mandate and stated its intent "to modernize and streamline our

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[35] *See* Section 2(a)(9) of Sarbanes-Oxley (emphases added); PCAOB Rule 1001(p)(i)(2).

[36] The Board's definition of an "associated person" expressly contemplates that a person may be primarily associated with one registered firm while also being associated with another firm. Rule 1001(p)(i)'s definition of an "associated person" provides that if a firm reasonably believes that one of its associated persons is primarily associated with another registered firm, then that person is excluded from the definition of an "associated person," but only "for purposes of completing a registration application on Form 1, Part IV of an annual report on Form 2, or Part IV of a Form 4 to succeed to the registration status of a predecessor." For all other purposes, that carveout does not apply, thus underscoring that, in the context of Rule 3502's reference to an "associated person," a person can be associated with two or more registered firms at once. *See* PCAOB Rule 1001(p)(i).

[37] *See, e.g.*, Hannah L. Buxbaum, *The Viability of Enterprise Jurisdiction: A Case Study of the Big Four Accounting Firms*, 48 U.C. DAVIS L. REV. 1769, 1798 (2015) (detailing how some of the larger firm networks "have interposed additional coordinating organizations between the global entity and the individual affiliates that provide client services" via "a regional structure"); *see also* Honigsberg, *supra* footnote 26, at 1903 ("The incentive effects of individual accountability are particularly important given the changes in audit design over the past decade. . . . For multinational firms, presumably over half of audit hours are frequently performed overseas.").

existing standards . . . where necessary to meet today's needs."[38] The Board also expressed an intent to "engag[e] in vigorous and fair enforcement that promotes accountability and deterrence," including by "tak[ing] a more assertive approach to bringing enforcement actions" and "hold[ing] accountable" those who commit "violations that result from negligent conduct."[39] The proposed amendments to Rule 3502 are consistent with those goals.

When Congress enacted Sarbanes-Oxley, it empowered the Board to promulgate and adopt certain standards and rules, to inspect registered firms for compliance with those standards and rules, and to enforce compliance by firms and their associated persons. Among the tools that Congress provided to the Board for enforcement is the ability to sanction negligent conduct, including single instances of negligence.[40] That liability threshold serves a dual function: It incentivizes auditors to conduct their work knowing that reasonable care is the standard for assessing it, and it allows the Board to publicly discipline auditors who were found to have not exercised an appropriate degree of care.[41] Each of those functions—one *ex ante* to auditors' conduct and the other *ex post*—goes to the core of the Board's mission of protecting investors and promoting high-quality audits.

The current formulation of Rule 3502, however, stops short of deploying the negligence standard to its fullest extent by requiring at least reckless conduct before an associated person can be held secondarily liable. The proposed change in Rule 3502's liability standard would

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[38] PCAOB, Strategic Plan 2022-2026, at 10, *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/strategic-plan-2022-2026.pdf?sfvrsn=b2ec4b6a_4/.

[39] *Id.* at 3, 13; *see also id.* at 8 ("[W]e are focused on aggressively pursuing all statutory legal theories for charging respondents and remedies available in executing our enforcement program, which is central to protecting investors and promoting the public interest.").

[40] *See* Sections 105(c)(4) & (c)(5) of Sarbanes-Oxley; *Rules on Investigations and Adjudications*, PCAOB Release No. 2003-015, at A2-58 (Sept. 29, 2003), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_005/release2003-015.pdf?sfvrsn=35827b4_0 ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act.").

[41] *See* Honigsberg, *supra* footnote 26, at 1899 ("Individual accountability could provide a counterweight to the current incentive structure. . . . [A]udit partners do not internalize the full consequences of an audit failure. Promoting individual brands will better address this inefficiency and reduce externalities by causing audit partners to internalize these failures."); *see also* Gina-Gail S. Fletcher, *Deterring Algorithmic Manipulation*, 74 VAND. L. REV. 259, 268-69 (2021) ("[I]f the applicable laws are narrow, only capturing the most blatant misconduct, wrongdoers may not be deterred from breaking the law. . . . [D]eterrence is effective if regulators have strong, suitable tools to enforce the regime and market actors know whether they are violating the law.").

remove this self-imposed constraint and make the rule both a more effective deterrent and a more effective enforcement tool, and in so doing, better align the rule with Sarbanes-Oxley.[42]

The proposal to amend Rule 3502 with respect to *who* can violate the rule is also intended to align the rule with the PCAOB's statutory mission. Proposing to amend Rule 3502 so that liability is not contingent upon a person's formal role or relationship with the firm that commits the primary violation would be an appropriate modification to the rule—what matters is whether a person has directly and substantially contributed to a firm's violation of the laws, rules, and standards that the Board enforces.

Questions:

5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors?

6. Beyond the dual purposes of deterrence and accountability, are there other ways that the proposed amendments would protect investors?

III. DISCUSSION OF THE PROPOSED AMENDMENTS

As discussed above, the Board is proposing to amend PCAOB Rule 3502 in two ways: (1) changing the liability standard from recklessness to negligence, and (2) providing that, to be subject to potential liability under the rule, a contributory actor need not be an associated person of the registered firm that has committed a primary violation. Consistent with prior Board interpretations, the Board is proposing these amendments pursuant to its authority under Sarbanes-Oxley.[43] The details of these amendments are discussed in the following subsections.

A. Changing the Liability Standard

As seen in Appendix A, the Board is proposing to modify Rule 3502's liability standard by deleting the phrase "knowing, or recklessly not knowing" (and certain ancillary surrounding

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[42] *See* PCAOB, Strategic Plan 2022-2026, at 10 ("Effective auditing, attestation, quality control, ethics, and independence standards advance audit quality and are foundational to the PCAOB's execution of its mission to protect investors.").

[43] Consistent with the original proposal and adoption of Rule 3502, the Board is proposing the amendments to Rule 3502 pursuant to the Board's authority in Sections 105 and 103 of Sarbanes-Oxley. *See* Sections 105(c)(4) & (c)(5) of Sarbanes-Oxley (authority to sanction single instances of negligent conduct); *id.* § 103(a)(1) (authority to promulgate ethics standards); *see also* PCAOB Release No. 2003-015, at A2-58 ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act."). Section 101, moreover, also authorizes the proposed amendments. *See* Sections 101(a), (c)(2), (c)(4), (c)(5), (c)(6), (f)(6) & (g)(1) of Sarbanes-Oxley (establishment, duties, powers, and rules of the Board).

text) and inserting elsewhere into the rule the phrase "knew or should have known" (and certain ancillary surrounding text). The current phrase describes conduct that amounts to at least recklessness,[44] whereas the proposed phrase sets a negligence standard using "classic negligence language."[45] Consequently, the Board is proposing to change the standard for secondary liability from an "extreme departure from the standard of ordinary care"[46] (recklessness) to "the failure to exercise reasonable care or competence" (negligence).[47]

Such a change would address the incongruity and related issues noted above. Specifically, it would align the requisite mental states for liability of a registered firm and for liability of an associated person whose conduct directly and substantially contributed to the firm's violation.[48] In so doing, the proposed modification should incentivize associated persons to exercise the appropriate level of care, thus promoting investor protection.

In furtherance of administering this new rule, the Board notes two aspects of today's proposal.

First, associated persons already are subject to potential liability—including money penalties—for negligently contributing to registered firms' violations of numerous laws and rules governing the preparation and issuance of audit reports via the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, among other things, the Exchange Act authorizes the Commission to institute cease-and-desist proceedings against any "person that is, was, or would be a cause of [a] violation [of the Exchange Act or any rule or regulation thereunder], due to an act or omission the person knew or should have known would contribute to such violation,"[49] and further authorizes the Commission to "impose a civil penalty" upon finding

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[44] *See* 2005 Adopting Release at 12 n.23.

[45] *In re KPMG Peat Marwick LLP*, SEC Release No. 34-43862 (Jan. 19, 2001) ("Ordinarily, the phrase 'should have known' . . . is classic negligence language."), *pet. for review denied*, *KPMG*, 289 F.3d at 112; *see also Erickson Prods., Inc. v. Kast*, 921 F.3d 822, 833 (9th Cir. 2019) ("'[S]hould have known' . . . is a negligence standard. To say that a defendant 'should have known' of a risk, but did not know of it, is to say that he or she was 'negligent' as to that risk."); *KPMG*, 289 F.3d at 120 ("knew or should have known" is language that "virtually compel[s]" a negligence standard).

[46] *Marrie*, 374 F.3d at 1204 (citation and quotation marks omitted).

[47] *S.W. Hatfield*, SEC Release No. 34-69930, at 35 n.169.

[48] However, the sanctions to which a contributory actor may be subject upon being found to have violated Rule 3502—including whether the Board may impose any of the heightened sanctions in Section 105(c)(5) of Sarbanes-Oxley—depend on the associated person's conduct and not that of the firm that commits the primary violation.

[49] 15 U.S.C. § 78u-3(a); *see also* 15 U.S.C. §§ 77h-1(a), 80a-9(f)(1), 80b-3(k)(1).

that such person "is or was a cause of [such] violation."[50] Section 3(b)(1) of Sarbanes-Oxley, in turn, provides that "[a] violation by any person of . . . any rule of the Board shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder." Thus, the proposed amendment to Rule 3502's liability threshold would not subject auditors to any new or different standard to govern their conduct.[51] And indeed, Commission proceedings under the Exchange Act have resulted in sanctions (including civil penalties) against auditors for negligently contributing to primary violations by firms and issuers.[52]

Second, the Board is proposing to retain the "directly and substantially" modifier to describe the connection between a contributory actor's conduct and a registered firm's primary violation.[53] Thus, for conduct to "directly" contribute to a primary violation, it must "either essentially constitute[ ] the violation"—in which case it necessarily is a direct cause of it[54]—or

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[50] 15 U.S.C. § 78u-2(a)(2). The Commission's Section 21B authority to impose civil penalties for violations in Section 21C cease-and-desist proceedings was added in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Pub. L. 111-203.

[51] Nor does the Commission's authority to sanction associated persons' negligent contributory conduct detract from the proposed amendment's deterrent effect, as an increase in the number of regulators on the lookout for the same or similar violative conduct increases the likelihood of that conduct being detected and, consequently, the likelihood that the conduct would be sanctioned. *See* Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1, 12 (2010) ("One of the most powerful deterrents to misconduct is an increased threat of prosecution. . . . A 'can do' accountant is less likely to provide questionable opinions if there is a substantial certainty that he will be caught and punished."); *see also* Fletcher, *supra* footnote 41, at 268 ("Certainty of punishment"—including "the possibility of detection, apprehension, conviction, and sanctions"—is one of two "primary factors" that drive deterrence.).

[52] *See, e.g.*, *In re David S. Hall, P.C.*, SEC Initial Decision Release No. 1114 (Mar. 7, 2017) (ALJ Op.) (cease-and-desist order and $10,000 civil penalty against engagement quality reviewer for negligently causing primary violations by registered firm and firm's issuer client, respectively), *decision made final*, SEC Release No. 34-80949 (June 15, 2017); *see also In re Gregory M. Dearlove, CPA*, SEC Release No. 34-57244 (Jan. 31, 2008) (cease-and-desist order against firm engagement partner for negligently causing violations by firm's issuer client); *In re Philip L. Pascale, CPA*, SEC Release No. 34-51393 (Mar. 18, 2005) (same).

[53] *See* 2005 Adopting Release at 13. As discussed above, the "directly and substantially" modifier was added in response to commenters' concerns that a negligence standard might sweep too broadly. *See supra* pages 5-6 & n.17; *see also* 2005 Adopting Release at 13. Because the Board is retaining "directly and substantially," as explained herein, the guardrails that the Board put in place in 2005 in response to such concerns would remain under this proposal.

[54] *Cf. Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980) ("[C]ommon law agency principles, including the doctrine of respondeat superior, remain viable in actions brought under the Securities Exchange Act and provide a means of imposing secondary liability

be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation"; but it need not "be the final step in a chain of actions leading to the violation."[55] Moreover, "directly" does not excuse an associated person who negligently "engages in conduct that substantially contributes to a violation, just because others also contributed to the violation, or because others could have stopped the violation and did not."[56] Nor would it necessarily excuse an associated person's conduct when another actor engages in intentional misconduct that might otherwise break the chain of causation—in particular where the associated person should have realized the potential for, and likelihood of, such third-party intentional misconduct.[57]

For its part, "substantially" continues to require that the associated person's conduct "contribute[ ] to the violation in a material or significant way," though it "does not need to have been the sole cause of the violation."[58] The Board stresses that Rule 3502 is not intended to "reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation."[59]

The Board further notes that, based on the proposed rule text, "directly and substantially" would apply only to the sufficiency of the connection between an associated person's conduct and a firm's violation. Thus, to be liable under proposed Rule 3502, a person must have known, or should have known, that an act or omission by them would contribute—but not that it would *directly and substantially* contribute—to a firm's violation.

Questions:

7. Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate?

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for violations of the Act independent of § 20(a). The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.").

55 *See* 2005 Adopting Release at 13.

56 *Id.*

57 *See* RESTATEMENT (SECOND) OF TORTS § 448 ("The act of a third person in committing an intentional [violation] is a superseding cause of harm to another resulting therefrom, although the actor's negligent conduct created a situation which afforded an opportunity to the third person to commit such a [violation], unless the actor at the time of his negligent conduct realized or should have realized the likelihood that such a situation might be created, and that a third person might avail himself of the opportunity to commit such a [violation].").

58 2005 Adopting Release at 13.

59 *Id.*; *see also id.* at 14 (The Board does not "seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation.").

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?

9. Are there other phrases or terms that the Board should consider to modify "contribute," or other limitations that the Board should incorporate into the proposed rule? If so, what are they?

B. Clarifying the Relationship Between Contributory Actor and Primary Violator

As seen in Appendix A, the Board is proposing to amend Rule 3502 by changing the word "that" to "any" immediately before the reference to the registered public accounting firm that commits the primary violation. The relative pronoun "that" generally is understood to refer back to a specific preceding noun,[60] which, in the current formulation of Rule 3502, means that the registered firm of which the contributory actor is an associated person must be the same firm that commits the primary violation. The Board confirmed this reading of Rule 3502 when it adopted the rule, noting that "Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated."[61]

The "ordinary meaning" of the word "any," by contrast, "encompass[es] all varieties of" whatever noun follows it.[62] Thus, by proposing to prohibit associated persons from negligently contributing to a violation by "*any* registered public accounting firm," the Board intends for proposed Rule 3502 to apply to associated persons that contribute at least negligently (and directly and substantially) to a registered firm's primary violation, regardless of whether the person is an associated person of the registered firm. As discussed above, the Board believes that this proposed amendment would enhance investor protection by clarifying the application of Rule 3502, mindful of registered firms' contemporary organizational structures, operational

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[60] *See In re Connors*, 497 F.3d 314, 319 (3d Cir. 2007) ("The word 'that' is a relative pronoun that restricts and, therefore, modifies, [a] preceding noun[.]"); *see also Carondelet Canal & Nav. Co. v. Louisiana*, 233 U.S. 362, 382 (1914) ("The natural and grammatical use of a relative pronoun is to put it in close relation with its antecedent, its purpose being to connect the antecedent with a descriptive phrase.").

[61] 2005 Adopting Release at 11 n.20.

[62] *Buffalo Marine Servs. Inc. v. United States*, 663 F.3d 750, 755 (5th Cir. 2011); *see New York v. EPA*, 443 F.3d 880, 889 (D.C. Cir. 2006) ("[T]he word 'any' indicates the intent to cover all of the ordinary meanings of the phrase" that follows it.); *see also Regions Bank v. Legal Outsource PA*, 936 F.3d 1184, 1194 (11th Cir. 2019) ("[T]he word 'any' without language limiting the breadth of that word, . . . means all." (citation and quotation marks omitted)); *e.g.*, *Ali v. Fed. Bureau of Prisons*, 552 U.S. 214, 220 (2008) ("Congress' use of 'any' to modify 'other law enforcement officer' is most naturally read to mean law enforcement officers of whatever kind.").

practices, and varied roles and assignments for certain personnel.[63] The Board also points out that Sarbanes-Oxley does not restrict the Board's authority to investigate and discipline individuals for violative conduct based on the particular registered firm or firms of which they are associated persons.[64]

The Board further notes that although it is proposing to change which *registered firms* can be the primary violator for purposes of Rule 3502, contributory liability under Rule 3502 remains distinct from liability for contributing to a primary violation by another *individual*, which the Board's rules currently do not contemplate and which the Board is not proposing at this time. Thus, under the proposal, an associated person would not violate Rule 3502 by negligently contributing to another associated person's violation of an applicable standard.[65]

However, consistent with the meaning of "directly and substantially," an associated person could be liable under proposed Rule 3502 for conduct that contributes to another person's act or omission that in turn also contributes to a violation by a registered firm if the Board were to find that the associated person's conduct nonetheless "directly and substantially" contributed to the firm's violation, notwithstanding the intervening actor's conduct (which may or may not be violative, including of Rule 3502).[66]

Questions:

10. Is the proposed substitution of "any" in place of "that" in Rule 3502 (as seen in Appendix A) clear, understandable, and appropriate?

11. Should the Board expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons (i.e., not just by any registered firm)? If so, what (if any) limits or conditions should the Board place on such secondary liability?

12. Are there scenarios where an associated person's conduct might contribute to another individual's primary violation but the conduct would be outside the

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[63] *See supra* pages 9-10.

[64] *See, e.g.*, Sections 101(c)(4), 101(c)(6), 105(a), 105(b)(1), 105(b)(3)(A), 105(c)(1) & 105(c)(4) of Sarbanes-Oxley.

[65] However, two or more associated persons may be liable under the proposed rule for contributing to the same primary violation, including where one of them acts or fails to act in a manner that causes the other to directly and substantially contribute to the primary violation.

[66] *See* 2005 Adopting Release at 13 ("'Directly and substantially' does not mean that the associated person's conduct must be the *sole cause* of the violation, nor that it must be the *final step in a chain of actions* leading to the violation." (emphases added)); *id.* ("[T]he term 'directly' should not be misunderstood to excuse someone who knowingly or recklessly engages in conduct that substantially contributes to a violation, *just because others also contributed to the violation* . . . ." (emphasis added)).

scope of any Board standard or rule (current or proposed), including the current and proposed versions of Rule 3502? If so, what are the scenarios?

IV. ECONOMIC CONSIDERATIONS

The Board is mindful of the economic impacts of its rulemaking. This section discusses economic considerations related to the proposed amendments, including a description of the baseline, the need for rulemaking, the economic impacts and potential unintended consequences, and the alternatives considered. Because there are limited data and research findings available to quantify the economic impacts of the proposed amendments, the economic analysis is largely qualitative; however, where reasonable and feasible, the analysis incorporates quantitative information, including PCAOB enforcement data.

A. Baseline

Section II above describes important components of the baseline against which the proposed amendments' economic impacts are considered, including the current formulation of Rule 3502 and the Board's implementation experience. We discuss below additional data on the Board's enforcement activities.

Table 1 presents Board enforcement data on Rule 3502 charges for 2009-2022.[67] Column A shows the number of cases in which associated persons were found to have violated Rule 3502, column B shows the number of cases in which registered firms were sanctioned (for any violation), and column C is the ratio of the two, expressed as a percentage to reflect the proportion of times when a Rule 3502 charge could be considered by the Board because there was a sanction of the firm. As seen, there have been a total of 87 Rule 3502 cases in 14 years. At an average of six per year, the number of cases was highest in 2015 at 17 and lowest in 2010, when no Rule 3502 violations were found.[68] The 87 cases represent 36 percent of the total number of cases in which firms were charged by the Board with violations from 2009-2022. Although this data does not predict how many Rule 3502 violations the Board might find if Rule 3502 were amended as proposed, the data indicates that in nearly two-thirds of cases in which a firm was charged with a violation, no contributory actor was held accountable under Rule 3502.

[67] The Board brought the first Rule 3502 charge in 2009 for conduct committed after the effective date of Rule 3502 in April 2006.

[68] Column A reflects Rule 3502 cases involving sanctions of one or more respondents as one instance. Some firm violations were charged in different years than the Rule 3502 violations by the associated persons.

Table 1. Number and Incidence of Rule 3502 Charges, 2009-2022

	Cases with Rule 3502 Charges (A)	Firms Sanctioned (B)	Incidence of Rule 3502 Charges C = A / B
2009	2	5	40%
2010	0	2	0%
2011	2	6	33%
2012	3	4	75%
2013	5	10	50%
2014	2	20	10%
2015	17	37	46%
2016	14	30	47%
2017	15	42	36%
2018	8	13	62%
2019	8	19	42%
2020	2	13	15%
2021	3	14	21%
2022	6	30	20%
Total	**87**	**245**	**36%**

B. Need

This section discusses the problems the proposed amendments are intended to address and how they are expected to address them.

1. Problems to Be Addressed

In its current form, Rule 3502 creates two distinct misalignments between the Board's ability to hold accountable persons who contribute to registered firms' violations and the real-world ways in which individuals carry out their responsibilities vis-à-vis registered firms.

First, there is a mismatch between individuals' and firms' respective minimum culpability levels, which limits the Board's ability to hold accountable individuals who contribute to a firm's violation by failing to act reasonably. Specifically, the current rule's recklessness standard for imposing liability on an individual who contributes to a registered firm's violation is a more stringent liability standard than the negligence standard for the primary violation. But a legal entity can act only through natural persons, which suggests that the standards for liability should be aligned. Individuals are also expected to act with due care with respect to their primary responsibilities under PCAOB standards and rules, which fails to align with the current recklessness standard of Rule 3502.

Second, although rare, there is the potential for a mismatch to the extent that two people who similarly contribute to a registered firm's primary violation might face different consequences solely by virtue of their "associated person" status with respect to that firm. The possibility that Rule 3502's current formulation could result in differing liabilities creates a risk of reduced individual auditor accountability, potentially diminishing investor protection and the public interest.

As discussed in Section III above, however, the Commission has the authority to discipline an individual for causing a registered public accounting firm to commit a violation, including when the individual acts negligently or is not an associated person of the firm that commits the violation. Accordingly, the purpose is not to cause associated persons for the first time to feel as if they could be subject to liability (i.e., to impose liability for conduct that currently is not subject to enforcement). Rather, the purpose is narrower: to provide the PCAOB with jurisdiction over these matters so that individuals can be brought to account regardless of the resource allocation decisions that result in particular issuer or broker-dealer audit cases being brought by the Commission or by the PCAOB pursuant to the PCAOB's concurrent jurisdiction with the Commission.

2. How the Proposed Amendments Address the Need

The proposed amendments seek to promote investor protection and the public interest by changing Rule 3502 in two ways.

First, the proposed amendments would change the liability standard from recklessness to negligence. Doing so would allow the Board to hold individuals accountable when they contribute to a firm's violation if their contributory act or failure to act was negligent but not reckless.

Second, the proposed amendments would provide that the individual contributing to a violation need not be an associated person of the firm that commits the primary violation. Under this proposed amendment, so long as the person contributing to a registered firm's primary violation is an associated person of *any* registered firm, the person could be subject to liability under Rule 3502.

C. Economic Impacts

This section discusses the expected benefits and costs of the proposed amendments and potential unintended consequences. Overall, we expect that the economic impacts of the proposal will be modest, particularly given that the Commission's framework for imposing sanctions against persons who cause others' primary violations does not include either of the attributes of current Rule 3502 that are the subject of this proposal.

However, to the extent that individuals are not acting reasonably today because a gap between the Commission's and the PCAOB's respective frameworks creates a possibility that the

conduct would elude enforcement were the matter to be investigated by only the PCAOB, eliminating the inconsistencies would increase the probability of sanction. As firms act through individuals, an increase in the quality of individual performance should improve the firm's audit quality. The proposed amendments, by increasing the likelihood that individuals take more seriously their audit, quality control, and other compliance responsibilities, will make it more likely for registered firms to comply with PCAOB standards. Improved compliance with the standards promotes audit quality and protects the interests of investors.

The proposed amendments will impose certain additional costs on firms as potential misconduct is investigated and to defend against charges.[69] And they may impose certain unintended consequences to the extent that persons react inefficiently to the increase in the threat of sanction. We expect the proposed amendments' benefits will justify the costs and any unintended adverse effects.

1. Benefits

Enabling the PCAOB to enforce Rule 3502 in both situations identified in the Need section above will generate certain benefits.

Academic literature suggests that litigation risk and legal liability are important factors affecting audit quality. Studies provide empirical evidence that litigation risk against auditors improves audit quality as auditors become more careful about their work.[70] The studies do not, however, address whether the relationship is linear.[71] Imposing liability against individuals who contribute to a firm's violation provides additional deterrence against misconduct as compared with a regime where authorities are only able to sanction the firm and then rely on the firm potentially imposing private sanctions on culpable individuals; public authorities' sanctioning

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[69] We do not separately account for any incremental costs that may be incurred by firms or associated persons to ensure, in light of the proposed amendments to Rule 3502, that associated persons do not act negligently in ways that contribute to firms' violations. Those costs are properly costs of complying with the primary rules, which generally assume full compliance at a reasonable level of care. However, we acknowledge their existence.

[70] *See, e.g.*, Clive Lennox & Bing Li, *Accounting Misstatements Following Lawsuits Against Auditors*, 57 J. ACCT. & ECON. 58-75 (2014); Baolei Qi, Liuchuang Li, Ashok Robin & Rong Yang, *Can Enforcement Actions on Engagement Auditors Improve Audit Quality?*, Accounting and Business Research (2015), SSRN 2549041; Ramgopal Venkataraman, Joseph Weber & Michael Willenborg, *Litigation Risk, Audit Quality, and Audit Fees: Evidence from Initial Public Offerings*, 83 ACCT. REV. 1315-1345 (2008); Jerry Sun, Steven Cahan & Jing Xu, *Individual Auditor Conservatism After CSRC Sanctions*, 136 J. BUS. ETHICS 133-46 (2016).

[71] Excessive litigation risk might bring declining returns or even harm audit quality. We discuss this potential effect in Section IV.C.3 below.

tools (e.g., public censure, fines, associational prohibitions) may more effectively deter future misconduct.[72]

Under the proposed rule, the increase in litigation and liability risk would be modest, but meaningful. Currently, individuals may act inappropriately if they discount the likelihood of public sanction because the PCAOB lacks the ability to bring charges for merely negligent contributory conduct or contributory conduct by someone who is not an associated person of the registered firm committing the primary violation (although they may not avoid private sanction by their firm or sanction by the SEC). The proposed amendments would provide enhanced incentives for individuals to perform important roles at a reasonable person level of care, as individuals could be subject to sanction regardless of whether the Commission or the PCAOB pursues their conduct.

To the extent that individuals may perceive greater litigation risk and therefore change their behavior and take their audit, quality control, or other compliance responsibilities more seriously by ensuring that their actions are objectively reasonable under the circumstances, registered firms in turn will be more likely to comply with their respective legal requirements (which will reduce firms' legal risks). These legal requirements—e.g., audit standards, quality control standards, and ethics and independence standards—were enacted to promote audit

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[72] *See, e.g.*, John T. Scholz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 L. & CONTEMP. PROBS. 253, 265 (1997). Scholz states:

> When corporations have the means of punishing subordinates for illegal behavior, punishing the corporation rather than individuals responsible for wrongdoing may serve to strengthen the corporation's private enforcement system. Criminal prosecution of individuals will be necessary, however, whenever the potential gains to the individual from illegal behavior far exceed the worst punishment the firm could impose.

Here, a firm may expel a partner, but such action is unlikely to be public (e.g., a private settlement may contain nondisclosure and antidisparagement clauses) and thereby is less likely to be an effective deterrent to associated persons of other firms as compared to a public sanction. Similarly, a firm may be able to inflict a private financial penalty (e.g., through a claw-back or forfeiture of paid-in capital or deferred compensation). Still, a firm may not have effective provisions in its partnership agreements or may view enforcing those clauses as uneconomical if forced to litigate them as a contractual dispute. These tools therefore may be less effective than an enforceable public civil penalty, which can be set in an amount appropriate to protect the public interest. Additionally, in the absence of a noncompete agreement, a firm cannot prevent that partner from associating with a different registered public accounting firm and performing issuer or broker-dealer audit work or becoming employed by an issuer or broker-dealer in a financial-management capacity; by contrast, a PCAOB sanction may do so. *See* Section 105(c)(7) of Sarbanes-Oxley. Lastly, a firm cannot suspend an individual's CPA license, but a PCAOB sanction can lead to collateral consequences with relevant state accountancy authorities. *See, e.g.*, N.Y. State Rules of the Board of Regents § 29.10(f); *see also* Section 105(d)(1) of Sarbanes-Oxley (requiring the Board to report disciplinary sanctions it imposes to, among others, "any appropriate State regulatory authority or any foreign accountancy licensing board with which [a sanctioned] firm or person is licensed or certified").

quality and the interests of investors. Better compliance with these requirements therefore will promote audit quality and protect the interests of investors.[73]

The proposed amendments also are expected to generate efficiencies in enforcement activities. The efficiencies are attained by enabling the PCAOB to bring negligence-based cases against firms and the relevant associated persons, rather than perpetuating the status quo in which only the Commission can bring such cases.

An additional benefit of the proposed amendments is that they address the potential absence of coordination among audit firms. Currently, individual firms may recognize the advantages of giving their personnel sufficient staffing and resources to exert greater effort (e.g., through staffing or otherwise resourcing quality control systems more robustly). However, they may hesitate because of the fear of a competitive disadvantage. This is because they might incur higher costs than rivals who operate with fewer resources, counting on the idea that their staff would not view the risk of detection and penalty as sufficiently high to either demand more resources or resign.

The proposed rule would apply across the board and level the playing field: To the extent that firms would prefer not to invest in sufficient staffing and resources are compelled by their associated persons' enhanced possibility of sanctions to make additional investments, firms that would prefer to make such investments absent competitive pressures would be freed to do so voluntarily, thereby promoting elevated standards among all firms. This collective uplift mitigates any single firm's competitive concerns and promotes broader societal benefits by fostering a more robust and reliable audit environment.

From a capital market perspective, improvements in audit quality would enhance investors' confidence in the information provided in companies' financial statements. This, in turn, can increase the efficiency of capital allocation decisions. As perceived risk in capital markets decreases due to enhanced audit quality, the supply of capital increases, leading to both an increase in capital formation and a reduction in the cost of capital to companies.[74] This increase in capital supply, coupled with reduced costs, can elevate the overall market valuation and create wealth for investors. Even when no additional capital is reallocated to companies, the reduced cost of capital inherently boosts the value of existing investments, thus benefiting companies and their shareholders. Finally, research has found a direct association between

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[73] Quality control systems play a fundamental and widespread role in overall audit quality. These systems are essential in ensuring the audit process adheres to professional standards. A robust quality control system can help firms to detect and address factors that compromise audit quality.

[74] *See*, *e.g.*, Hanwen Chen, Jeff Zeyun Chen, Gerald J. Lobo & Yanyan Wang, *Effects of Audit Quality on Earnings Management and Cost of Equity Capital: Evidence from China*, 28 CONTEMP. ACCT. RES. 892, 921 (2011); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. ACCT. RES. 385, 387 (2007); William Robert Scott & Patricia C. O'Brien, *Financial Accounting Theory* 412 (Prentice Hall 3d ed. 2003).

auditors' compliance with PCAOB standards and capital market efficiency,[75] indicating that the proposed amendments should have an incremental positive effect on capital market efficiency.

2. Costs

The proposed amendments are expected to result in increased costs.

In most cases, we expect that the costs of defending associated persons will be borne by the registered firm whose violation the associated person is alleged to have contributed to through indemnification agreements or otherwise. Direct costs include increased hours and resources (including attorneys, experts, and other personnel) to prepare for, respond to, and defend against investigations and charges—actual or anticipated. There may also be opportunity costs, as individuals are distracted from their normal responsibilities by the enforcement action.

The additional costs can be grouped into two categories based on the stage of the matter:

- First, during the investigative stage, Board staff works to determine whether a primary violation occurred and if so whether an individual contributed to that violation. Because that inquiry is conducted today (albeit with an objective of determining whether someone acted recklessly rather than negligently), we believe that the incremental cost of increased resources at the investigative stage would not be significant.

- Second, once Board staff were to preliminarily determine that an individual acted negligently and notify a potential respondent of that determination, the direct costs of the proposed amendments would increase more significantly. Staff lacks the data sufficient to form an estimate of the costs of each matter because the costs depend on numerous factors, including the duration of the matter,[76] the complexity of the matter (e.g., a complex audit case versus a simpler case of noncompliance with PCAOB filing requirements, the extent of expert testimony), the number and nature of counsel retained, and so forth.

While we could not estimate the per-case cost, we endeavored to estimate how many additional cases may result from the proposed amendments to give a sense of the magnitude of these costs. Board staff examined enforcement matters from the year 2022 to assess the

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[75] *See, e.g.*, Nemit Shroff, *Real Effects of PCAOB International Inspections*, 95 ACCT. REV. 399-433 (2020).

[76] As set out in the PCAOB rules, a PCAOB enforcement case has numerous stages where the proceedings might halt. For example, a persuasive Rule 5109(d) submission may convince the staff not to recommend proceedings; the Board may determine not to institute proceedings under Rule 5200; the Hearing Officer might dismiss the matter; the matter might end with a Hearing Officer initial decision; or the initial decision might be appealed to the Board, the SEC, or beyond. The lengthier the litigation, the greater the costs (primarily lawyer or expert witness fees, but also opportunity costs).

potential increase in recommended cases had Rule 3502 included a negligence standard. Staff estimates two to three instances in 2022 where an amended Rule 3502 would have prompted staff to recommend a Rule 3502 charge.[77] Based on experience, staff also estimates that this number is likely a fair average representation across other years and provides an estimate of the additional cases that would result from the Board pursuing charges under the proposed amendment to the liability standard. However, this estimate may vary to the extent that there are modifications in other Board standards (e.g., adopting and implementing a new quality control standard) or changes in enforcement priorities.

While the relatively small number of incremental cases may limit the aggregate amount of the costs of the proposed amendments, these costs could nonetheless be substantial to the firms and individuals involved. We also acknowledge that the costs may have more impact on smaller firms where the direct costs and distractions are less absorbable by the firms' other activities or personnel. Relatedly, the proposed amendments could result in fee increases to cover probable future litigation losses to the extent that firms pass on some of the costs to their audit clients. Several academic studies find that higher litigation exposure for auditors is associated with higher audit fees,[78] and any such audit fee increases are ultimately borne by investors.

Indirect costs of the proposed amendments could result as individuals adjust their behavior and put forth additional effort to ensure that they are not contributing to any registered firm's violation through their negligence. However, to the extent that these costs are incurred to bring previously negligent conduct up to a level of due care, these costs are properly allocable to the underlying law, rule, or standard that the firm is alleged to have violated, as those provisions each assumes a level of costs necessary for the firm to comply. But because we acknowledge all the costs that may reasonably flow from the proposed amendment, we mention these costs here.

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[77] The estimate reflects both aspects of the proposal and is an estimate of cases in which staff likely would have recommended charges against natural persons only. To be sure, because Rule 3502 charges can be brought against associated persons, which includes both natural persons and legal entities, it is possible that the estimate could be higher if it were to include potential additional cases against legal entities. Due to the complexity of the fact patterns that might be involved in such cases, however, Board staff was unable to estimate the number of additional cases that likely would have been brought against such entities.

[78] Fee increases are a transfer payment or distributional impact from audit clients to audit firms. Academic studies address the empirical relationship between audit fees and liability regime. *See, e.g.*, Venkataraman et al., *Litigation Risk, Audit Quality, and Audit Fees* 1315-1345; Ananth Seetharaman, Ferdinand Gul & Stephen Lynn, *Litigation Risk and Audit Fees: Evidence from UK Firms Cross-Listed on U.S. Markets*, 33 J. ACCT. & ECON. 91-115 (2002); Henock Louis, Thomas Pearson, Dahlia Robinson, Michael Robinson & Amy Sun, *The Effects of the Extant Clauses Limiting Auditor Liability on Audit Fees and Overall Reporting Quality*, 16 J. EMPIRICAL LEGAL STUDIES 381-410 (2019).

3. Potential Unintended Consequences

In addition to the benefits and costs, the proposed amendments could have unintended economic impacts. The following discussion describes potential unintended consequences we considered and, where applicable, factors that mitigate the adverse effects, such as steps we have taken or the existence of countervailing forces.

i. Self-Protective Behavior

While the threat of litigation can motivate individuals to act in a manner consistent with their legal obligations, it can also result in excessive monitoring and self-protective behavior, leading to an inefficient allocation of time and resources. The effect on audit quality may change as the degree of intervention increases. Individuals may spend more time on a task than is necessary to accomplish it at the appropriate level of due care. Similarly, individuals may excessively document the nature of their task performance to demonstrate compliance in a future proceeding. Time spent on unproductive, self-protective activities may detract from other important obligations and directly impact audit quality.

While we acknowledge the potential unintended consequences of these self-protective activities, compliance with documentation requirements in applicable professional standards should sufficiently demonstrate compliance if challenged, limiting additional unproductive documentation. In addition, the possibility of self-protective behavior is already largely present. As discussed in the Economic Impacts section above, the Commission currently can bring enforcement actions against individuals for negligent contributory conduct (and without regard to the formal relationship between the contributory actor and the primary violator), so the potential for litigation (and sanctions) already exists.

ii. Lack of Available Personnel or Compensation Enhancements

Excessive litigation risk could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals. Alternatively, auditors may seek to offset the increased legal risk by demanding higher compensation for taking certain roles or responsibilities, which could have downstream effects on audit fees.

While we acknowledge these potential outcomes, we are not proposing a novel burden on individuals to refrain from acting negligently and thereby contributing to a firm's violation; instead, we are merely providing a mechanism for the PCAOB to discipline individuals who fail to reach that standard. The effect is, therefore, the incremental probability of PCAOB enforcement. However, this increase is not so novel and significant that it would be expected to impact noticeably the market for associated persons' services.

iii. Reduced Competition in the Audit Market

The proposed amendments to Rule 3502 could disproportionately impact small- and medium-sized firms if they are less able to bear the costs of defending their personnel. As discussed in Section IV.C.2, these costs include indemnification expenses (including attorney fees) to defend associated persons against charges and distracting personnel from generating income from the performance of services. In an extreme case, a firm might not be able to sustain its practice considering the negative impact, while more broadly, less profitable firms may perceive that the risk of such costs is too significant compared to their existing net profit from issuer and broker-dealer audit work and, therefore, decide to exit those markets. This result could further consolidate the market for issuer and broker-dealer audit services.

The likelihood that defense costs would cause substantial changes in the relevant markets is lowered by two factors. First, a firm already may be defending against an allegation of negligent primary conduct (brought using the PCAOB's current authority), such that, in any additional cases brought under the proposed rule, defending individuals facing contributory charges likely would involve common sets of facts and legal theories and could be done more efficiently (i.e., at lower additional cost) as compared to a wholly novel proceeding. Second, the Commission's existing authority to sanction associated persons for negligent contributory conduct means that firms' profitability calculations already should factor in the risk of defending personnel against such charges. Thus, the incremental cost of defending an individual, in addition to the firm's defense, might not be as significant as it appears at first glance.

Questions:

13. Are there other benefits and costs of the amendments that the Board should consider?

14. Are there any data sources that could provide a quantitative estimation of the expected benefits and costs? If so, please provide the names of such sources.

15. Are there other academic studies that would inform our analysis of the expected economic impacts of the proposed amendments? If so, please provide citations for the studies.

16. Are there additional unintended consequences that might result from the proposed amendments?

17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

D. Alternatives Considered

The Board considered two alternatives to the proposed amendments, discussed below. However, the Board believes that the proposed amendments strike a better balance of benefits and costs.

1. Alternative Articulations of the Standard of Liability

Rather than making the more modest amendments to the rule text that the Board is proposing, we considered rewriting Rule 3502 to mirror the language in the cease-and-desist provisions of the Exchange Act, 15 U.S.C. § 78u-3(a).

The primary benefit of such an approach would be to facilitate interpretive alignment with the scope of the Commission's causing-liability regime, which may provide associated persons with more clarity on the nature of the legal risk. However, for more than a dozen years, the Board has developed a distinguishable body of practice under Rule 3502 through its enforcement program—including via the rule-based requirement that any contribution to a primary violation be "direct[ ] and substantial[ ]"—and the proposed approach would maintain that familiar practice while narrowly adjusting only the standard of liability and the association requirement.

2. Removing Additional Barriers to Contributory Liability

We also considered an alternative to expand further the Board's ability to hold persons liable for contributing to firm violations by changing the "directly and substantially" modifier that describes the relationship of an associated person's contribution to a firm's primary violation, including by removing it altogether. This is currently an element of proof required for the Board to find a violation of Rule 3502.

Removing "directly and substantially" would enable the Board to use proposed Rule 3502 to hold accountable any individual who took part in any way in the chain of events leading to a firm's violation, even if only remotely. The relationship between the contributory conduct and the primary violation could be a discretionary factor to consider in bringing a proceeding in the first instance and when determining the appropriate sanction.

This alternative could improve audit quality by ensuring that all persons with relevant professional responsibilities are appropriately motivated to perform their responsibilities with due care. However, it could exacerbate the costs and unintended consequences discussed above in conjunction with the proposed amendments. Therefore, we are concerned that this alternative might tip the balance too far and lead to excessive motivation for auditors to increase defensive efforts that do not contribute to audit quality (e.g., excessive self-protective measures in anticipation of future litigation).

The proposal maintains the criteria of nexus and magnitude ("directly and substantially") for an associated person's contribution. We believe that these requirements appropriately specify the conduct that the Board considers to be actionable for purposes of "contributing" to a primary violation, as outlined above.[79] This approach tailors the incentives and potential unintended consequences to individuals with the most direct responsibility for firm compliance. In other words, the proposed amendments continue to focus on individuals most likely influenced by increased litigation risk, leading to improved firm compliance and audit quality. Conversely, individuals who are less involved would experience lower benefits in relation to costs and unintended consequences.

Questions:

18. Are there additional economic impacts or considerations associated with the two regulatory alternatives discussed above that should be considered? If so, what are those considerations?

19. Are there other regulatory alternatives the Board should consider? If so, what are they?

20. Are other regulatory alternatives preferable to the proposed amendments? If so, please explain the reasons.

V. SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES

The proposed amendments do not impose any additional requirements on emerging growth company (EGC) audits. Accordingly, the Board believes that Section 103(a)(3)(C) of Sarbanes-Oxley does not apply. Nevertheless, we are including this analysis to inform the rulemaking. The discussion of benefits, costs, and unintended consequences in Section IV.C generally applies to audits of EGCs.

Under Section 104 of the Jumpstart Our Business Startups Act (JOBS Act), rules adopted by the Board subsequent to April 5, 2012, generally do not apply to the audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act, unless the Commission "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[80] As a result of the JOBS Act, the rules and related

[79] *See supra* pages 14-15.

[80] *See* Pub. L. No. 112-106 (Apr. 5, 2012). Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act, also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and

amendments to PCAOB standards that the Board adopts are generally subject to a separate determination by the Commission regarding their applicability to audits of EGCs.

To inform consideration of the application of auditing standards to audits of EGCs, Board staff prepares a white paper annually that provides general information about the characteristics of EGCs.[81] As of November 15, 2021, PCAOB staff identified 3,092 companies that self-identified with the Commission as EGCs and filed audited financial statements in the 18 months preceding that date.

EGCs are likely to be newer companies, which may increase the importance to investors of the external audit to enhance the credibility of management disclosures. All else equal, the benefits of the higher audit quality resulting from the proposed amendments may be more significant for EGCs than for non-EGCs, including improved efficiency of capital allocation, lower cost of capital, and enhanced capital formation. In particular, by increasing the likelihood that associated persons are held accountable for their roles in audit violations, proposed Rule 3502 aims to bolster investor confidence in the audit process. Because investors who lack confidence in a company's financial statements may require a larger risk premium that increases the cost of capital to companies, the improved audit quality resulting from applying the proposed amendments to EGC audits could reduce the cost of capital to those EGCs.[82] While the associated costs may also be higher for EGC audits than for non-EGC audits, they are unlikely to be disproportionate to the benefits because, as discussed in Section IV.C.2, the costs are expected to be relatively small.

The proposal could impact competition in an EGC product market if the costs of the proposed amendments disproportionately affect the EGCs relative to their competitors. However, as discussed above, the costs associated with the proposed amendments are expected to be relatively small, particularly given the Commission's existing authority to sanction associated persons. Therefore, the impact of the proposed amendments on competition, if any, is expected to be limited.

Overall, the proposed amendments are expected to enhance audit quality and contribute to an increase in the credibility of financial reporting by EGCs, thereby fostering efficiency. Accordingly, and for the reasons explained above, the Board believes that if it adopts the proposed amendments, it will request that the Commission determine, to the extent

analysis) do not apply to an audit of an EGC. The new proposed standard falls outside these two categories.

[81] For the most recent EGC report, see *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2021* (Jan. 5, 2023), *available at* https://pcaobus.org/resources/other-research-projects.

[82] For a discussion of how increasing reliable public information about a company can reduce risk premiums, see David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1578 (2004).

that Section 103(a)(3)(C) of the Act applies, that it is necessary or appropriate in the public interest after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the proposed amendments to audits of EGCs.

Questions:

21. What impact would the proposal have on EGCs, and how would this affect efficiency, competition, and capital formation?

22. Would the economic impacts be different for smaller firms or EGCs? If so, how?

23. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made to make the proposal appropriate for EGCs?

VI. EFFECTIVE DATE

If the proposed amendments to PCAOB Rule 3502 are adopted by the Board and approved by the Commission, the Board envisions that the proposed amendments would become effective sixty days from the date of Commission approval. In that regard, the Board anticipates that conduct occurring more than sixty days after Commission approval would be subject to Rule 3502, as amended, but that conduct occurring within sixty days after Commission approval would not be subject to the amendments to Rule 3502. The Board believes that the sixty-day delay in the amendments taking effect is appropriate to allow associated persons to ensure that their conduct conforms to the applicable legal standards and to increase their diligence as necessary and appropriate, which enhances audit quality and therefore serves the interests of the public and better protects investors.

Question:

24. Is the proposed effective date (sixty days after Commission approval) appropriate? If not, what would be an appropriate effective date for the proposed amendments?

VII. OPPORTUNITY FOR PUBLIC COMMENT

The Board is seeking comments on all aspects of its proposal, including in response to the specific questions presented above in Sections II through VI, which are reproduced below:

1. Are the regulatory concerns discussed above clear and understandable?

2. Are there other regulatory concerns related to the current formulation of Rule 3502? If so, what are they and how should the Board address them, if at all?

3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms?

4. Are there common types of cases or fact patterns not discussed above in which a negligent standard of liability would be particularly useful to promote greater individual accountability under Rule 3502?

5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors?

6. Beyond the dual purposes of deterrence and accountability, are there other ways that the proposed amendments would protect investors?

7. Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate?

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?

9. Are there other phrases or terms that the Board should consider to modify "contribute," or other limitations that the Board should incorporate into the proposed rule? If so, what are they?

10. Is the proposed substitution of "any" in place of "that" in Rule 3502 (as seen in Appendix A) clear, understandable, and appropriate?

11. Should the Board expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons (i.e., not just by any registered firm)? If so, what (if any) limits or conditions should the Board place on such secondary liability?

12. Are there scenarios where an associated person's conduct might contribute to another individual's primary violation but the conduct would be outside the scope of any Board standard or rule (current or proposed), including the current and proposed versions of Rule 3502? If so, what are the scenarios?

13. Are there other benefits and costs of the amendments that the Board should consider?

14. Are there any data sources that could provide a quantitative estimation of the expected benefits and costs? If so, please provide the names of such sources.

15. Are there other academic studies that would inform our analysis of the expected economic impacts of the proposed amendments? If so, please provide citations for the studies.

16. Are there additional unintended consequences that might result from the proposed amendments?

17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

18. Are there additional economic impacts or considerations associated with the two regulatory alternatives discussed above that should be considered? If so, what are those considerations?

19. Are there other regulatory alternatives the Board should consider? If so, what are they?

20. Are other regulatory alternatives preferable to the proposed amendments? If so, please explain the reasons.

21. What impact would the proposal have on EGCs, and how would this affect efficiency, competition, and capital formation?

22. Would the economic impacts be different for smaller firms or EGCs? If so, how?

23. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made to make the proposal appropriate for EGCs?

24. Is the proposed effective date (sixty days after Commission approval) appropriate? If not, what would be an appropriate effective date for the proposed amendments?

Comments may be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. Comments also may be submitted to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 053 in the subject or reference line and should be received by the Board by November 3, 2023.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any such final rules adopted will be submitted to the Commission for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take effect unless approved by the Commission.

* * *

On the 19th day of September, in the year 2023, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

September 19, 2023

Appendix—Amendments to Board Rules

The proposed amendments to PCAOB Rule 3502 are set forth below. Language that would be deleted by the amendments is struck through; language that would be added is underlined.

RULES OF THE BOARD

SECTION 3. Auditing and Related Professional Practice Standards

* * * *

Rule 3502. Responsibility Not to ~~Knowingly or Recklessly~~ Contribute to Violations.

A person associated with a registered public accounting firm shall not ~~take or omit to take an action knowing, or recklessly not knowing, that the act or omission would~~ directly and substantially contribute to a violation by ~~that~~ any registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, by an act or omission that the person knew or should have known would contribute to such violation.

* * * *

PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Exhibit 2(a)(B)

Alphabetical List of Commenters on Proposed Rules in PCAOB Release No. 2023-007	
1	Baker Tilly US, LLP
2	BDO USA, P.A.
3	Better Markets, Inc.
4	Nathan Cannon, Associate Professor, Texas State University; Melissa Carlisle, Assistant Professor, Case Western Reserve University; Brant Christensen, Associate Professor, Brigham Young University; et al.
5	Center for American Progress
6	Center for Audit Quality
7	Chamber of Digital Commerce
8	Council of Institutional Investors
9	Crowe LLP
10	Deloitte & Touche LLP
11	Ernst & Young LLP
12	Florida Institute of Certified Public Accountants
13	Grant Thornton LLP
14	Illinois CPA Society
15	Johnson Global Accountancy
16	KPMG LLP
17	Mazars USA LLP
18	Members of the Investor Advisory Group
19	Moss Adams LLP
20	National Association of State Boards of Accountancy
21	North American Securities Administrators Association, Inc.
22	Pennsylvania Institute of Certified Public Accountants

Alphabetical List of Commenters on Proposed Rules in PCAOB Release No. 2023-007	
23	Plante & Moran, PLLC; Plante Moran, PC
24	PricewaterhouseCoopers LLP
25	RSM US LLP
26	Thomas H. Spitters, C.P.A.
27	U.S. Chamber of Commerce, Center for Capital Markets Competitiveness

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November 2, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via e-mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 053

To the Office of the Secretary:

Baker Tilly US, LLP ("Baker Tilly" or "we") appreciates the opportunity to provide comment on *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (the "Proposal"), issued by the Public Company Accounting Oversight Board ("PCAOB" or the "Board") on September 19, 2023.[1]

Baker Tilly is committed to providing the highest quality audits for our clients and for investors, and we acknowledge the role of enforcement proceedings in promoting audit quality. High quality audits require auditors to act with due professional care and, on a daily basis, to exercise significant professional judgment. Because an auditor's judgment is integral to the performance of quality audits, we are concerned that the Proposal's shift to a negligence standard for individual conduct could unfairly punish professionals who, acting in good faith, made difficult judgment calls in technical, complex audits that, in hindsight, turned out to be incorrect.

Rule 3502 was adopted in 2005 as part of a rulemaking effort specifically "designed to address certain concerns related to auditor independence when auditors become involved in marketing or otherwise opining in favor of aggressive tax shelter schemes or in selling personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients."[2]

At the time, the Board considered a negligence standard for Rule 3502, but ultimately chose to adopt recklessness standard instead, explaining that "[t]he Board does not seek to create through this rule a vehicle

[1] In addition to the views stated herein, Baker Tilly also shares the views expressed in the Center for Audit Quality's public comment letter in this matter.

[2] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-020, at 14 (Nov. 22, 2005), available at: https://pcaobus.org/Rulemaking/ Docket017/2005-11-22_Release_2005-020.pdf

to pursue compliance personnel who act in an appropriate, reasonable manner, that in hindsight, turns out to have not been successful."[3]

We are concerned that, under the Proposal, Rule 3502 could become exactly that: a vehicle to pursue individual disciplinary action against auditors and other firm personnel who exercised reasonable professional judgment in complex circumstances. As former Board member Duane DesParte noted, "If anything, audits have become more complex, involve greater judgment, and include more participants than in 2004 when Rule 3502 was first contemplated."[4] In that context, we believe that the Proposal would create an environment where both auditors and the firm professionals who work full time to enhance and ensure audit quality control will fear that the exercise of their best professional judgment could still be the end of their careers.

The risk of sanction for good faith errors has potentially enormous implications for the auditing profession more broadly. As the Board is aware, there has been a marked decline in the number of professionals in the accounting industry in recent years, a result of both lower numbers of people entering the profession and increasing numbers of people departing it.[5] Indeed, the current decline in new graduates will be compounded by the retirement of a substantial number of senior professionals in the coming years.[6]

The Proposal has the potential to create further downward pressure on the number of accountants in the profession by subjecting them to the risk of individual sanction anytime their judgment is determined, in hindsight, to have led to the wrong result, regardless of whether they knew or should have known their conduct would cause a violation of applicable rule and law. It seems highly likely that even more accountants will choose to opt out of public company audits, leave the profession, or never enter it at all because of the risk that the exercise of their best professional judgment, done in good faith, could be punished with sanctions that might devastate their reputation and their careers.

The Board's economic analysis identified this risk, noting that the Proposal "could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals."[7] As Board member Christina Ho noted, this risk is particularly high for more junior auditors, who might decide "to leave the public company auditing profession

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[3] *See Public Company Accounting Oversight Board; Notice of Filing of Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, S.E.C. Release No. 34-53427 (Mar. 7, 2006), available at: https://www.sec.gov/files/rules/pcaob/34-53427.pdf.

[4] DesParte, Duane M., *Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (Sept. 19, 2023), available at: https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability.

[5] *See e.g.*, Ellis, Lindsay, *Why So Many Accountants Are Quitting*, The Wall Street Journal (Dec. 28, 2022), available at: https://www.wsj.com/articles/why-so-many-accountants-are-quitting-11672236016?mod=article_inline; *2021 Trends: A report on accounting education, the CPA exam and public accounting firms' hiring of recent graduates*, AICPA, (Mar. 24, 2022), available at: https://www.aicpa-cima.com/professional-insights/download/2021-trends-report; Ho, Christina, *Technology and Talent - Audit Quality Challenges in the 21st Century* (Sept. 15, 2022), available at: https://pcaobus.org/news-events/speeches/speech-detail/ho-technology-and-talent-audit-quality-challenges-in-the-21st-century

[6] *See e.g.,* Mutoh, Anna, *Why Graduates Aren't Hot on Accounting Careers: Low Starting Pay, Onerous Testing*, The Wall Street Journal (May 12, 2023), available at: https://www.wsj.com/articles/why-graduates-arent-hot-on-accounting-careers-low-starting-pay-onerous-testing-c05bf267

[7] *Proposal* at 26.

altogether" rather than face disciplinary action, especially if Rule 3502 is enforced against junior auditors themselves.[8] In the long term, fewer auditors means less investor protection and, eventually, consolidation in the number of firms that provide public company audits and a functional limit on the number of public companies that can operate in the U.S.

We urge the Board not to adopt the Proposal.

Sincerely,

Baker Tilly US, LLP

Baker Tilly US, LLP

[8] Ho, Christina, *The Cost of Unintended Consequences: Accounting Talent, Audit Quality, Investor Protection* (Sept. 19, 2023), available at: https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability).

November 3, 2023

Via email: *comments@pcaobus.org*

Public Company Accounting Oversight Board
Attn: Office of the Secretary
1666 K Street NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 053

Dear Office of the Secretary:

BDO USA, P.C. (BDO USA) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) proposing Release No. 2023-007, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability (the Proposal).

BDO USA understands the critical role of independent auditors as gatekeepers to capital markets. We are committed to continuous improvement in the quality of our audits, and we recognize and support the mission of the PCAOB to protect investors by improving audit quality. We also fully support the PCAOB and other regulators holding accountable those accounting firms and professionals whose failure to adhere to the Board's rules and standards threatens the capital markets.

While we confirm our unequivocal commitment to protecting the interests of the investing public from auditors who engage in misconduct, we respectfully do not support the proposed amendments to PCAOB Rule 3502. We believe that existing Rule 3502 gives the PCAOB the tools and processes to improve audit quality by imposing disciplinary sanctions on those who violate applicable rules and standards. We further believe that the proposed revisions to Rule 3502 would, if enacted, have the significant risk of the unintended consequence of being a detriment to our collective mission to improve audit quality.

Our concerns are outlined below:

1. *A Single Simple Act of Negligence, Without More, Should Not Expose Professionals to Regulatory Discipline.* While not defined in detail, the Proposal implicitly includes the risk of severe career consequences for the lowest possible threshold for negligence – a single instance of the failure to exercise reasonable care or competence. We believe this low threshold could allow the Board unfettered discretion to impose sanctions whenever it finds that an associated person's single decision, including those in a highly judgmental area, is one with which the Board disagrees.

If negligence is the standard to be imposed, we believe the Board should qualify the definition of negligence to conform to SEC Rule 102(e), which clarifies that significantly more than a simple single act of negligence is required before severe consequences may be imposed.

Specifically, the SEC's rule for suspension and debarment defines negligent conduct in this context to mean:

> (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
>
> (2) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

SEC Rules of Practice, Rule 102(e)(iv).

This standard under the SEC's Rule 102(e) is also consistent with the provisions of the Sarbanes-Oxley Act that already limit the PCAOB's ability to impose more severe sanctions to those circumstances where there is

> (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or
>
> (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

Sarbanes Oxley Act, Section 105(c)(5).

2. *The Board's Cost/Benefit Analysis Is Not Sufficiently Thorough and Does Not Fully Consider Unintended Consequences.* We believe the cost/benefit analysis described in the Proposal does not fully consider the cost of imposing sanctions for a single act of negligence.

For example, the Board's analysis evaluates at length the percentage of cases where there was a charge against a firm but no charges against an individual and suggests this demonstrates gaps under existing Rule 3502. However, the Board does not give adequate consideration in its analysis to alternative facts and circumstances where sanctions against an individual would be inappropriate even under the proposed Rule 3502, or where the absence of charges was supported by the Board's exercise of prosecutorial discretion not to seek sanctions against individuals.

Additionally, the Proposal includes supposition that changes to Rule 3502 would result in only two or three additional enforcement cases annually. The absence of empirical data evaluating how many cases could have been brought under the proposed Rule 3502 as

compared with cases actually brought suggests that further analysis – particularly of unintended consequences of the proposed rule change - would be extremely valuable.

Further, we believe such a low threshold for regulatory sanctions could – and is likely to – result in "defensive auditing" where auditors move toward unduly conservative and unproductive judgments regarding the nature, timing and extent of audit procedures, and potentially leading to unduly conservative overall conclusions by auditors. The cost implications of such human nature reaction to a low standard of culpability for good faith errors in judgment have not been fully considered by the PCAOB in its Proposal.

3. *The Board's Intentions in Expanding the Language in Rule 3502 Should Be Clarified.* The Board's intentions are unclear in expanding the misconduct covered by Rule 3502 from the current standard (an associated person substantially contributing to a violation of the PCAOB's rules by his or her employer registered accounting firm – "that firm") to the proposed standard (an associated person substantially contributing to a violation of the PCAOB's rules by "any" registered accounting firm). This expanded language could be used by the PCAOB to pursue enforcement actions against junior auditors; or could be used to target individuals who are involved in the development of internal policies, procedures and methodologies or who perform firm-wide or network-wide quality reviews or other professional practice roles.

The potential impact of broader enforcement against junior accountants is self-evident. There are already well documented concerns about the attractiveness of the accounting profession to college students. Putting these junior accountants in harm's way and at risk for career-ending consequences for a single error in judgment, particularly when they are continuing to learn and improve their professional skills, does not make the profession more attractive.

For professionals later in their careers, if the goal is to police those individuals who agree to take on firm-wide, network-wide or similar broader responsibilities in pursuit of enhanced audit quality, those individuals will likely be dissuaded from taking on those roles when they understand the low bar for disciplinary action for judgment calls with which the PCAOB disagrees.

4. *The Board Should Clarify Language Relating to "directly and substantially contributing to a violation."* The Board's Proposal includes revisions to the current rule around the necessary elements of proximate causation. The current rule is clear that an associated person may be subject to sanctions only if they "take or omit to take an action … [that] would *directly and substantially contribute to a violation*." The Proposal retains the language requiring that the actionable conduct "directly and substantially contribute to a violation" but goes on to state that the act or omission subjecting the associated person to sanctions "would contribute to such violation."

The Board's Proposal does not explain its intentions in this regard, and specifically does not address the significance of adding the words "contribute to" but dropping the words "directly and substantially" in the last clause of the proposed rule.

This proposed change in wording creates potential ambiguity and thus unfairness in the manner in which the Proposal would be enforced, and the Board should be explicit that absent conduct "directly and substantially contributing to a violation", an individual's actions or omissions are not subject to discipline under the Proposal.

5. *The Board's Proposal Does Not Adequately Consider Its Negative Impact on the Attractiveness of Public Accounting.* Unquestionably, the ability to attract the best and the brightest college students to careers in public accounting is a key element of any accounting firm's commitment to continuous improvement in audit quality.

Yet it is well-documented that there are significant existing pressures on the accounting profession to attract and retain high quality talent. Board Member Ho made these points clearly in her statements in connection with the Proposal, and much has been written on this topic elsewhere in recent months. *See, e.g.,* Wall Street Journal, "Why No One's Going Into Accounting," October 6, 2023; Wall Street Journal, "Job Security Isn't Enough to Keep Many Accountants From Quitting," September 22, 2023; Wall Street Journal, "The Accountant Shortage Is Showing Up in Financial Statements," July 11, 2023.

While the war for talent is complex and multifaceted, we believe one important element of consideration of the attractiveness of public accounting is the risk of career-ending regulatory enforcement. Anecdotally, many have left the profession, and many others have made career choices not to enter public accounting, based on these concerns.

To be clear, we support holding auditors accountable when they engage in misconduct – particularly intentional, knowing, or reckless acts or omissions. However, we believe that the risk of a career-ending regulatory sanction for a simple error in nuanced professional judgment will only increase the challenge of attracting and retaining high quality talent in public accounting.

Given the obvious connection between winning the war for talent and improving audit quality, we fear that implementation of the Proposal and thereby lowering the standard of liability to a single simple act of negligence runs the risk of further discouraging high quality professionals from joining and staying in public accounting. This will in turn create even greater challenges for the accounting profession in its pursuit of continuous improvement of audit quality.

6. *The Board Has Adequate Tools Today to Enforce its Rules.* As recognized in the Proposal, the Board currently has the authority to impose a wide range of disciplinary sanctions against both registered accounting firms and the associated persons of such firms who directly and substantially contribute to a violation of the Board's rules and standards.

The Board's current Rule 3502 permits discipline against an associated person where that individual knowingly or intentionally engaged in misconduct or exhibited recklessness in the form of an extreme departure from the standard of ordinary care for auditors. As

demonstrated by the Board's history and trends of imposing significant and frequently career-ending sanctions on such associated persons, there is little evidence that the current standard has been a deterrent to the Board imposing such sanctions.

We note that the Board's Proposal highlights the fact that, in limited circumstances, the Securities and Exchange Commission (SEC) has the authority to impose certain sanctions for mere negligence. However, based on our review, we found few if any examples where the SEC has done so. Indeed, each such situation cited by the Board in the Release involved findings of a significantly higher level of culpability beyond simple negligence, and generally a pattern of negligent activity. So, despite this authority of the SEC to impose disciplinary sanctions based on simple negligence, it appears the SEC has acted almost without exception only when there has been at least an instance of highly unreasonable conduct or a pattern of negligent behavior.

Given the highly judgmental nature of performance of audits and the significant number of judgments made by auditors during the performance of an audit, we believe the current standard is sufficient to achieve the Board's mission of improving audit quality by disciplining those accountants who do not adhere to the Board's current rules and standards. A good faith, even if erroneous, professional judgment should not in our view by itself expose an associated person to the risk of career-ending regulatory discipline.

* * * * *

Our comments and recommendations are intended to be constructive in nature, and we appreciate your consideration of our point of view.

We would be pleased to discuss them with you at your convenience. Please direct any questions to Phillip Austin, National Managing Principal – Professional Practice and Auditing at paustin@bdo.com.

Very truly yours,

BDO USA, P.C.

cc:

PCAOB
Erica Y. Williams, Chair
Christina Ho, Board Member
Kara M. Stein, Board Member
Anthony C. Thompson, Board Member
George R. Botic, Board Member
Barbara Vanich, Chief Auditor

SEC
Gary Gensler, Chair
Hester M. Peirce, Commissioner
Caroline A. Crenshaw, Commissioner
Mark T. Uyeda, Commissioner
Jaime Lizarraga, Commissioner
Paul Munter, Chief Accountant

November 3, 2023

Public Company Accounting Oversight Board
ATTN: Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Proposed Rule to Amend PCAOB Rule 3502, Responsibility Not to Knowingly or Recklessly Contribute to Violations; PCAOB Rulemaking Docket Matter No. 053; PCAOB Release No. 2023-007 (Sept. 19, 2023)

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule to Amend PCAOB Rule 3502 issued by the Public Company Accounting Oversight Board ("PCAOB" or "the Board"). Better Markets applauds the PCAOB for its proposed amendments to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, which is the Board's rule governing the liability of associated persons who contribute to a registered public accounting firm's violation of accounting standards.[2]

Better Markets strongly supports the Board's Proposal to lower the threshold of liability for contributory actions by associated persons from recklessness to negligence. Better Markets also supports the Board's Proposal to prohibit associated persons from negligently contributing to a violation by *any* registered public accounting firm, instead of solely the registered firm with which they are associated. In keeping with the Board's statutory mission of investor protection set forth in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"),[3] the proposed changes would advance the public interest by improving auditing quality, strengthening PCAOB enforcement, incentivizing compliance, and enhancing investors' confidence in the reliability of companies' financial statements.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies – including many in finance – to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 PCAOB, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* ("the Proposal"), PCAOB Release No. 2023-007 (Sept. 19, 2023), https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9.

3 Pub. L. No. 107-204, 15 U.S.C. § 7201 *et seq*.

I. Background

In the late 1990s and early 2000s, a series of high-profile corporate scandals rocked the financial markets and resulted in massive financial losses and significant harm to investors. Companies like Enron, WorldCom, Tyco, and others engaged in rampant accounting fraud, manipulated financial statements, and misled investors.[4] These scandals resulted in a severe erosion of investor confidence in the financial markets, as investors felt that they could no longer trust the accuracy and reliability of corporate financial statements, which are fundamental to investors' ability to make informed investment decisions. The PCAOB was created as a direct response to these accounting scandals and corporate failures. Its establishment was a key component of Sarbanes-Oxley, which aimed to restore public confidence in financial reporting and corporate governance. The Sarbanes-Oxley Act, at its core, "was designed to fix auditing problems of US public companies, which is consistent with the official name of the law: the Public Company Accounting Reform and Investor Protection Act of 2002."[5]

The establishment of the PCAOB was thus driven by a commitment to protect the public, investors, and markets by ensuring high auditing standards, transparency, and accountability in the financial reporting process. High auditing standards are vital for a well-functioning, robust, and trustworthy financial system that attracts investment and maintains market stability. As part of this mandate to protect investors and the public, Congress authorized the PCAOB to issue rules to regulate auditor conduct.[6]

In 2005, the Board codified auditors' longstanding obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.[7] PCAOB Rule 3502 is a pivotal component of the regulatory framework that governs the auditing and financial reporting profession in the United States. It establishes the standard for liability for violations of PCAOB's rules and standards, aiming to enforce accountability, maintain professionalism, and protect the interests of investors and the public. The rule's significance lies in its contribution to audit quality, investor confidence, and the overall integrity of financial reporting.

As explained by the Proposal, "PCAOB Rule 3502 provides grounds for secondary liability when an associated person of a registered firm acts *at least recklessly* to directly and substantially contribute to a violation by that firm of a law, rule, or standard that the Board is charged with

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4 *See, e.g.*, C. William Thomas, *The Rise and Fall of Enron*, J. OF ACCOUNTANCY 1 (Apr. 2002).

5 John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSPECTIVES 91 (2007), https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.21.1.91.

6 Sarbanes-Oxley, § 103(a)(1); § 101(c)(2), (c)(4), (c)(6) & (g)(1).

7 *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005), https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf.

enforcing."[8] For nearly two decades since its issuance in 2005, Rule 3502 has served as the PCAOB's basis for bringing enforcement actions against associated persons who contribute to violations, and it has played a critical role in ensuring the integrity and accountability of auditors, audit firms, and other professionals engaged in the audit and review of financial statements.

II. The Current Rule Is Inappropriately Limited, and the Board's Proposed Changes Harmonize the Liability Provisions in Accordance with Logic and Policy.

Despite the importance of Rule 3502, the rule's "current formulation contains an incongruity that places *negligent* contributors to firms' violations beyond the rule's reach."[9] This incongruity stems from the fact that although a firm can commit a primary violation of an accounting rule by acting *negligently*, an "an associated person who directly and substantially contributed to that violation must have acted at least *recklessly* to be secondarily liable."[10] In other words, Rule 3502 currently requires "a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who contribute to firms' negligence-based violations."[11]

The difference between these two standards of liability is substantial and consequential, directly impacting the Board's ability to fulfill its statutory mission. As the Board describes it, whereas negligence is "the failure to exercise reasonable care or competence,"[12] recklessness requires "an extreme departure from the standard of ordinary care for auditors" that "is either known to the actor or is so obvious that the actor must have been aware of it."[13] Thus, the current Rule 3502 can produce anomalous results where "associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not."[14]

The illogic of applying two separate standards to firms and individuals is apparent on its face. First, as the Proposal notes, registered firms can only act through natural persons, and "[i]t logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person's negligence."[15] It makes little sense, then, that

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8 Proposal, at 4 (emphasis added).

9 Proposal, at 7 (emphasis added) ("A firm can commit a primary violation of certain laws, rules, or standards by acting negligently, but an associated person who directly and substantially contributed to that violation must have acted at least recklessly to be secondarily liable.")

10 Proposal, at 7 (emphasis added).

11 Proposal, at 3.

12 *In re S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 35 n.169 (July 3, 2013) (citation and quotation marks omitted).

13 *Marrie v. SEC*, 374 F.3d 1196, 1203 (D.C. Cir. 2004) (citation and quotation marks omitted); *see also* 2005 Adopting Release, *supra* note 7 at 13 ("[T]he phrase 'knew, or was reckless in not knowing' is a well-understood legal concept, and the Board intends for the phrase to be given its normal meaning.").

14 Proposal, at 3.

15 Proposal, at 3.

the individuals whose negligence directly contributed to a firm's violation can escape liability while the firm is nonetheless found liable.[16]

The Board has therefore rightly proposed to change the standard for secondary liability from an "extreme departure from the standard of ordinary care" (recklessness) to "the failure to exercise reasonable care or competence" (negligence).[17] Under the new negligence standard, an associated person can be held liable for an act or omission the person "knew or should have known" would contribute to a violation. This is in keeping with the ordinary negligence standard found elsewhere in the law, which is subject to the traditional "reasonable person" test.[18]

Moreover, as a second component of the rule, the Board proposes to amend the rule to remove the longstanding requirement that the individual who causes a violation by the registered firm be an associated person of that very same firm. Under the new rule, "an individual contributing to a registered firm's primary violation need not be an associated person of the firm that commits the violation so long as the individual is an associated person of some registered firm."[19] This too is an important reform that will appropriately expand the universe of persons who can be held accountable for contributing to violations of the accounting standards. Our comments here focus primarily on the first enhancement to the rule, which lowers the standard of liability for associated persons from recklessness to negligence.

III. The Proposal on the Liability Threshold Is Well-Justified on Multiple Grounds, and It Will Serve the Objectives of the PCAOB and the Broader Public Interest.

Better Markets strongly agrees with the PCAOB that reducing Rule 3502's liability threshold from recklessness to negligence will better protect investors and strengthen financial markets. It will do so by (1) better deterring misconduct and enhancing audit quality; (2) strengthening PCAOB enforcement efforts; (3) increasing investor confidence in corporate financial statements; (4) imposing fair and appropriate ethical standards in keeping with industry practices elsewhere; and (5) clearly and unambiguously advancing the Board's statutory mission.

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16 *See* Anthony C. Thompson, Board Member, *PCAOB Open Board Meeting, Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (Sept. 19, 2023) ("The PCAOB can hold a firm accountable for negligently violating PCAOB rules and standards; however, an associated person who directly and substantially contributes to such violations is held to a recklessness standard, which is a higher threshold [and] [t]his discrepancy is inconsistent with our investor protection mission."), https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson.

17 Proposal, at 13.

18 Proposal, at 22.

19 Proposal, at 3.

1. The Proposed Rule Would Deter Auditor Misconduct and Thereby Enhance Audit Quality.

Rule 3502's current recklessness standard inadequately incentivizes associated persons to exercise the appropriate level of due care in their audit work. If an associated person knows that they cannot be held individually liable by the PCAOB for a firm's primary violation unless an act or omission by them amounts to an "an extreme departure from the standard of ordinary care for auditors," they may be less inclined to exercise reasonable care in all aspects of their auditing work.[20]

Conversely, the threat of liability for negligence under the revised Rule 3502 will encourage auditors and audit firms to maintain a high level of quality in their audit work, benefiting investors and financial markets alike.[21] A negligence standard sends a strong message to auditors that they must exercise a higher level of care and diligence in their auditing.[22] This heightened level of deterrence will reduce the risk of substandard audits by encouraging auditors to be more diligent in adhering to professional standards and regulations to avoid potential liability.[23] The rule will not only incentivize individual compliance but also induce firms to ensure, through training and other measures, that their employees are more scrupulously compliant with auditing standards. This, in turn, will contribute to the reliability and accuracy of financial statements, which are essential for investors and other stakeholders.

2. The Proposed Rule Would Strengthen PCAOB Enforcement Efforts.

By reducing the relevant burden of proof for the liability of associated persons to a more appropriate level, the proposed rule will strengthen the Board's enforcement of important accounting rules. As the Proposal rightly notes, demonstrating recklessness entails meeting a higher burden of proof than a showing of negligence and can thus be challenging and resource-intensive to establish in legal proceedings. A negligence standard, which, contrary to recklessness, does not require a showing of knowledge or intent, will make it easier for regulators to establish liability against individuals who bear responsibility for violations, freeing up time and resources

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20 *See* Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 VAND. L. REV. 1871, 1885 (2019) (observing that "existing deterrence mechanisms have failed to produce optimal audit quality").

21 *See* Alan Reinstein, Carl Pacini, & Brian Patrick Green, *Examining the Current Legal Environment Facing the Public Accounting Profession: Recommendations for a Consistent U.S. Policy*, 35 J. ACCOUNT. AUD. & FIN. 3, 21 (2020) ("[S]uccessful malpractice lawsuits and PCAOB sanctions help improve the target's and other CPA firms' audit procedures."), https://tinyurl.com/yufo3k9s.

22 *See* Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1, 12 (2010) ("One of the most powerful deterrents to misconduct is an increased threat of prosecution. . . . A 'can do' accountant is less likely to provide questionable opinions if there is a substantial certainty that he will be caught and punished.").

23 *See* Dharmasiri P, Phang SY, Prasad A, Webster J., *Consequences of Ethical and Audit Violations: Evidence from the PCAOB Settled Disciplinary Orders*, 179 J. BUS. ETHICS 179 (2022) ("Prior research indicates that legislation and regulations formulated by the PCAOB create pressure for auditors to adopt or pursue certain practices."), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7975239/.

for other enforcement efforts. The proposed changes are thus in keeping with the Board's stated goal to "strengthen enforcement," as set forth in its Draft Strategic Plan for 2022–2026.[24]

3. The Proposed Rule Would Increase Investor Confidence in Corporate Financial Statements, Bolstering Financial Markets and Capital Formation.

Ensuring the integrity of financial reporting is critical to maintaining confidence in the capital markets. This protection is especially important because consumers and investors rely on financial statements and audit reports for making informed financial decisions. By establishing a clear framework of liability for negligent auditors, the proposed rule will likely boost investor confidence in the financial reporting process, thereby strengthening our financial markets as a whole. As Board member Anthony C. Thompson put it, "[t]his rulemaking seeks to ensure that persons who orchestrate or facilitate firm violations cannot continue to perpetuate such conduct uncharged and unsanctioned. As we know, such conduct can erode investors' perception of the quality of audits and their confidence in the capital markets."[25] Under the new standard, investors would be able to more safely rely on audited financial statements as a credible source of information for their investment decisions, an outcome that not only better protects investors but also strengthens and attracts capital to our financial markets.

4. The Proposed Rule Is Fair, Limited in Scope, and Consistent with the Law Elsewhere.

To the extent associated persons impacted by this rule change may be concerned about an ostensibly overbroad rule ensnaring them in liability for relatively minor accounting mistakes, these concerns should be allayed by the rule's limitation to solely individuals who "*directly and substantially contributed* to a firm's violations of the laws, rules, and standards that the Board enforces."[26] As Chair Erica Williams rightly put it, the scope of the rule's language is narrow and is not intended to trap unsuspecting accountants with minor mistakes:

> [T]hese updates are not intended to ensnare junior professionals or other auditors who are responsibly executing their duties. Again, to be held liable under the proposal, not only do associated persons have to act negligently, this proposal also maintains the current requirement that their negligence must have contributed to the firm's violation both "directly and substantially." That does not include auditors whose conduct is remote from, or tangential to, the firm's violation.[27]

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[24] *Draft 2022-2026 PCAOB Strategic Plan*, PCAOB Release No. 2022-003 (Aug. 16, 2022), https://tinyurl.com/ys9h8ucp.

[25] Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, *Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations*, (Sept. 19, 2023), https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson.

[26] Proposal, at 12 (emphasis added).

[27] Erica Y. Williams, Chair, *PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (Sept. 19, 2023), https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.

The proposed negligence standard would also better align with the approach in the majority of states, which overwhelming do not limit auditors' liability for negligent violations of auditing standards.[28] Indeed, in private suits brought against auditors for negligent misrepresentation, courts have long applied the *Restatement (Second) of Torts* to hold that auditors owe a duty not only to their clients but also to any foreseeable third-party who reasonably relies on the auditor's work to their detriment:

> A 1968 Rhode Island federal district court first expanded auditor liability for negligent misrepresentation to foreseen or known users in *Rusch Factors v. Levin* (284 F. Supp. 85 [D.R.I. 1968]). The court applied §552 of the *Restatement (Second) of Torts*. Thus, an auditor who audits or prepares client financial information owes a duty to the client and to any other person or one of a class of persons whom the accountant or client intends the information to influence if that person justifiably relies on the information in a transaction that the accountant or client intends the information to influence, and such reliance results in a pecuniary loss for the person. The . . . *Restatement* standard . . . does not require the auditor to know the specific persons' identity; it instead requires only that the third parties be members of a limited class of persons known to the auditor.[29]

As summarized by Reinstein *et al.*, thirty-three states now follow some version of this *Restatement* standard when determining liability for negligent auditors.[30] The Board's proposal to expand the scope of liability for associated persons to include negligence is thus far from a radical departure from common industry practice.

5. The Proposed Rule Clearly and Unambiguously Advances the Board's Statutory Mission.

While any profit-driven firm — such as the accounting firms and professionals regulated by this rule — will predictably and understandably always be concerned by the prospect of an expansion in the scope of their potential liability, the PCAOB's mission is not to protect accountants' bottom line. Under Sarbanes-Oxley, the main function of the PCAOB is "to oversee the auditors of public companies, protect the interests of investors, further the public interest in the preparation of informative, accurate, and independent audit reports," and generally, to administer

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28 Reinstein *et al*., at 13 ("[O]nly 15 states limit auditors' liability for negligence to third parties. Much variation exists among the other 35 states.").

29 Reinstein *et al.*, at 6–7.

30 Reinstein *et al.*, at 7; *see also* Tim Bush, Stella Fearnley, & Shyam Sunder, *Auditor Liability Reforms in the UK and the US: A Comparative Review*, pp. 1-47 (2007), https://depot.som.yale.edu/icf/papers/fileuploads/2575/original/07-33.pdf.

the accounting provisions of the Sarbanes-Oxley Act.[31] The proposed changes to Rule 3502 fall squarely within the scope of this mission and clearly and unambiguously advance its cause.

We also urge the Board to look skeptically upon the claims of undue burden, cost, and expense coming from industry voices subject to the proposed rule. Time and again, those seeking to derail any attempt at stronger regulation will levy unjustified predictions of industries being wholly upended or stifled by agencies' rules and regulations. Virtually never do these predictions come to pass, and nor will they here. The Proposal clearly and unambiguously puts the interests of the public and investors front and center, which is precisely what the Board is tasked to do under Sarbanes-Oxley.

IV. The Second Component of the Proposal Will Advance the PCAOB's Mission by Expanding the Rule's Scope to Better Account for Contemporary Auditing Realities.

To be subject to potential liability under the current Rule 3502, "an associated person of a registered public accounting firm must at least recklessly, directly, and substantially 'contribute to a violation by that registered public accounting firm,' meaning the firm of which the individual is an associated person—and *only* that firm."[32] In other words, "Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated."[33]

The second component of the proposed rule amends Rule 3502 to provide that "an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation (i.e., that an associated person of one firm can contribute to a primary violation of another firm)."[34] In other words, the proposed amendment would remove the current requirement that "the registered firm of which the contributory actor is an associated person must be the same firm that commits the primary violation."[35]

This is a welcome revision to Rule 3502 that better takes into account "the complexity of many contemporary audits and the multiple firms involved in them."[36] As the Proposal rightly notes, "contributory liability for an associated person who directly and substantially contributes to a firm's primary violation shouldn't be contingent upon the individual's formal role or relationship with that firm, so long as the individual is an associated person of *any* registered firm."[37] This

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31 *See* Sarbanes-Oxley Act, Section 101 *et seq*; *see also* John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, *supra* note 5; Thomas C. Pearson, *Potential Litigation Against Auditors for Negligence*, 5 BROOK. J. CORP. FIN. & COM. L. 405, 406 (2011), https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1100&context=bjcfcl.

32 Proposal, at 8 (emphasis added).

33 Proposal, at 16.

34 Proposal, at 1.

35 Proposal, at 16.

36 Proposal, at 3.

37 Proposal, at 9.

change would clarify the scope and application Rule 3502, "mindful of registered firms' contemporary organizational structures, operational practices, and varied roles and assignments for certain personnel."[38] Better Markets therefore agrees with the Board that the proposed amendments would better enhance investor protection and advance the statutory mission of the PCAOB.

CONCLUSION

We hope these comments are helpful as the Board finalizes this meritorious Proposal.

Sincerely,

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[38] Proposal, at 16–17.

November 2, 2023

Via email to comments@pcaobus.org

Office of the Secretary, Public Company Accounting Oversight Board
1666 K Street, NW
Washington D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 53 Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability

Dear Secretary Brown and Members of the PCAOB:

We appreciate the opportunity to provide feedback to the Board regarding the proposed amendments to PCAOB Rule 3502. We are accounting professors from several universities located in the United States. We teach auditing and conduct research in the areas of auditor judgment and decision making and audit regulation. We also have years of collective experience in public practice. Our background leads us to care deeply about the viability and future of the auditing profession.

Overall, we support the Board's mission to oversee the audits of public companies to protect investors and further the public interest. Academic research suggests that the Board's inspection efforts have resulted in higher audit quality, higher financial reporting quality, and better information environments for managers and external users.[1] We also support a robust enforcement function that is focused on reckless and intentional noncompliance, as specified in the Sarbanes-Oxley Act of 2022 ("The Act," Sec. 105(c)(5)). Consistent with this mandate, research suggests that such targeted enforcement actions can be beneficial in motivating better auditor behavior.[2]

However, we do **not** support the proposal to reduce the threshold standard of conduct for contributory liability from recklessness to ordinary negligence for two primary reasons. First, the proposal would place a disproportionate burden on individuals assigned quality control responsibilities within a firm's system of quality control. Second, the proposal reflects a fundamental shift in the PCAOB's approach to regulatory oversight, moving away from a supervisory approach and towards an enforcement approach. We are concerned that if enacted, the proposed changes would reduce the desirability of the profession for students, reduce the

[1] See, for example, Carcello, Hollingsworth, and Mastrolia, 2011; Lamoreaux, 2016; DeFond and Lennox, 2017; Fung, Raman, and Zhu, 2017; Krishnan, Krishnan, and Song, 2017; Aobdia, 2019; Gipper, Leuz, and Maffett 2020; Kim, Su, Zhou, and Zhu 2020; Lamoreaux, Mauler, and Newton 2020; Shroff, 2020; He, Li, Liu, and Pittman 2021; Carlisle, Yu, and Church 2022; Christensen, Lei, Shu, and Thomas 2023.
[2] See Lamoreaux, Mowchan, and Zhang 2023.

likelihood that high qualified CPAs remain in the profession, and ultimately have an adverse impact on audit quality.

Disproportionate Impact on Quality Control Partners

The proposed change in the threshold for liability would place an unfair burden on national office partners responsible for a firm's quality control functions and engagement quality review partners. National office partners typically have responsibilities for establishing and communicating policies and procedures related to audit engagements and for monitoring compliance. These individuals do not, however, typically have the authority to establish firm strategies or allocate resources. Instead, these individuals are tasked with maintaining high audit quality without control over key factors that impact audit quality.

In the executive summary, the Board argues that "It logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person's negligence."[3] We are concerned that, based on this premise, the PCAOB will pursue enforcement actions against a single scapegoat when the firms' partners collectively are responsible for the strategy and resource allocation decisions that led to the firm's negligence. Recently, the SEC took enforcement action against the National Assurance Leader for a national public accounting firm.[4] His firm's issuer practice had grown dramatically in a short period of time and the firm's staffing did not keep up. The firm was subject to severe disciplinary actions, including significant civil monetary penalties levied by the SEC and the PCAOB.[5] This civil monetary penalty is borne by each of the firm's partners and thus reduces overall firm profit available to be distributed to them. This outcome is appropriate because the partners of the firm should be held collectively responsible for the firm's strategy and resource allocation decisions. However, in the same enforcement action the SEC also singled out one of the firm's partners for additional disciplinary action. This additional action does not appear appropriate because although this individual was responsible for quality control, there is no indication that he controlled the firm's strategy or resource allocation decisions.

The current proposal argues that we should not be concerned about lowering the threshold for liability because the cost of defense will be borne by the firm rather than the individual.[6] The SEC enforcement action discussed in the preceding paragraph demonstrates the fallacy of this thinking. The individual who received further discipline could not rely on his firm to fully defend himself because the most important arguments in his defense were prejudicial to his firm. Specifically, he could have argued that the firm established the growth strategy and/or that the

[3] PCAOB Release No. 2023-007, page 3.

[4] SEC Accounting and Auditing Enforcement Release No. 4458. September 12, 2023. https://www.sec.gov/files/litigation/admin/2023/34-98352.pdf

[5] SEC Accounting and Auditing Enforcement Release No. 4423, June 21, 2003 https://www.sec.gov/files/litigation/admin/2023/34-97773.pdf and PCAOB Release No. 105-2023-005, June 21, 2023, https://assets.pcaobus.org/pcaob-dev/docs/default-source/enforcement/decisions/documents/105-2023-005-marcum.pdf?sfvrsn=e46a22c_7.

[6] PCAOB Release No. 2023-007, page 24.

firm failed to allocate sufficient resources to the support of the quality control function. Absent these defenses, the individual faced a significant civil monetary penalty and a bar from practice.

We are concerned that increasing the personal liability for quality control partners and engagement quality reviewers will make it difficult to attract and retain qualified individuals to these positions.[7] While it would be preferable to fill these positions with individuals who are somewhat risk averse, the lower threshold for liability will disincentivize such individuals from seeking these positions, to the further detriment of audit quality.

In its proposal, the Board implies that auditors will fail to exercise due care "if they know they cannot be held individually liable by the PCAOB."[8] However, this argument is premised on a belief that the only incentive for due care is the threat of PCAOB disciplinary action. The reality is that firms can and do incentivize auditors to exercise due care in the performance of their responsibilities. Academic research documents that auditors' compensation and promotion opportunities are adversely impacted by deficient audit work.[9]

Moreover, we share Board Member Ho's concerns that "under the proposed negligence standard, the public company auditing profession will become even less attractive."[10] We are concerned that if this proposal is adopted it will further degrade the pipeline to the accounting profession more broadly, a topic of critical importance that is gaining increasing attention, as well as retention of high quality practicing CPAs.

The Shift in Regulatory Approach

When the PCAOB was established, the founding board members determined that the Board would adopt a supervisory approach to regulation. In a 2005 speech, Dan Goelzer explained that under this approach, the PCAOB would use its inspection approach to make recommendations rather than bring disciplinary actions. He said enforcement would be reserved for firms that were "unwilling or unable to follow the rules."[11] The PCAOB continued to take a supervisory approach under Chairman James R. Doty. For example, in 2013, he explained that "selectivity" was the "hallmark" of the PCAOB's enforcement program, stating "We look for cases that involve something more than mere negligence. In fact, we look for cases that involve reckless

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[7] Westermann, K., J. Cohen, and G. Trompeter. 2019. PCAOB Inspections: Public Accounting Firms on "Trial." *Contemporary Accounting Research.* 36 (2): 694-731

[8] PCAOB Release No. 2023-007, page 7.

[9] For example, see Westerman et al. 2019 and, separately, Johnson, L.M., M.B. Keune, and J. Winchel. 2019. U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination. *Contemporary Accounting Research* 36 (3): 1540-1574. https://doi.org/10.1111/1911-3846.12467.

[10] Ho, C. 2023. Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability. https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability).

[11] Speech to the Colorado Society of CPAS 2005 SEC Conference in Denver Colorado on December 15, 2005. https://pcaobus.org/news-events/speeches/speech-detail/pcaob-update-a-year-three-progress-report-and-2006-challenges_114.

disregard of the auditor's duty."[12] Relating to the proposed rule change specifically, Board member Duane DesParte commented on the fact that the PCAOB originally considered a negligence-based framework for Rule 3502 but after much deliberation decided to move ahead with the recklessness standard in part because of the professional judgment inherent in public company audits.[13]

Importantly, the proposed negligence-based approach to enforcement would contradict the approach outlined by the Act in Sec. 105(c)(5), specifying that "the sanctions and penalties described [in the Act] shall only apply to (A) intentional or knowing conduct, including reckless conduct…; or (B) repeated instances of negligent conduct." Thus, the Act is clear that unless negligent conduct is repeated, sanctions and penalties under the Act—the enforcement approach—should not be applied.

We suspect that the current Board is abandoning the supervisory model to embrace an enforcement approach to regulation. We are concerned with this approach because we do not believe that it will have a positive impact on audit quality. Responsive regulation theory suggests that the PCAOB should employ penalties only after persuasion attempts have failed, i.e., the noncompliance in question was repeated.[14] Moreover, the slippery-slope framework helps to explain how a coercive enforcement strategy can be counterproductive in achieving regulatory objectives.[15] This academic research suggests that the PCAOB enforcement resources would be most effective when reserved for excessive auditor misbehavior that has resulted in actual investor harm or that threatens the PCAOB's regulatory oversight (e.g., backdating workpapers in anticipation of inspection; failure to cooperate with inspectors; providing false or misleading information to inspectors).

[12] Keyser, J.D. 2023. The Regulatory Approach of James R. Doty: PCAOB Chair 2011-2018. *Abacus* (forthcoming). https://doi.org/10.1111/abac.12301.

[13] Duane DesParte, September 19, 2023. https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability

[14] Ege, M., W.R. Knechel, P.T. Lamoreaux, and E. Maksymov. 2020. A multi-method analysis of the PCAOB's relationship with the audit profession. *Accounting, Organizations and Society* 84: 101131. https://doi.org/10.1016/j.aos.2020.101131.

[15] Dowling, C., W.R. Knechel, and R. Moroney. Public oversight of audit firms: The slippery slope of enforcing regulation. *Abacus* 54 (3): 353-380. https://doi.org/10.1111/abac.12130; Johnson, L., M. Keune, and J. Winchel. 2019. US Auditor's Perceptions of the PCAOB Inspections Process: A Behavioral Examination. *Contemporary Accounting Research*. https://doi.org/10.1111/1911-3846.12467

Conclusion

The existing threshold for contributory liability is adequate and should not be changed. We believe that the costs of the proposed rule change outweigh any potential benefit and we urge the PCAOB to return to the supervisory model of regulation.

Thank you for the opportunity to comment on the proposed standard. If you have any questions, please contact John Keyser at 216-368-8895.

Sincerely,

Nathan Cannon, Associate Professor, Texas State University

Melissa Carlisle, Assistant Professor, Case Western Reserve University

Brant Christensen, Associate Professor, Brigham Young University

John Keyser, Assistant Professor, Case Western Reserve University

Phillip Lamoreaux, Professor, Arizona State University

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November 3, 2023

Erica Y. Williams, Chair
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

VIA Online submission

Re: PCAOB Rulemaking Docket Matter No. 053—Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability

Dear Chair Williams:

The Center for American Progress (CAP or "we") respectfully submits this letter regarding the above-referenced proposal ("the proposal").

CAP is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans through bold, progressive ideas, strong leadership, and concerted action.

We strongly support the Public Company Accounting Oversight Board's (the Board or PCAOB) proposed amendments to PCAOB Rule 3502, relating to persons who contribute directly and substantially to violations by a registered public accounting firm. Specifically, we support the Board's proposals to change the liability standard for associated persons from "recklessness" to "negligence" and to specify that a contributory actor need not be an associated person of the registered firm that has committed a primary violation in order to be subject to potential liability under the rule.

The proposed amendments are clear, understandable, and appropriate for the reasons explained in the proposal. They will promote efficient coordination between the SEC and the PCAOB in enforcing standards and ensuring quality audits. As such, they will promote efficiency in the capital markets and increase investors' confidence in audits, which are a critical tool for investor protection.

The proposed amendments appropriately update Rule 3502 to reflect the current environment surrounding audits today.

The environment in which companies operate today is rapidly changing, which adds to the risks companies face and the potential impacts on their financial statements. As emerging risks, such as climate-related disasters,[1] proliferate and the financial crises of recent decades have prompted repeated concerns about the economy,[2] audited financial statements have become ever more important to investors. Investors need to know that individual auditors of financial statements are exercising the same level of care as the auditing firms they assist are required to take in order to ensure that there are no material misstatements or omissions in the financial statements that investors and others rely on.

Markets are also changing rapidly, along with the growth of very large companies.[3] As a result, it is increasingly common for firms to have multiple individuals contributing to audits, making it difficult to find any one individual whose behavior rises to the level of recklessness, even when the auditing firm's conduct is clearly reckless.

The proposal to change the liability threshold for an associated person to negligence is both logical and efficient

The fact that a natural person contributed to a violation committed by a firm is not a reason to lower the standard of care they must exercise, especially since the firm's activities are also carried out by natural persons. Since the firm's work cannot be carried out except by natural persons, it makes no sense to say that the firm can be held accountable if negligent but the person actually doing the auditing work cannot be held accountable unless their behavior amounts to recklessness. This is an obvious gap in accountability. With the proposed changes to Rule 3502, associated auditors will be more likely to act reasonably in carrying out audits and comply with their legal requirements, such as standards relating to the audit itself, quality control, and ethics.

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[1] See, e.g., NOAA National Centers for Environmental Information (NCEI), U.S. Billion-Dollar Weather and Climate Disasters (2023), available at https://www.ncei.noaa.gov/access/billions/.

[2] See., e.g., "The biggest financial crises of the last four decades," Reuters, March 25, 2023, available at https://www.reuters.com/business/finance/biggest-financial-crises-last-four-decades-2023-03-25/; and U.S. Department of the Treasury, Financial Stability Oversight Council, web page at https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc (last accessed November 2023)("The Council is charged by statute with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging threats to the stability of the U.S. financial system.").

[3] Austan Goolsbee, "Big Companies Are Starting to Swallow the World," The New York Times, September 30, 2020, available at https://www.nytimes.com/2020/09/30/business/big-companies-are-starting-to-swallow-the-world.html.

Moreover, the liability change will enable the PCAOB and the SEC to more efficiently and effectively pursue enforcement cases regardless of which entity has the resources to bring the case.

Congress clearly intended, when it enacted the Sarbanes-Oxley Act of 2002,[4] to provide the newly created PCAOB with the tool of sanctioning registered firms and their associated persons for negligent conduct.[5] Current Rule 3502 undermines the statute's intent by requiring an associated person's conduct to reach a level of recklessness before they can be held liable under the rule.

Individual auditors should be held accountable for their contributions to the primary violation of "any" registered public accounting firm

Given the complexity and scope of many audits today and the frequent use of unaffiliated experts, we see no reasonable explanation for requiring that the associated person be an affiliate of the firm committing the primary violation.

A person whose actions or inactions materially contribute to a primary violation should have liability regardless of whether that person is an affiliate of the firm. Otherwise, there is a material liability and accountability disparity based solely on the person's affiliation status and not on their misconduct.

Having third-party contributors avoid basic liability rewards a lack of careful audit quality control protections and also incentivizes individual audit experts to structure their provision of services so as to escape liability.

Worse, the Board may not have a window into actions carried out by an associated auditor and may be limited in its ability to question those auditors. The changes proposed would go a long way toward creating the right incentives for associated auditors to ensure that they comply fully with applicable laws, rules, and standards that the Board is charged with enforcing.

If nearly two-thirds of cases in which a firm was charged with a violation did not result in a contributory actor being held accountable, as the staff research found (p.18), it is clear that there is a regulatory gap—because a firm violation necessarily has to be carried out by a natural person.

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[4] 15 U.S.C. Sections 7211-7220.

[5] See, Public Law 107-204, Section 105, available at https://www.govinfo.gov/content/pkg/PLAW-107publ204/html/PLAW-107publ204.htm.

Conclusion

We strongly agree that the proposed changes would make the rule both a more effective deterrent and a more effective enforcement tool and thus carry out the intent of Sarbanes-Oxley in creating the PCAOB to investigate, bring charges against, and sanction registered public accounting firms and associated persons for violations of relevant laws, rules, and standards.

Not only would the proposed changes make Rule 3502 more consistent with the purposes of deterrence and accountability, it would also ensure that the PCAOB's standard is consistent with investor expectations as to the accountability of any registered accountant who contributes to a registered firm's violation—an expectation that Sarbanes-Oxley clearly recognized that investors should have.

For any questions regarding this comment letter, please contact Alexandra Thornton, Senior Director, Financial Regulation, at the Center for American Progress, athornton@americanprogress.org.

Sincerely,

Center for American Progress

November 2, 2023
By email: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability; PCAOB Rulemaking Docket Matter No. 053

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is a nonpartisan public policy organization serving as the voice of U.S. public company auditors and matters related to the audits of public companies. The CAQ promotes high-quality performance by U.S. public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, U.S. public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of U.S. public company auditors and audits to dynamic market conditions. This letter represents the observations of the CAQ based upon feedback and discussions with certain of our member firms, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Support for a Fair and Effective PCAOB Enforcement Program

The CAQ appreciates the opportunity to share our views and provide input on the proposed amendments to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (referenced herein as proposed Rule 3502, the proposed rule or the proposal) issued by the Public Company Accounting Oversight Board (PCAOB or the Board). The CAQ is supportive of the Board continuing to evaluate how it can best structure its rules and enforcement program in a manner that will protect investors and improve audit quality. The CAQ and our member firms are committed to promoting audit quality and appreciate that the Board's enforcement program plays a role in achieving that outcome.

As we discuss below, we believe that any project to modify the framework by which auditors can be held liable for violations of PCAOB rules and standards[1] should include a clear assessment of why that current

[1] The PCAOB has the power to sanction any "violation of [the Sarbanes-Oxley Act of 2002], the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards." 15 U.S. Code § 7215(c)(4). We use the phrase "PCAOB rules and standards" for convenience

framework exists and whether, in practical application, the current framework has impeded the PCAOB's effectiveness in bringing enforcement actions to fulfill its mission. This assessment should be performed considering all of the enforcement tools at the PCAOB's disposal and in light of the structure of other enforcement programs such as that of the U.S. Securities and Exchange Commission (SEC or Commission). That exercise is especially important in a situation like this one, where the Board in 2004 and 2005 considered, and then rejected, the very negligence standard in the context of contributory liability that it is now proposing. To that end, we offer our observations regarding both the current Rule 3502 and what we see as the likely key effects of the proposed rule. Our comments are intended to be constructive in nature, and we welcome the opportunity to discuss our comments with the Board and staff.

We discuss below several concerns about the proposal that we encourage the Board to consider as it evaluates whether to adopt the proposed rule.

Adoption of the Proposed Rule Could Have Unintended Consequences by Negatively Impacting Audit Quality

As multiple Board Members suggested in statements accompanying the issuance of the Proposing Release, it is important to have confidence that reducing the standard for contributory liability under Rule 3502 from recklessness to simple negligence would not negatively impact the profession and, correspondingly, that audit quality would not be negatively impacted. We are concerned that there are at least three significant ways in which this proposal could have such unintended consequences.

The Proposal Could Exacerbate the Accounting Talent Crisis

We share the Board's concern (echoed by Board member Ho) that an unintended consequence of the proposal could be to discourage auditors from accepting important audit roles due to fear of being held liable under a simple negligence standard for good faith judgments.[2] This concern is particularly relevant in relation to key roles associated with a firm's quality control system, where the activities of the individual may touch numerous PCAOB engagements and be significant to a firm's overall quality system but may not involve the performance of audit procedures governed by the PCAOB auditing standards.

Another concern in this respect is the Board's proposal to amend Rule 3502 to permit sanctions against associated persons who contribute to a violation by a firm other than that with which they are associated. Individuals who conduct audit quality- or quality control-related activities that touch on the activities of another firm could reasonably fear that a negligence standard would permit the PCAOB to second-guess

to refer to this entire body of laws, regulations, rules, and standards, as does the Board in the proposing release. *See Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, PCAOB Rel. No. 2023-007, page 9 fn.31 (Sept. 19, 2023) ("Proposing Release").

[2] *See* Proposing Release, page 26 ("Excessive litigation risk could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals"); Ho Statement.

professional judgments that they make, and could be dissuaded from accepting roles designed to promote audit quality across registered firms.

In addition to these concerns, there is a risk that the proposal could also adversely impact the willingness of accounting professionals to enter or remain in the audit profession, which has been declining steadily in recent years, as noted by both the PCAOB and the media more broadly.[3] While it may not appear obvious that a change in a legal standard would impact the accounting pipeline, our research shows that 30% of undergraduate accounting majors who have chosen *not* to pursue, or are undecided on, CPA licensure cite as a *major* reason for such decision the belief that the "reg[ulatory] environment makes [the] profession unappealing."[4] An additional 64% cite this belief as *part of the reason* for not planning to pursue, or being undecided on, CPA licensure. While we support appropriately holding professionals accountable and using enforcement where appropriate to improve audit quality, we believe the existing standard of liability under Rule 3502 already empowers the PCAOB to reasonably and adequately address violations of PCAOB rules and standards. By contrast, the change the Board contemplates in this release would likely be perceived negatively by those considering entering or staying in the profession as raising the likelihood of enforcement actions over good-faith judgments.

There Is a Risk of Inefficient and Unproductive "Self-Protective" Behavior

It is clear that audit quality has improved since the PCAOB's inception due to enhanced auditing standards, a robust inspection program, and appropriate enforcement efforts, among other reasons. These improvements to audit quality have occurred even as efforts toward continuous improvement remain ongoing. Notably, audit firms have invested in enhancing their systems of quality control, leveraging technology, and developing delivery models – actions all aimed at supporting the performance of quality audits. At the same time, audits of public companies have become significantly more complex, with nuanced professional judgments taking an ever-greater role in the process of obtaining and evaluating audit evidence and otherwise performing required audit and quality control procedures.

In our view, the proposal likely would lead to scenarios where firm professionals engage in what the Board refers to as "excessive monitoring and self-protective"[5] behavior as they make good-faith professional judgments against the backdrop of a lower standard for liability. We are concerned that moving to a

[3] *See, e.g.*, "Technology and Talent – Audit Quality Challenges in the 21st Century," Board Member Christina Ho (Sept. 15, 2022) (discussing "a more daunting pipeline challenge glaring right at us"); "Why No One's Going Into Accounting," Wall Street Journal (Oct. 6, 2023); "Accounting salaries rise as talent pipeline shrinks," Accounting Today (Oct. 13, 2023); "Accounting Graduates Drop by Highest Percentage in Years," Wall Street Journal (Oct. 12, 2023); "There's an accountant shortage," Fortune (Sept. 7, 2023); "Shortage of Accountants Adversely Impacting Early-Stage Companies," Forbes (July 23, 2023); "The Accounting Shortage is Showing Up in Financial Statements," Wall Street Journal (July 11, 2023).

[4] *Increasing Diversity in the Accounting Profession Pipeline: Challenges and Opportunities*, page 31 of the Appendix (July 2023), Edge Research and the Center for Audit Quality.

[5] Proposing Release, page 26. Examples of "self-protective behavior" described in the Proposing Release include that "[i]ndividuals may spend more time on a task than is necessary to accomplish it at the appropriate level of due care" and that "individuals may excessively document the nature of their task performance to demonstrate compliance in a future proceeding." *Id.*

negligence standard for contributory liability would inappropriately lead to sanctions of professionals who make judgments in good faith. If associated persons become subject to enhanced exposure for contributing to violations when the Board concludes that they have failed to exercise due care rather than only when they have acted recklessly, it will likely follow that professionals will engage, in the Board's words, in "inefficient" and "unproductive"[6] steps that increase the length and cost of audits without a corresponding increase in quality, and perhaps even a reduction in quality as attention is diverted from more important aspects of the audit, to the detriment of investor protection. These considerations appear to have played into the Board's overarching concern when it concluded in 2005 that a recklessness standard "strikes the right balance."[7] Similarly, in the context of the present proposal, Board Member DesParte noted that "[a]udits are complex and require significant input and judgment from a wide array of professionals with distinct responsibilities, expertise, and experience, all working collaboratively to comply with complex laws, professional standards, and rules,"[8] suggesting that a negligence standard might not be appropriate to that environment.

The Proposal Could Have a Negative Impact on Small Firms and Reduce the Market for Audit Services

These same types of concerns about generating inefficiency and "self-protective" behavior among professionals may present an especially acute threat to smaller firms. This possibility appears to have animated Board Member Ho's statement that a consolidation of the market for auditing services could result from the application of the proposal to smaller firms.[9] Smaller firms might be most at risk from any misallocation of resources that results from "self-protective" behavior, because they may have fewer compensating resources to help ensure compliance with PCAOB rules and standards even with the inefficiencies created by such behavior. Additionally, smaller firms may be less able to insure or self-insure against costs arising from investigations and actions related to allegations of negligence, and may be more affected by any impact that the proposed rule has on the accounting talent crisis discussed above. To the extent that any individual PCAOB enforcement action can call into question for a particular smaller firm whether the benefits of an issuer or broker-dealer auditing practice outweigh the costs, a negligence standard for contributory liability could turn out to be a deciding factor in causing a firm to exit the market for public company and registered broker-dealer engagements, thereby reducing competition and audit quality.

The Rationale for the Proposal Is Not Clear

In light of the proposal's potential negative impacts on audit quality, it is important that any modification of the recklessness standard in Rule 3502 be grounded in a clear and well-supported conclusion that the expected benefits of an amended Rule 3502 outweigh the expected costs. We have concerns that the proposal has not provided such a rationale. While the Board has suggested that the recklessness standard

[6] Proposing Release, page 26.
[7] *Ethics and Independence Rule Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Rel. No. 2005-014, page 13 (July 26, 2005) ("2005 Adopting Release").
[8] Statement of Board Member Duane DesParte (Sept. 19, 2023).
[9] *See* Statement of Board Member Christina Ho (Sept. 19, 2023) ("Ho Statement").

creates an "incongruity"[10] between the direct liability of firms and the contributory liability of associated persons, the release contains only a general discussion of the costs and benefits that might accrue under the proposed rule, without a comprehensive evaluation of the potential costs and unintended consequences.[11]

Four examples may help to illustrate the ways in which the Board's proposal leaves open crucial questions about the completeness of the analysis on anticipated costs and benefits:

- First, the Board projects that the costs of its proposal will be reduced by the fact that the Commission already has the authority to sanction negligent conduct that contributes to another party's violations.[12] As is discussed further below, however, the Board's further statement that the Commission actually exercises this authority in practice to sanction negligent conduct cites exclusively to cases in which the Commission concluded that discipline of an associated person was appropriate under SEC Rule of Practice 102(e) or Securities Exchange Act of 1934 (Exchange Act) Section 4C, neither of which permits the Commission to charge a respondent based on a single instance of simple negligence.[13] To the extent that the Board plans to charge single instances of simple negligence for contributory liability, then, it is proposing to wield a power that its analysis does not demonstrate the Commission having exercised, which naturally raises questions about the costs and benefits that the Board articulates.

- Second, the Board's proposal makes it very difficult to predict overall what incremental enforcement might result from its adoption of a modified Rule 3502, which in turn presents notable challenges for a thorough cost-benefit analysis.

    - On one hand, the Board seems to suggest in parts of the proposal that enforcement will not increase significantly under a modified Rule 3502. As the Board recognizes in its proposal, Rule 3502 "is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons."[14] In fact, the Board already possesses a number of tools to hold individuals accountable for their roles in both individual audits and a firm's quality control system as a whole, as it makes clear each time it initiates proceedings against an individual. As the Board notes in the proposal, it believes that these tools include the authority to impose limited sanctions for a single instance of

[10] Proposing Release, page 3.
[11] Proposing Release, pages 21-27.
[12] Proposing Release, page 13 n.49 (citing Exchange Act § 21C(a), 15 U.S.C. § 78u-3(a) (authorizing the Commission to sanction "any other person that is, was, or would be a cause of [a violation of the Exchange Act or any related SEC rules or regulations], due to an act or omission the person knew or should have known would contribute to such violation")).
[13] *See* SEC Rule of Practice 102(e) (defining "improper professional conduct" as recklessness, multiple acts of negligence, or "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted"); 15 U.S.C. § 78d-3(b) (same).
[14] *See* Proposing Release, page 9 n.31 (quoting 2005 Adopting Release, page 14 n.25).

negligence that directly violates PCAOB rules or standards.[15] As such, it appears the Board may already be sanctioning associated persons for negligence – including a single instance of negligence – separate and apart from the proposed modified Rule 3502. That fact appears to underlie the Board's acknowledgement that its modification might result in only "two to three" additional cases per year against individuals, though the basis of that statement in an estimate based on a consideration of enforcement proceedings from 2022 makes its accuracy uncertain.[16]

- On the other hand, the Board notes in Table 1 of the proposal that only 36 percent of firm enforcement orders from 2009 through 2022 were accompanied by a Rule 3502 charge.[17] This appears intended to suggest that the Board believes there may be room for significant growth in its contributory liability enforcement program. However, the 36 percent figure provides little guidance in practice because, as noted above, some PCAOB enforcement actions against firms appear to take advantage of the Board's existing tools to initiate proceedings against associated persons for violations other than Rule 3502 (such as an individual's direct violation of applicable auditing standards), meaning that a Rule 3502 charge in those instances would essentially be duplicative. The Board is also silent on whether it expects to allege individual contributory liability for firm violations as to which the Board alleges that the firm acted with recklessness, a situation in which contributory liability for mere negligence would seem to be inappropriate.

Because the Board lacks the benefit of supporting evidence for any conclusion about what its use of a modified Rule 3502 would be, it does not seem that either the costs or the benefits of the Board's proposal have been adequately assessed.

- Third, as then-Board Member DesParte noted in opposing the Board's recent proposal to replace AS 2405, *Illegal Acts by Clients*, with a broader standard, the Board has laid out an "ambitious standard-setting agenda…that will significantly expand the scope and cost of audits."[18] That agenda includes proposed new standards on quality control[19] and the general responsibilities of an auditor,[20] among others. The true costs and benefits of amendments to Rule 3502 cannot be known until the Board determines the final shape of these other proposed standards, especially its quality control proposal given the additional responsibilities and obligations that proposal would place on certain personnel at registered firms.[21] The Proposing Release notes in passing

[15] *See* Proposing Release, page 11.
[16] Proposing Release, page 25.
[17] Proposing Release, page 19.
[18] Statement by Board Member Duane DesParte (June 6, 2023).
[19] *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Rel. No. 2022-006 (Nov. 18, 2022) ("QC Proposal").
[20] *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2023-001 (Mar. 28, 2023).
[21] *See, e.g.*, QC Proposal, page 67-74 (describing the modified roles and responsibilities for a registered firm's quality-control system under that proposal).

that these other agenda items might have an effect on the estimate of "two to three" incremental enforcement actions against individuals that might result from its rule each year, but does not otherwise appear to include them in its cost-benefit analysis even though the effects could turn out to be quite substantial.[22]

- Fourth, the Board mentions in passing that, under the text of proposed Rule 3502, "'directly and substantially' would apply *only* to the sufficiency of the connection between an associated person's conduct and a firm's violation."[23] Thus, it would be the case that "a person must have known, or should have known, that an act or omission by them would contribute—but not that it would directly and substantially contribute—to a firm's violation."[24] This would represent an important change from the present rule under which an alleged violator must know (or recklessly not know) not only that they are contributing to a violation but also that the contribution is direct and substantial.[25] Yet the Board does not appear to weigh the costs and benefits of this aspect of the proposed rule.

In light of the above, we are concerned that a final Board rule that tracks the proposal will be based on an inadequate cost-benefit assessment.

Individual Liability for Single Instances of Simple Negligence Would be Contrary to SEC Practice and Inappropriate

As noted above, the Board's proposal would permit an individual or entity to be held liable not only directly for a single instance of negligence that violates a Board rule or standard, but also secondarily for a single instance of negligence that is not itself a violation but directly and substantially contributes to the violation of another.[26] Although the Board notes the SEC holds similar power under Exchange Act Section 21C,[27] its conclusion that the proposed modification of Rule 3502 would merely put the PCAOB on par with the SEC is unsupported. First, the SEC enforcement precedent regarding auditors that the Board cites appears to involve cases where the SEC has charged an individual either with multiple acts of negligence

[22] Proposing Release, page 25 ("this estimate may vary to the extent that there are modifications in other Board standards (e.g., adopting and implementing a new quality control standard) or changes in enforcement priorities").
[23] Proposing Release, page 15 (emphasis added).
[24] Proposing Release, page 15.
[25] To be clear, the CAQ supports the Board's decision to retain the requirement in Rule 3502 that the secondary liability concept present in this rule can result only from conduct that directly and substantially contributes to the firm violation. Any proposed liability for conduct that only indirectly or to a minor extent relates to a violation would exacerbate the concerns discussed herein to an even greater degree.
[26] Based on footnote 65, the Board even appears to imagine the possibility of tertiary liability, in which one associated person's conduct contributes to the conduct of a second associated person, which in turn contributes to a registered firm's violation. While the footnote appears to recognize that the first associated person's conduct would still have to meet the criteria of "directly and substantially" contributing to the ultimate firm violation, the mere mention of such a scenario suggests that the Board may intend to stretch the definition of "directly" beyond the bounds of common usage.
[27] *See* 15 U.S.C. § 78u-3(a).

or with a heightened form of negligence, not with a single instance of simple negligence.[28] Second, the SEC's authority to punish contributory conduct under Section 21C is limited to obtaining an administrative cease-and-desist order against the contributor, as well as certain additional sanctions such as the imposition of a penalty.[29] The SEC has no power to impose on a contributing individual all of the other sanctions that the Board can impose, including certain sanctions that do not require a finding of recklessness or multiple acts of negligence.[30] The Board does not appear to be correct, therefore, when it claims that its proposal would merely put it on par with the SEC; in practice, its proposal would appear to give it enforcement authority that is unprecedented.

Further, outside of the SEC context, the parallel civil concept of aiding and abetting liability generally requires knowing conduct, as set out in the Restatement (Third) of Torts:

> The defendant is held liable because someone else committed a tort and the defendant gave **knowing** and substantial assistance to the wrongdoing. . . . **Negligence will not suffice**; nor is it enough to prove that the defendant should have known of the primary actor's wrongful conduct but did not. The defendant's knowledge must be actual.[31]

There is good reason for this restriction: When an individual acts in a manner that is not itself a violation of any PCAOB rule or standard, fairness dictates that derivative liability for the misconduct of another be held to a higher standard, given that the connection between the individual's conduct and the alleged violation of PCAOB rules and standards is lower.

The Board appears to believe that derivative liability for negligence is appropriate because, in at least some of the cases where it will employ the revised Rule 3502, it will merely be holding a natural person associated with a firm responsible for the violations of the firm entity that are caused by that natural person, making it appropriate that the threshold for entity and personal liability be the same.[32] There is a reason, however, that PCAOB rules and standards place certain obligations on individuals and certain obligations only on the firm as a whole—namely, there may be instances where it is appropriate for a firm entity to be sanctioned for a violation but where no particular individual has played a sufficient role in

[28] *See* David S. Hall, P.C., SEC Initial Decision Rel. No. 1114 (Mar. 7, 2017); Gregory M. Dearlove, CPA, SEC Rel. No. 34-57244 (Jan. 31, 2008); Philip L. Pascale, CPA, SEC Rel. No. 34-51393 (Mar. 18, 2005).

[29] *See* 15 U.S.C. § 78u-3(a); *id.* § 78u-2(a)(2)(B) (permitting civil penalties where a contributing actor "is or was a cause of the violation of any provision of this chapter, or any rule or regulation issued under this chapter").

[30] *Compare* 15 U.S.C. §§ 78u-2, 78u-3 (SEC remedies) *to* 15 U.S.C. § 7215(c)(4) (PCAOB remedies).

[31] Restatement (Third) of Torts § 28. The SEC's power to allege aiding and abetting liability is distinct from its power to charge causing liability. *Compare* 15 U.S.C. § 78t(e) (aiding and abetting) *to* 15 U.S.C. § 78u-3(a) (permitting cease-and-desist proceedings against "any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation").

[32] *See* Proposing Release, page 7 ("a registered firm can only act through the natural persons who serve as its agents, including its associated persons. Accordingly, a natural person's actions may render both the firm primarily liable and the natural person secondarily liable") (internal quotations, citations, and brackets omitted).

that violation to have their career permanently affected by a sanction on them personally. The Board should not use Rule 3502 to collapse this distinction.[33]

The Legal Basis for a Contributory Liability Standard Based in Negligence Is Not Clear

As with any Board action, a modification of Rule 3502 must rest on the foundation of the Board's statutory authority. In its 2005 release adopting Rule 3502, the Board cited two sources: its authority under Section 103 of Sarbanes-Oxley "to set ethical standards;"[34] and the authority "inherent in, and necessary to," the Board's enforcement authority under Sarbanes-Oxley Section 105.[35] However, in approving the Board's adoption of Rule 3502 in 2006, the Commission cited only Section 103 as the statutory basis.[36] In its current proposal, the Board appears to rely again on Sections 103 and 105, though its argument under Section 105 now appears to be that the Board is permitted—in general—to bring enforcement actions based on a single act of negligence.[37] Neither of these provisions provides a basis for the proposed rule.

With regard to Section 103, the problem inherent in the Board's reliance on this provision as a basis for the proposed contributory liability rule is that it is not clear that the statutory power to regulate *ethical* conduct equates to a statutory power to punish *negligent* conduct. The Board appeared to acknowledge this fact in its recent quality control proposal, which would define "integrity" under proposed EI 1000 to mean in part "[n]ot **knowingly** or **recklessly** misrepresenting facts."[38] The concept, in the context of secondary liability, that ethics pertains to knowing or reckless action is similarly found in other professional standards, including the AICPA Code of Professional Conduct (which prohibits a member from "knowingly permit[ting] a person" under the member's control to violate the Code);[39] and the American

[33] The Board acknowledged the distinction between the responsibilities of individual professionals and the responsibilities of the firm as a whole in 2011 when it released its proposed rule relating to the naming of the engagement partner on Form AP. In that context, the Board stated that it "remains sensitive to concerns about minimizing the role of the firm or suggesting that the engagement partner is solely responsible for the audit engagement and its performance…The engagement partner is not expected to fulfill his or her responsibilities alone." *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2*, PCAOB Rel. No. 2011-007, page 9 & fn.19 (Oct. 11, 2011).

[34] 2005 Adopting Release, pages 9-10.

[35] 2005 Adopting Release, page 12.

[36] *See Public Company Accounting Oversight Board; Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules*, SEC Rel. No. 34-53677 (Apr. 19, 2006) ("Proposed Rule 3502 establishes a standard of ethical conduct for persons associated with registered public accounting firms").

[37] Proposing Release, page 12 n.43. The Board also cites Sarbanes-Oxley Sections 101(c)(2), 101(c)(4), 101(c)(6), and 101(g)(1) for authority. *See id.* at 2 n.4. Those provisions speak to the Board's authority to sanction registered firms and associated persons, but not to the availability of contributory liability (let alone negligent contributory liability) as a permissible theory of violation.

[38] QC Proposal, page A4-5 (emphasis added). The QC Proposal also notes that liability for contributing to violations of proposed QC 1000 would only be based on knowing or reckless conduct under current Rule 3502, a statement which will not be accurate should the Board adopt the proposed amendment to Rule 3502. *See* QC Proposal, page 75.

[39] AICPA Code of Professional Conduct § 0.200.020.04.

Bar Association Model Rules of Professional Conduct (which prohibit "knowingly assist[ing] or induc[ing] another" to violate the Rules).[40] To the extent that the Board uses a modified Rule 3502 to sanction a professional for good-faith actions that the Board concludes after the fact to have been unreasonable, then, the Board has strayed from the scope of its remit under Section 103.

Section 105 provides no further basis to sanction contributory conduct. As the AICPA's Center for Public Company Audit Firms (the predecessor to the CAQ) noted in connection with the Board's adoption of original Rule 3502, the Supreme Court held in 1994 that the lack of an express statutory basis for aiding and abetting liability in the Exchange Act at that time precluded an aiding and abetting claim by private plaintiffs, and by extension the SEC.[41] Although Congress responded to the Supreme Court's ruling by granting the Commission the express power to sanction aiding and abetting conduct,[42] it made no provision in Sarbanes-Oxley for the Board to exercise similar power. Instead, it permitted the Board to impose enforcement sanctions only upon a finding that

> a registered public accounting firm or associated person thereof has engaged in any act or practice, or omitted to act, in violation of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards.[43]

None of these sources (with the exception of Rule 3502, which cannot be the basis for itself) expressly permits the Board to establish liability for negligently contributing to a firm violation. As a result, we believe that the Board should exercise caution in seeking to expand its authority in the area of contributory liability, especially to the extent that it seeks to sanction an associated person for conduct that falls short of the "knowing" or "recklessness" standards that have historically been applied. This expansion of the Board's authority to single instances of negligence may invite legal challenges to the Board's statutory authority related to pursuing secondary liability actions.

Other Recommendations

The Board Should Clarify the Negligence Standard That It Proposes to Enforce in a Modified Rule 3502

In its proposal, the Board articulates two different formulations of the mental state that might lead an associated person to face potential liability under its proposed rule. The proposed text of a modified Rule 3502 would permit sanctions if an associated person "should have known" that their conduct contributes to a violation (and if that contribution is direct and substantial).[44] The proposal also, however, uses the

[40] Am. Bar Ass'n Model R. of Prof. Conduct 8.4(a).
[41] *See* Letter of American Institute of Certified Public Accountants Center for Public Company Audit Firms, PCAOB Docket No. 017 (Feb. 24, 1005) (citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994)).
[42] *See* Private Securities Litigation Reform Act, P.L. 104-67, § 104 (Dec. 22, 1995) (establishing Exchange Act § 20(e), 15 U.S.C. § 78t(e)).
[43] Sarbanes-Oxley Section 105(c)(4), 15 U.S.C. § 7215(c)(4).
[44] Proposing Release, page A-1.

formulation that associated persons will be held to a negligence standard that entails "the failure to exercise reasonable care or competence."[45] While both of these standards are familiar in the American legal system, the Board does not address whether there is any difference between them, and (if there is) how that tension should be resolved in enforcing Rule 3502. As an example, the Board's own AS 1015, *Due Professional Care in the Performance of Work*, explains that due care does not require a professional to exercise perfect judgment at all times:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. . . . But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[46]

In the event the Board moves forward in seeking to adopt its proposed Rule 3502, the Board should confirm that "pure errors of judgment" would not be subject to liability under Rule 3502, and should clarify in general how the standard of due care like that set out in AS 1015 interacts with the "should have known" mental state of the proposed rule.

The Board Should Affirm That Modification of Rule 3502 Will Not Impact the Imposition of Heightened Sanctions

Pursuant to Sarbanes-Oxley Section 105(c), the Board can impose heightened sanctions, including suspension or bar of a person from further association with any registered public accounting firm, only upon a finding that the respondent acted recklessly or engaged in "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."[47] Our understanding of the Board's release, and specifically footnote 48,[48] is that, while its proposed modification of Rule 3502 would purportedly permit the Board in general to impose sanctions on an

[45] Proposing Release, page 4 (quoting *In re S.W. Hatfield, C.P.A.*, SEC Rel. No. 34-69930, at 35 n.169 (July 3, 2013)).

[46] AS 1015.03, *Due Professional Care in the Performance of Work*. In a recent release, the Board has proposed to amend its standard relating to due professional care. Although the proposed new standard would not retain the above text, taken from a legal treatise, the Board appears to acknowledge that it remains an accurate description of the concept of due care. *See Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Rel. No. 2023-001, page 22 (Mar. 28, 2023) ("We believe the reference to that treatise is unnecessary and are proposing to describe in plain language the concept of due professional care, **without changing its meaning**") (emphasis added). In its comment letter relating to the Board proposal on this point, the CAQ recommended that certain of the concepts in the treatise should remain in any new auditing standard, to appropriately describe to investors what they can expect in the performance of an audit. *See* Letter of the CAQ, PCAOB Docket No. 049, page 6 (May 30, 2023).

[47] 15 U.S.C. § 105(c)(4), (5).

[48] *See* Proposing Release, page 13 n.48 ("However, the sanctions to which a contributory actor may be subject upon being found to have violated Rule 3502—including whether the Board may impose any of the heightened sanctions in Section 105(c)(5) of Sarbanes-Oxley—depend on the associated person's conduct and not that of the firm that commits the primary violation").

associated person based on a finding that that person acted negligently in a single instance, the modified rule would not permit the sanctions identified in Section 105(c)(5) unless the Board made one of the heightened findings described in Section 105(c)(5)–i.e., a finding that the associated person who violated Rule 3502 acted recklessly or committed multiple acts of negligence. The Board should clarify the statement in footnote 48 to confirm this assessment in the event it moves forward with a final rule to modify Rule 3502.

The Board Should Consider Extending the Effective Date of Its Proposal

We note that the Board proposes that the modified version of Rule 3502 should be effective sixty days after Commission approval, on the basis that such period of time would "allow associated persons to ensure that their conduct conforms to the applicable legal standards and to increase their diligence as necessary and appropriate."[49] As we mention above, the impact of this proposal will depend to a significant extent on certain proposed auditing standards not yet adopted by the Board (such as QC 1000 and AS 1000). Therefore, we recommend that any modifications to Rule 3502 be implemented subsequent to the effective dates of those other standards (or subsequent to a determination by the Board not to adopt those standards), and with additional analysis by the Board concerning the expected costs and benefits of its proposal in light of those standards.

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[49] Proposing Release, page 31.

The CAQ appreciates the opportunity to comment on the Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability. In view of the concerns discussed above, at this time we do not believe that the Board's proposal is adequately supported. As the Board gathers feedback from other interested parties, we look forward to future engagement with the Board and would be pleased to discuss our comments or answer questions from the Board regarding the views expressed in this letter. Please address questions to Vanessa Teitelbaum (vteitelbaum@thecaq.org) or Dennis McGowan (dmcgowan@thecaq.org).

Sincerely,

Vanessa Teitelbaum
Senior Director, Professional Practice
Center for Audit Quality

cc:

PCAOB
Erica Y. Williams, Chair
George R. Botic, Board member
Christina Ho, Board member
Kara M. Stein, Board member
Anthony C. Thompson, Board member
Barbara Vanich, Chief Auditor

SEC
Paul Munter, Chief Accountant
Diana Stoltzfus, Deputy Chief Accountant

November 2, 2023
Office of the Secretary Public Company Accounting Oversight Board
Via Email: comments@pcaobus.org

Re: **PCAOB Release No. 2023-007 - Proposed Amendments to PCAOB Rule 3502 on Contributory Liability Standards**

Dear Chair Williams,

On behalf of the Chamber of Digital Commerce, we appreciate the opportunity to provide comments on the Public Company Accounting Oversight Board (PCAOB)'s proposed amendments to Rule 3502 concerning the standards of contributory liability.

The Chamber is the world's largest digital asset and blockchain trade association. The Chamber represents more than 200 diverse members of the blockchain industry globally, including digital asset exchanges, leading accounting firms, and other digital asset economy participants.

We recognize the PCAOB's intent to rectify the incongruity where firms, acting through individuals, can be found negligent, yet those individuals are held accountable only if their conduct reaches the higher threshold of recklessness. The effort to align individual liability with firm liability is clear and understandable. However, the proposed amendments may inadvertently create barriers for smaller audit firms and those servicing emerging industries such as digital assets. The lowered threshold of negligence could significantly elevate the risk profile, thereby possibly deterring such firms from engaging with innovative sectors where the regulatory and legal frameworks may still be evolving due to the fear of increased liability.

Furthermore, the broader scope of liability could also potentially stifle collaborative efforts within audit firms, especially in complex audit scenarios often encountered in emerging industries. We believe the proposal's potential chilling effect on smaller firms and those servicing emerging, and innovative sectors warrants careful consideration. It is imperative to strike a balanced approach that upholds the integrity of the auditing profession while fostering an environment conducive to innovation and growth.

We recommend that the PCAOB consider conducting a thorough impact assessment, particularly on smaller audit firms and those servicing emerging industries, to better understand the proposal's potential impact on these firms and the level of increased risk of market consolidation risk to ensure that the proposed amendments do not inadvertently stifle innovation and growth in these crucial sectors.

We appreciate your consideration of our comments and remain available for further discussion.

Sincerely,

Cody Carbone
Vice President, Policy
Chamber of Digital Commerce

Council of Institutional Investors®
The voice of corporate governance

Via Email

October 26, 2023

Ms. Phoebe W. Brown
Office of Secretary
Public Company Accounting Oversight Board
1616 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 053, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, PCAOB Release No. 2023-007.

Dear Secretary Brown:

The Council of Institutional Investors (CII) appreciates the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's (PCAOB or Board) *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (Proposal).[1]

CII is a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $5 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true "Main Street" investors through their pension funds. Our associate members include non-U.S. asset owners with about $4.8 trillion in assets, and a range of asset managers with more than $55 trillion in assets under management.[2]

CII Policies

As the leading U.S. voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.[3] That belief is

[1] PCAOB, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, PCAOB Release No. 2023-007 (Sept. 19, 2023), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9#:~:text=As%20discussed%20above%2C%20the%20Board,the%20registered%20firm%20that%20has.

[2] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.

[3] CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

reflected in the following CII membership-approved policy on the **Independence of Accounting and Auditing Standard Setters**:

> Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the . . . standards that . . . auditors use in providing assurance that the preparers' recognition, measurement and disclosures are free of material misstatements or omissions.[4]

The policy on **Independence of Accounting and Auditing Standard Setters** also importantly establishes that the key attributes that underpin an effective auditing standard setter include: "A clear, rigorous and consistent mechanism for enforcement by regulators of the accounting and auditing standards."[5]

CII also has a long-standing, membership-approved policy on **Financial Gatekeepers**.[6] That policy explicitly identifies auditors as "financial gatekeepers."[7] The policy indicates that it is imperative that auditors be subject to "[r]obust oversight and [have] genuine accountability to investors. . . ."[8] The policy also states that the "Sarbanes-Oxley Act of 2002 . . . bolstered the . . . oversight and accountability of accounting firms . . . [and that] [c]ontinued reforms are needed to ensure that the pillars of transparency, independence, oversight and accountability are solidly in place."[9]

Finally, CII's membership-approved policy on **Audit Committee Responsibilities Regarding Independent Auditors** states, in part, that:

> The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company's independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality.[10]

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[4] *Id.*
[5] *Id.*
[6] CII, Policies on Other Issues, Financial Gatekeepers (adopted Apr. 13, 2010), https://www.cii.org/policies_other_issues#fin_gatekeepers.
[7] *See id.* ("Auditors, financial analysts, credit rating agencies and other financial 'gatekeepers' play a vital role in ensuring the integrity and stability of the capital markets.").
[8] *Id.*
[9] *Id.*
[10] CII, Policies on Corporate Governance § 2.13a Audit Committee Responsibilities Regarding Independent Auditors (last updated on Mar. 6, 2023), https://www.cii.org/corp_gov_policies.

The Proposal

CII generally agrees with the observation of PCAOB Chair Erica Y. Williams that:

> Like many of the standards this Board has voted to modernize, Rule 3502 is nearly 20 years old. Things have changed since it was first adopted in 2005.
>
> The [Securities and Exchange Commission (SEC or Commission)] SEC now has the ability to seek civil money penalties in enforcement actions against associated persons when they negligently cause firm violations. The way that firms operate has changed. And the expert staff at the PCAOB who have seen how Rule 3502 plays out in the real world are recommending this update.[11]

CII also generally agrees with the PCAOB that the proposed amendments would better align Rule 3502 with the scope of the Board's enforcement authority under the Sarbanes-Oxley Act of 2002 (SOX) and address the regulatory gap within the existing framework, which can lead to anomalous results.[12] As Board Member Kara Stein explained:

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[11] Erica Y. Williams, Chair, PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.

[12] *See* Sarbanes-Oxley Act §105(c)(5)(A)-(B), 15 U.S.C. § 7201 (2002), *available at* https://pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf ("The sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of paragraph (4) shall only apply to— (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."); *see also* S. 2673, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT, S. Rep. No. 107-205, § 105(b) (2d Sess. 2002), *available at* https://www.govinfo.gov/content/pkg/CRPT-107srpt205/html/CRPT-107srpt205.htm ("Section 105(b) authorizes the Board to impose a full range of sanctions if it finds that a registered firm, or its partners or employees, have engaged in any act or practice that violates the Act, the Board's rules, professional standards, or the portion of the securities laws (and SEC rules) relating to audits of public companies . . . [and] the Board's ability to suspend or bar an associated person from the auditing of public companies, and the Board's ability to impose civil money penalties above a certain amount, is limited to situations involving intentional, knowing, or reckless conduct, or repeated negligent conduct.").

[12] Kara M. Stein, Board Member, PCAOB Open Board Meeting, Statement on Responsibility and Accountability for Persons Contributing to a Registered Audit Firm's Violations of Law or Professional Standards, Proposed Amendments to PCAOB Rule 3502 (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/responsibility-and-accountability-for-persons-contributing-to-a-registered-audit-firm-s-violations-of-law-or-professional-standards-proposed-amendments-to-pcaob-rule-3502; *see* Erica Y. Williams, Chair, PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Noting that "firms don't make the decisions or take the actions that lead to these violations [of quality control or independence standards] on their own [, p]eople participate in these decisions and actions."); Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson ("The PCAOB can hold a firm accountable for negligently violating PCAOB rules and standards; however, an associated person who directly and substantially contributes to such violations is held to a recklessness standard, which is a higher threshold [and] [t]his discrepancy is inconsistent with our investor protection mission.").

> The PCAOB currently cannot bring an action against negligent auditors whose direct and substantial contributions furthered an audit firm's violations. This creates an obvious gap in the Board's ability to protect investors and public markets, as Table 1 in the economic analysis suggests. Today's proposal would close this oversight gap, thus emphasizing the obligations under the auditing standards that auditors act with reasonable care and competence.[13]

More specifically, CII generally believes that the Proposal's updating of Rule 3502's liability threshold from recklessness to negligence will appropriately bring it in line with the existing requirement for auditors to exercise a standard of reasonable care during the performance of their professional responsibilities.[14] And like the SEC has done historically, we believe the PCAOB will appropriately exercise its prosecutorial discretion when the underlying conduct is negligent.

Finally, CII notes that the Proposal includes two questions that appear to be directed at investors. Those questions and our specific responses follow:

5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors?[15]

CII generally believes it is clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors. We note that our September 2022 letter in response to the PCAOB Draft Plan 2022-2026[16] expressed support for the Board's goal of strengthening enforcement.[17] That letter stated:

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[13] Kara M. Stein, Board Member, PCAOB Open Board Meeting, Statement on Responsibility and Accountability for Persons Contributing to a Registered Audit Firm's Violations of Law or Professional Standards, Proposed Amendments to PCAOB Rule 3502 (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/responsibility-and-accountability-for-persons-contributing-to-a-registered-audit-firm-s-violations-of-law-or-professional-standards-proposed-amendments-to-pcaob-rule-3502; *see* Erica Y. Williams, Chair, PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Noting that "firms don't make the decisions or take the actions that lead to these violations [of quality control or independence standards] on their own [, p]eople participate in these decisions and actions."); Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson ("The PCAOB can hold a firm accountable for negligently violating PCAOB rules and standards; however, an associated person who directly and substantially contributes to such violations is held to a recklessness standard, which is a higher threshold [and] [t]his discrepancy is inconsistent with our investor protection mission.").

[14] *See* PCAOB Release No. 2023-007 at 11 (Noting that the current "liability threshold serves a dual function: It incentivizes auditors to conduct their work knowing that reasonable care is the standard for assessing it . . . .").

[15] *Id.* at 12 (emphasis added).

[16] *See* Request for Public Comment, Draft 2022-2026 PCAOB Strategic Plan, PCAOB Release No. 2022-003 (Aug. 16, 2022), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/2022-003-rfc-draftstrategicplan.pdf?sfvrsn=fdc9859a_4.

[17] Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of the Secretary, PCAOB 9-10 (Sept. 15, 2022), https://www.cii.org/files/issues_and_advocacy/correspondence/2022/September%2015,%202022%20PCAOB%20letter%20(final).pdf.

> CII strongly supports the objective of rigorously enforcing PCAOB and other applicable standards, laws, and rules. We agree with the Board that "[r]igorous enforcement incentivizes the auditing profession to diligently follow all applicable requirements and, in so doing, promotes audit quality and investor protection."
>
> As indicated by our policy on Independence of Accounting and Auditing Standard Setters, our members view rigorous enforcement of PCAOB auditing standards as an important tool for the Board to successfully promote audit quality and investor protection. In furtherance of this objective, we respectfully request that, consistent with the recent statement of SEC Acting Chief Accountant Paul Munter, the PCAOB rigorously enforce those audit requirements that may be violated by "accounting firms looking to avoid the uncertainty about whether they will be in compliance with the Holding Foreign Companies Accountable Act (HFCA Act)." CII was an active proponent of the legislation that resulted in the HFCA Act and continues to support its effective implementation and enforcement.[18]

In addition, we agree with the Board that the Proposal is consistent with the investor protection provision of SOX which '"plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act.'"[19] And, as indicated in our policy on **Financial Gatekeepers,** we view as favorable those SOX provisions that were intended to enhance auditing firms' accountability to investors with a recognition that additional requirements, like those provided by the Proposal, may be needed.

6. Beyond the dual purposes of deterrence and accountability, are there other ways that the proposed amendments would protect investors?[20]

CII generally believes that beyond the dual purposes of deterrence and accountability, there are other ways that the proposed amendments would protect investors. For example, we believe that, generally consistent with the support for audit quality in our policies on **Independence of Accounting and Auditing Standard Setters** and **Audit Committee Responsibilities Regarding Independent Auditors**, the Proposal may improve "audit quality as auditors become more careful about their work . . . . "[21] In addition, and generally consistent with the references to the markets in our policies on **Independence of Accounting and Auditing Standard Setters** and **Financial Gatekeepers,** we believe the proposed amendments may **"**have an incremental positive effect on capital market efficiency."[22]

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[18] *Id.* (footnotes omitted).
[19] Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, at A2-58 (Sept. 29, 2003), *available at* https://pcaobus.org/Enforcement/Documents/Release2003-015.pdf ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act.").
[20] PCAOB Release No. 2023-007 at 12 (emphasis added).
[21] *Id.* at 21.
[22] *Id.* at 24.

We appreciate the opportunity to provide CII's investor-focused perspective on the Proposal. Please let me know if you have any questions about the content of this letter.

Sincerely,

Jeffrey P. Mahoney
General Counsel

Crowe LLP
Independent Member Crowe Global

November 3, 2023

By email: comments@pcaobus.org

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 053: *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (PCAOB Release No. 2023-007)

Dear Ms. Brown:

Crowe LLP ("Crowe") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or "the Board") proposed amendments to Rule 3502 Governing Contributory Liability (the "Proposal" or the "Proposed Rule").[1]

We support a strong enforcement program as an important tool the PCAOB has available to penalize bad actors, deter poor conduct, and support strong audit quality. We have significant concerns, however, about the proposed changes to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (the "Rule"), that are under consideration, including a lack of sufficient justification for the changes and substantial potential consequences that are likely to be detrimental to audit quality. In addition, we do not believe the statutory authority is clear. Based on these concerns, Crowe does not support the adoption of the Proposed Rule.

The Rule that was adopted in 2006 was first proposed as a negligence standard. However, after consideration of comments received, the PCAOB determined it was not appropriate to adopt a negligence standard. Instead, the PCAOB required that there be, at a minimum, recklessness to underlie an enforcement action under Rule 3502. Since the Rule's adoption, the PCAOB has not indicated that the recklessness standard does not sufficiently protect investors. To adopt the Proposal and thereby change the well-established and well-reasoned Rule that the PCAOB adopted 17 years ago, under pertinent law,[2] the PCAOB should provide a justification for the change, including how a negligence standard will better enhance audit quality and protect investors. Yet, the Proposal does not provide such a justification, and certainly not one which demonstrates that the benefits outweigh the costs and potential consequences of the Proposal. Instead, adoption of the Proposal would be inconsistent with the findings that the PCAOB made when it adopted the Rule.

The SEC's experience and implementation of Rule 102(e)(1)(iv)(B) provides additional reasons why the Proposal should not be implemented. That rule provides the SEC with authority to bring enforcement actions based on two types of negligent conduct. Because the SEC has the ability to bring enforcement actions based upon this negligence predicate, it follows that any change in auditor behavior that the PCAOB hopes to accomplish with the change to the Rule has already been accomplished by the SEC's

[1] Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, Release No. 2023-007, Public Company Accounting Oversight Board (Sept. 19, 2023).
[2] *See, e.g., F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (noting such requirements when, as here, the Proposal is contrary to the finding made when present Rule 3502 was adopted, and people have relied upon the present Rule).

ability to bring such actions. On the flip side, if the PCAOB believes the SEC's ability to bring such actions has not successfully changed auditor behavior, the PCAOB should explain why the Proposal will successfully effect such change where the SEC rule has not. Further, given the SEC's authority under Rule 102(e)(1)(iv)(B) to bring action against auditors for negligent conduct, there is no clearly articulated need for the PCAOB to add another layer of regulatory authority to the panoply of rules already governing auditors of public companies.

Finally, while the Proposal notes that the SEC could bring an enforcement action based upon a single negligent act under 15 U. S. C. Section 78u-3(a), no matter has been proffered where this was actually done by the SEC, which instead has utilized the negligence rule set forth in Rule 102(e).[3] The SEC's lack of enforcement actions based upon a single act of negligence suggests that the SEC has concluded such actions either are not warranted or would not further the SEC's mission. We do not believe the PCAOB's standard should be different.

The potential ramifications of changing Rule 3502 to reflect a negligence standard could be severe. Among other things, these changes could exacerbate the growing shortage of CPAs entering or choosing to stay in the profession. Adoption of the Proposed Rule may further dissuade potential accountants from joining the profession based on the increased personal regulatory scrutiny or dissuade individuals from accepting roles in the firm's quality control system. Firms may be reluctant to accept certain issuers as audit clients due to the lower liability threshold and some firms may choose to exit the public company or broker-dealer audit space altogether. To enact a change in the law which may lead to less competition in the marketplace because individuals and firms will stay out of public auditing, in whole or in part, may further a trend that Section 701 of the Sarbanes-Oxley Act of 2002 ("SOX") reflected as concerning.

Finally, given the fact that the Proposal does not provide sufficient justification for the change to a negligence standard, and that the proposed new standard could have significant adverse consequences, there should be especially clear statutory authority for the adoption of the new Rule. Instead, neither Section 103 nor Section 105 of SOX provide such clear authority.

I. Nothing Has Changed Since the Adoption of Rule 3502 That Justifies a Change in The Previously Adopted Rule and the Proposal Does Not Provide a Sufficient Basis for the Change

In December of 2004, the PCAOB issued a proposed Rule 3502.[4] The proposed rule permitted associated person liability based on a negligence standard.[5] However, when the PCAOB issued its final Rule, a recklessness requirement was the minimal threshold for regulatory action.[6] In fact, the final rule was entitled "Responsibility Not to Knowingly or Recklessly Contribute to Violations." In adopting a minimal threshold of recklessness in the Rule, the Board confronted the same issue that it faces today, and decided not to adopt a negligence standard. The reasons that the PCAOB declined to adopt negligence liability then are fully applicable today. The Board summed it up this way:

> After carefully considering the comments received, the Board has determined, however, to modify the scope of Rule 3502 to apply only when an associated person causes the registered firm's violation due to an act or omission the person "knew, or was reckless in not knowing, would directly and substantially contribute to such violation." …
>
> A number of commenters expressed concern that adoption of a negligence standard would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards. For example, commenters suggested that the proposed rule could be used against compliance personnel

[3] 17 C.F.R. §201.102(e), note 1 at 11-12.
[4] Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Release No. 2004-015, Public Company Accounting Oversight Board (Dec. 14, 2004).
[5] *Id.*
[6] SEC Release No. 34-53677, File No. PCAOB-2006-01 (April 19, 2006).

> within a firm who inadvertently design a firm's compliance system in a flawed manner. Commenters also expressed concern that, because the SEC can enforce PCAOB rules under Section 3 of the Act, the Board's rule could have the practical effect of altering the state-of-mind requirement applicable in SEC enforcement proceedings against accountants.
>
> It was not the Board's intention to establish a new standard for SEC enforcement of the securities laws and related applicable rules. The Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs. The Board does not seek to create through this rule a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful. Nor does the Board seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation. At the same time, the Board continues to believe that it is necessary and appropriate for its ethics rules to apply when an associated person has engaged in an act or omission with knowledge that, or in reckless disregard of whether, it would directly and substantially contribute to a violation.[7]

The findings and conclusions made by the Board in 2006 in adopting Rule 3502 are still valid. Indeed, a number of Board members have recently raised concerns similar to the concerns that the Board expressed in 2006 when it did not adopt a negligence standard. For example, the 2006 Release noted that: "The Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs."[8] Similarly, Board Member DesParte recently noted that "[a]udits are complex and require significant input and judgment from a wide array of professionals with distinct responsibilities, expertise, and experience, all working collaboratively to comply with complex laws, professional standards, and rules."[9] Additionally, in 2006, the Board noted that "commenters suggested that the proposed rule could be used against compliance personnel within a firm who inadvertently design a firm's compliance system in a flawed manner"[10] and the Board in 2023 noted a similar concern.[11] These similarities show that the same concerns exist today as when the Board changed course from a negligence standard and instead adopted a recklessness standard in 2006.

Since the same reasons exist today as in 2006 for not adopting a negligence standard, there should be clear justification for the change. However, the Proposal does not provide justifications to support a change. The Proposal suggests that the recklessness standard creates an "incongruity" between the direct liability of the firm and the contribution liability of associated person.[12] That asserted "incongruity" would have been equally present in 2006 when the Rule was adopted but that incongruity did not justify adoption of a negligence standard.

Further, given the concerns noted in Section II below, the proposed change in rule should be supported by a clear rationale and basis. The Proposal does not provide that. The Proposal estimates that there will be few additional enforcement actions if the Proposed Rule is adopted.[13] In light of the substantial potential consequences (discussed below) of the Proposed Rule, it should not be adopted if it will be largely unused. The Proposal suggests that there will not be substantial cost from the proposed rule change because it will not be any different than SEC Rule 102(e). It is not clear what the need for this

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[7] SEC Release No. 34-53427, File No. PCAOB 2006-01 (March 7, 2006). While the Board's proposed rule tracked some of the language of Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), the rule, as adopted, differs significantly from, and should not be interpreted in pari materia with, that statutory provision.

[8] *Id.*

[9] Duane M. DesParte, Board Member, Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, PCAOB Open Board Meeting (Sept. 19, 2023), https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability.

[10] SEC Release No. 34-53427, *supra* note 11 at 19.

[11] *See* Proposed Amendments to PCAOB Rule 3502, *supra* note 1 ("Excessive litigation risk could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals.").

[12] *Id.*, see note 1 at 3.

[13] *Id.*, see note 1 at 25.

rule change is or what will be gained by the rule making if the SEC already has the authority to bring enforcement actions against auditors for negligent conduct.

II. The Potential Consequences of the Proposed Rule Could Be Severe

Consequences of a rule change should be understood before implementing the change, including careful consideration of the costs of the proposed change. While the consequences associated with the Proposal may be difficult to predict and quantify, it is important for the PCAOB to undertake this effort to exhibit its commitment to thoughtful consideration of changing rules that may have significant negative impacts on audit firms and individual auditors.

The Proposed Rule may cause a decline in the number of firms willing to audit public companies or participate in public company audits conducted by other firms. Small and mid-sized accounting firms will need to consider whether the benefits of auditing certain public registrants, or participating in public company audits, is worth the additional risks to their partners and staff. Those firms may decide not to do such work at all.

When SOX was passed, Congress was aware of the downfall of Arthur Andersen LLP and other events in the market that affected competition in the public company audit market. Section 701 of SOX specifically required that there be a study to determine the effects of this lack of competition, and ways to address it. Given this expressed Congressional concern, it is especially appropriate to consider the effects of the Proposed Rule on competition for audit work in the marketplace. Indeed, the GAO Report that was issued pursuant to Section 701[14] noted that "the possible reduction in the number of accounting firms willing to audit public companies in the wake of the passage of Sarbanes-Oxley could further impact the availability and cost of capital for some smaller companies…." Given these concerns, Crowe suggests that the Proposed Rule be analyzed for its effect on audit firms which issue audit reports or participate in other firms' audits (and on the individuals at those firms who will be working on those audits). If the effect of the Proposal would be to decrease access to auditors, that would be contrary to the concern Congress expressed in requiring the report referenced in Section 701.

The Proposed Rule is also likely to further exacerbate the decline in individuals pursuing the CPA license and discourage highly qualified individuals from accepting roles on more challenging audits or in the firm's quality control system. As noted above, this risk was identified in the 2006 adoption of the present Rule, when the Board noted that "commenters suggested that the proposed rule could be used against compliance personnel within a firm who inadvertently design a firm's compliance system in a flawed manner."[15] Indeed, similar concerns have been expressed today.[16] There is significant publicity around the PCAOB's adoption of new policies, and its strengthened enforcement posture and the regulatory environment is of course known to individuals who are contemplating a career in public accounting. With that backdrop, students or junior auditors may reconsider a career in audit if that career is subject to being taken away at any time based on a single act of negligence, particularly if a new negligence standard is used to question judgment calls based on the clarity of hindsight. The Board appeared to recognize this concern when the Chair noted that the Proposal was not "intended" to be used against junior auditors.[17] But that "intent" is not in the Proposal, and as Board Member Ho noted, that "intent" could change with a future board (or even this Board).[18] Certainly, the Board needs to take action against

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[14] Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, "Mandated Study on Consolidation and Competition," GAO-03-864 July 30, 2003.
[15] Proposed Amendments to PCAOB Rule 3502, *supra* note 11 at 19.
[16] *See* Proposed Amendments to PCAOB Rule 3502, *supra* note 1 ("Excessive litigation risk could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals.").
[17] Erica Y. Williams, Chair, Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.
[18] Christina Ho, Board Member, The Cost of Unintended Consequences: Accounting Talent, Audit Quality, Investor Protection, PCAOB Open Board Meeting (Sept. 19, 2023), https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability).

bad actors; however, we do not believe that a person who acts negligently should necessarily be considered a bad actor, such as when their actions involve a single act of non-compliance with the professional standards. To the extent the Proposal exacerbates the shortage of auditors or a reduction in registered firms, adoption of the proposed changes could lead to issues of audit quality rather than improvements.

Finally, a premise of the rulemaking seems to be that auditors will act with more care if they are subject to an enforcement action based on a negligence standard.[19] Since auditors are already subject to negligence actions by the SEC, state regulators, and perhaps third parties, including their clients, the Proposal should provide some empirical evidence to support how auditor's behavior is going to change under the Proposed Rule. Moreover, even if this point has some validity, we believe the risk is greater that auditors will be "overly careful" to protect themselves by performing additional, unnecessary auditing procedures. If every judgment made in the context of an audit was subject to individual sanction, an auditor may, out of necessity, shy away from difficult decisions which will lead to less effective auditing or, at a minimum, will increase audit costs. Either way, this will not lead to enhanced audit quality.

III. Statutory Authority for the Change in the Rule is Not Clear

The Proposal references a number of provisions[20] as the basis of authority for the proposed new rule, with the focus on Sections 103 and 105 of SOX as authority for adoption of a negligence standard.[21] However, it is not clear that either of these provisions permits the Board to promulgate this change to Rule 3502. The Release first references the Board's authority "to set ethical standards" in Section 103 as the basis for adopting a negligence enforcement standard. This provision cannot serve as a basis for the Proposed Rule. Section 103 provides the PCAOB with the authority to set ethical standards (i.e., what is and what is not ethical conduct). The Release does not address ethical conduct at all; it only addresses negligent conduct which may relate to an ethical obligation or may relate to another obligation established by the PCAOB. Negligence is broader than just ethical conduct. Accordingly, the power to regulate ethical conduct does not encompass disciplinary authority over <u>all</u> conduct and it therefore does not provide clear support for the Proposed Rule.[22]

In addition, Section 105 does not clearly provide a basis for the Rule change. Section 105 is titled "Investigations and Disciplinary Proceedings"[23] with Section 105(c)(4) providing the authority for sanctions. The Release suggests this section gives the PCAOB the ability to bring a disciplinary action for negligence; however, nowhere in that language does one find a basis for establishing liability for negligently contributing to a firm violation. The fact that Congress specifically gave this authority to the SEC, but not the PCAOB, in the Private Securities Litigation Reform Act, U. S.C. 78 t (e), to regulate aiding and abetting liability, is evidence that the PCAOB does not have this authority. Again, Sections 103 and 105 do not give the PCAOB clear authority to do what the Proposal contemplates and is an additional reason why the Proposal should not be adopted.

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[19] Proposed Amendments to PCAOB Rule 3502, *supra* note 1 at 21 ("The proposed amendments, by increasing the likelihood that individuals take more
seriously their audit, quality control, and other compliance responsibilities, will make it more likely for registered firms to comply with PCAOB standards.").
[20] Proposed Amendments to PCAOB Rule 3502, s*upra* note 1 at 2 n.4, 12 n.43.
[21] *Id*. at 12 n.43.
[22] 15 U.S.C. § 7213.
[23] 15 U.S.C. § 7215.

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We appreciate the opportunity to share our perspectives on the Board's Proposal. We would be pleased to discuss our comments with the Board or its staff. If you have any questions, please contact Jennifer Kary or Matthew Schell.

Sincerely,

Crowe LLP

Crowe LLP

Deloitte.

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November 3, 2023

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Suite 300
Washington, DC 20006-2803

Re: Docket Matter No. 053: *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability,* Rel. No. 2023-007 (Sept. 19, 2023)

Dear Ms. Brown:

Deloitte & Touche LLP is pleased to respond to the request for public comment from the Public Company Accounting Oversight Board on its proposed amendments to PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (the "proposed amendments" or "proposing release").

Our recommendation

We support the Board's efforts to promote better compliance with PCAOB requirements and thereby promote audit quality. We also recognize that after-the-fact assessment of compliance with the PCAOB's rules and standards through its inspection and enforcement programs is an important part of the PCAOB's regulatory regime, and that the outputs of those programs can further contribute to audit quality. We strongly support the PCAOB's enforcement program, which serves to deter wrongdoing and hold accountable those who put investors at risk by violating PCAOB rules and standards in a reckless manner.

We note, however, that the enforcement cases that the Board is likely to bring under the amendment to Rule 3502 would involve conduct less serious than that which the Board is currently empowered to sanction. We also believe that investors in our capital markets are best protected when noncompliance is avoided in the first place. We therefore believe that the Board's attention and resources would be better focused on developing programs designed to support those who seek in good faith to comply with PCAOB rules and standards at the outset, such as more robust programs to provide interpretive guidance and to facilitate consultation with the PCAOB staff on audit quality and independence issues.

Supporting good faith compliance

When Rule 3502 was initially adopted by the PCAOB, the Board emphasized that it did not "seek to create through this rule a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful."[1] At that time, the Board also noted that it chose to adopt a recklessness standard for Rule 3502, rather than the negligence standard it initially proposed, in part in recognition of the fact that "persons subject to [the Board's] jurisdiction must comply with complex professional and regulatory requirements in performing their jobs."[2] In the intervening two decades, our capital markets have become more complex and companies have become larger and more global (and audits therefore more complex and subject to increasingly difficult judgments), making the rationale of the Board in 2005 even more compelling.

We believe that the Board in 2005 was correct in choosing to adopt a recklessness rather than a negligence standard, and we see no compelling reason to change it now. While enforcement is an important component of the regulatory ecosystem, using a negligence threshold could result, as the current proposing release observes, in excessive self-protective behavior by firms and individuals who reasonably fear after-the-fact second-guessing of good faith judgments. Contrary to the goal of the Board, time spent on unproductive, excessively self-protective, activities detracts from other important obligations and thus negatively impacts audit quality.

We therefore encourage the Board to consider more effective ways to support audit quality in today's complex environment, including by increasing the support the PCAOB makes available to firms and professionals to comply with its standards and rules at the outset. A regulatory approach that allocates resources to encouraging compliance would better support audit quality than would an approach that risks encouraging excessive self-protective behaviors and counterproductive second-guessing of good faith professional judgments.

The U.S. Securities and Exchange Commission has recognized the benefits of such support and therefore has a long history of providing guidance to the entities it regulates to encourage compliance at the outset. This takes the form of publicly available guidance, which can be general or targeted to certain categories of entities that the SEC regulates, including:

- ***Staff Accounting Bulletins***, setting out the staff's views on accounting-related disclosure practices[3]
- ***FAQs***, which provide the staff's views on frequently asked questions about compliance with SEC rules and regulations[4]
- ***Letters*** from the staff to certain groups, types of professionals, or industries[5]
- ***Compliance & Disclosure Interpretations***, and other published guidance reflecting the views of the staff on certain interpretive issues related to the laws and rules it administers[6]
- A robust ***Financial Reporting Manual,*** which originally served as internal guidance to the SEC staff but was made public to increase transparency of informal staff interpretations[7]

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[1] PCAOB Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees* (July 26, 2005) at https://cms-pcaob-staging.idevdesign.net/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf.
[2] *Id*.
[3] *See* https://www.sec.gov/regulation/staff-interpretations/accounting-bulletins.
[4] *See, e.g.*, https://www.sec.gov/page/oca-independence-guidance.
[5] *See, e.g.*, https://www.sec.gov/info/accountants/staffletters.
[6] *See* https://www.sec.gov/divisions/corpfin/cfguidance and https://www.sec.gov/corpfin/cfdisclosure#cfguidancetopics.
[7] *See* https://www.sec.gov/corpfin/cf-manual.

- ***Regulator meetings with the public accounting profession*** to discuss emerging interpretive issues, summaries of which are released publicly[8]

We appreciate that over the last few years the PCAOB has increased the frequency of its publications and developed new publications (such as the Spotlight series), intended to help auditors and other stakeholders understand PCAOB views and thus encourage compliance. We have found the Spotlight series especially helpful to support our continuous improvement efforts, particularly when it provides timely PCAOB staff insights from across its inspection program about common audit deficiencies and good practices, which we can consider proactively during the audit process. As the Board continues its efforts to update its standards, guidance from the Board and its staff will become even more important for firms trying in good faith to implement multiple new standards. We therefore encourage the Board to continue not only to provide guidance through its current channels, but also to consider the various types of interpretive guidance provided by the SEC to determine if any of those forms of guidance may be equally effective to aid audit firms and their professionals in complying with PCAOB rules and standards.

We also encourage the Board to consider establishing processes that facilitates auditors seeking real time, fact specific, guidance from the PCAOB staff. Here too, the SEC provides a useful model. The SEC has well-established processes to consult with companies and auditors both for the application of accounting and other professional standards, as well as to address financial disclosure requirements in specific situations.[9] The SEC process may vary based on the complexity of the issue and can range from informal oral inquiries to formal written requests and responses, including:

- Fact specific ***consultations*** on technical accounting matters—which can be oral or written, and in some cases anonymous[10]
- ***No-action, interpretive, and exemptive letters***, which are granted to specific entities based on specific facts and circumstances but are made public as reference for those facing similar circumstances[11]

In our experience, these consultations are invaluable to those who in good faith seek to comply with the SEC's requirements, even without insulating the consulting parties from all potential liability. This is because the SEC has established processes[12] that allow consulting parties to benefit from the SEC staff's significant experience and knowledge, as well as to understand better the staff's point of view on complex issues and consider any precedent that exists for the issue at hand. In fact, the SEC staff especially encourages companies and their auditors to consult on interpretations and questions that

[8] For example, the Center for Audit Quality's (CAQ) International Practices Task Force and SEC Regulations Committee are composed of CAQ and audit firm representatives who meet periodically with staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. Notes from those meeting are made public on the CAQ's website (*see* https://www.thecaq.org/committees-and-task-forces).

[9] *See* https://www.sec.gov/divisions/corpfin/cfreportingguidance.

[10] *See*, for example, the SEC Office of Chief Accountant's description of the accounting consultation process at https://www.sec.gov/page/oca-consulting-oca-what-expect.

[11] *See, e.g.,* https://www.sec.gov/corpfin/corpfin-no-action-letters.

[12] For example, in the SEC's Office of the Chief Accountant, consultation requests are assigned to staff members who have experience and knowledge about the topic, and each issue has a designated team leader who serves as a point of contact, following timing guidelines established to encourage timely resolution of issues. Consultations often begin orally, but the staff may ask the consulting party to prepare written documentation of the issue. The SEC staff also has an established escalation process to more senior staff, especially in the case of novel or controversial issues. The SEC staff may gather opinions and interpretations from outside parties, such as the Financial Accounting Standards Board, the PCAOB, or even non-participating public accounting firms. The consulting parties may also seek review of the staff's conclusion by the SEC's Chief Accountant. (See description of the process at https://www.sec.gov/page/communicating-oca).

involve unusual, complex, or innovative transactions for which no clear authoritative guidance exists, as well as on issues regarding auditor independence.[13]

We encourage the Board to look to the SEC as a model, both in considering whether the PCAOB could increase the amount, timeliness, and specificity of the general-use interpretive guidance it provides, and—perhaps more importantly—establish formalized processes and devote adequate staff resources to encourage firms and professionals to consult with the PCAOB staff on specific issues related to the implementation and application of PCAOB rules and standards. The long history of success in the SEC's efforts to guide the entities it regulates we believe is due in large part to the fact that it has dedicated significant expert resources to these efforts, as well as its transparent and formalized processes.

The need for the proposed amendments is unclear

The proposing release suggests that the principal benefit to investor protection of an amended Rule 3502 would be to increase compliance and audit quality. As noted, we believe that the PCAOB's enforcement authority, including its current authority under Rule 3502, is an important part of its regulatory authority. We also believe that the PCAOB increasing resources dedicated to supporting firms' good faith efforts to comply with PCAOB rules and standards at the outset is more in line with, and more likely to be successful in achieving, that goal than the proposed amendments to Rule 3502 would be.

The means by which the proposed amendments will achieve further investor protection benefits are unclear. Specifically, the Board already has the power to sanction negligent conduct in the context of a specific audit. All members of an audit engagement team are already bound by AS 1015, *Due Professional Care in the Performance of Work*, which requires the exercise of reasonable care, and failure to do so constitutes negligence. The Board also already possesses tools beyond Rule 3502 to sanction personnel who act negligently in other contexts. In the area of auditor independence, for example, the Board has sanctioned audit personnel as direct violators of applicable independence rules for engaging in activity that contributes to the impairment of the independence of the registered firm as a whole from its audit client.[14] Similarly, in the non-cooperation context, the Board routinely sanctions a firm and an individual for non-cooperation, without alleging that the individual contributed to the firm's violation under Rule 3502.[15]

The Board should also consider the necessity of the proposed amendments to Rule 3502 within the broader context of the PCAOB's rulemaking and standard setting agenda. For example, the Board's recent proposal to replace AS 2405, *Illegal Acts by Clients*, as well as its proposed updated standards on quality control and the general responsibilities of an auditor, would impose significant new responsibilities and obligations on firms and individuals. The potential for significant changes to firms' and individual's professional responsibilities if those proposals were adopted in some form underscores the benefit of developing robust processes for consultation on implementation and application of PCAOB rules and standards. It also separately reaffirms the need for further analysis of how the PCAOB's other agenda items may intersect with the proposed amendments to Rule 3502—and whether, when

[13] *See* https://www.sec.gov/page/communicating-oca.

[14] *See, e.g.*, *Susan E. Birkert*, PCAOB Rel. No. 105-2007-003 (Nov. 14, 2007). The *Birkert* order alleges that the respondent acted recklessly, but that finding was not necessary for the independence violation that the order alleged, merely for the heightened sanctions that the Board imposed, which would still be a necessary finding even if Rule 3502 were amended.

[15] *See, e.g.*, *Hay & Watson and Essop Mia, CPA*, PCAOB Rel. No. 105-2022-017 (Sept. 13, 2022).

viewed in that context the proposed amendments, are proportionate to the perceived problem that the Board is trying to address.

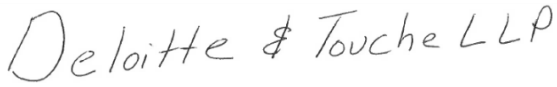
Finally, the Board has asserted that an expanded Rule 3502 is desirable to bring the PCAOB's enforcement regime into line with the SEC's power to bring actions for negligence. But the PCAOB's proposed amendments appear to contemplate broader enforcement power than the SEC has exercised. The SEC matters cited in the proposing release as evidence of the SEC's power to sanction negligent conduct all involve individuals who were alleged either to have acted recklessly or to have committed multiple acts of negligence.[16] In contrast, under the proposed amendments to Rule 3502, the Board would be empowered when there is a firm violation to bring enforcement proceedings against individuals who committed only a single simple act of negligence.

Conclusion

By definition, the cases that the Board is likely to bring under the proposed amendments to Rule 3502 would involve conduct less serious than that which the Board is currently empowered to sanction. We encourage the Board to reconsider whether it should adopt the proposed amendments in light of the limited benefit and significant risk that they will cause excessive self-protective behavior that would negatively affect audit quality. We believe that the Board would better drive improvements in audit quality—and therefore benefit investors—if it did not adopt the proposed amendments and instead focused resources on developing more robust programs to provide interpretive guidance and encourage consultation with the PCAOB staff on audit quality and independence issues.

We appreciate the opportunity to provide our perspectives. If you have any questions or would like to discuss our views further, please contact John Treiber (312-486-1808) or Consuelo Hitchcock (202-220-2670).

Sincerely,



Deloitte & Touche LLP

[16] *See David S. Hall, P.C.*, SEC Initial Decision Rel. No. 1114 (Mar. 7, 2017); *Gregory M. Dearlove, CPA*, SEC Rel. No. 34-57244 (Jan. 31, 2008); *Philip L. Pascale, CPA*, SEC Rel. No. 34-51393 (Mar. 18, 2005).

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3 November 2023

Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability (PCAOB Release No. 2023-007; Docket Matter No. 053)

Dear Ms. Brown:

Ernst & Young LLP is pleased to submit to the Public Company Accounting Oversight Board (PCAOB or Board) its comments on the proposed amendments to PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (the proposal).

We recognize the importance of an effective PCAOB enforcement program in holding individuals accountable when there are violations of rules and regulations. We also support the PCAOB's efforts to close gaps in its regulatory framework when they are consistent with its legislative mandate. However, we respectfully submit that there are currently no gaps related to secondary liability for associated persons that require closing.

The PCAOB today has a comprehensive toolkit for its enforcement program. The PCAOB can bring enforcement actions against individuals who violate the Sarbanes-Oxley Act of 2002, PCAOB rules or professional standards, and it can impose heightened sanctions when individuals engage in repeated instances of negligent conduct and in other circumstances. Additionally, under existing Rule 3502, the PCAOB can bring enforcement actions against individuals who substantially and directly contribute, knowingly or recklessly, to violations of registered firms of which the individuals are associated persons.

The PCAOB's authorities work in tandem with those of the Securities and Exchange Commission (SEC or Commission), which has its own active enforcement program, and auditors also are subject to discipline by state boards of accountancy and other regulators. These overlapping enforcement regimes address liability for a variety of conduct, including when the alleged misconduct was negligent rather than deliberate or reckless. That is, associated persons are currently subject to liability based on allegations that they departed from a standard of reasonable care, without a need for a regulator to establish anything regarding the intent of the individual, even when the evidence shows that the associated person was acting in good faith.

Despite the PCAOB's strong enforcement program and multilayered enforcement authorities, the proposal asserts that there is a "gap in the PCAOB's regulatory framework,"[1] and it would close that perceived gap by (1) lowering the threshold for secondary liability for associated persons to negligence from recklessness and (2) requiring that the primary violation be committed by "any" registered firm rather than by a registered firm of which the individual is an associated person.

We are concerned that the cost-benefit analysis contained in the proposal is insufficient to support the proposed changes. Our concerns are discussed below in our responses to selected questions in the proposal.

7. Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate?

We have several concerns about changing the standard for associated persons' contributory liability to negligence from recklessness.

First, the proposal creates a misimpression that associated persons currently can only be sanctioned for intentional or reckless misconduct. However, the Sarbanes-Oxley Act empowers the PCAOB to sanction associated persons for primary violations of applicable laws, rules and professional standards, including when their conduct was not intentional or reckless. In addition, the proposal acknowledges that "the Commission has the authority to discipline an individual for causing a registered public accounting firm to commit a violation, including when the individual acts negligently."[2] The fact that associated persons can be sanctioned for primary and secondary violations, including when their conduct is not intentional or reckless, means there is no significant regulatory gap requiring attention.

Second, the economic analysis in the proposal does not adequately support the proposed changes. Table 1 compares PCAOB enforcement actions against firms to PCAOB actions against individuals under Rule 3502. A more relevant comparison would be PCAOB enforcement actions against firms to PCAOB actions against individuals in general, although even that comparison would not shed meaningful light on the need for the proposed change.

Additionally, there is insufficient rigor in the assertions that Board "Staff estimates two to three instances in 2022 where an amended Rule 3502 would have prompted Staff to recommend a Rule 3502 charge,"[3] and that "this number is likely a fair average representation across other years."[4] Again, the more meaningful comparison would be to situations in which an enforcement action against an individual was an appropriate exercise of prosecutorial discretion, yet the Board didn't have the authority to bring such an action under either existing Rule 3502 or under the other charges it can bring directly against individuals.

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1 PCAOB Release No. 2023-007 at 4.

2 *Id.* at 20.

3 *Id.* at 25.

4 *Id.*

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Third, the proposal asserts that "[t]he proposed change in Rule 3502's liability standard would . . . make the rule both a more effective deterrent and a more effective enforcement tool,"[5] but it also asserts that "the proposed amendment to Rule 3502's liability threshold would not subject auditors to any new or different standard to govern their conduct,"[6] in part because the SEC already can sanction auditors for negligently contributing to audit firms' violations. The proposal does not sufficiently explain how it would have a more effective deterrent effect, or would close a regulatory gap, if it is not supposed to change associated persons' duties of care or subject associated persons to new liability.

Fourth, the proposal asserts that both the PCAOB and the SEC should be able to impose sanctions for secondary liability based on negligence, in the event there is an enforcement action against an associated person that the PCAOB would be inclined to prosecute but that the SEC would not be inclined to prosecute. However, there is no enforcement gap because the SEC already can sanction individuals for the same conduct at issue in the proposal. The proposal also does not suggest there have been any instances where the PCAOB encouraged the SEC to bring a negligence-based secondary liability charge that the PCAOB itself could not bring, and the SEC declined to do so.

Finally, the proposal asserts that "there is a mismatch between individuals' and firms' respective minimum culpability levels,"[7] because "the current rule's recklessness standard for imposing liability on an individual who contributes to a registered firm's violation is a more stringent liability standard than the negligence standard for the primary violation."[8] However, the proposal does not address whether or when individual auditors would be held secondarily liable for negligent conduct if the primary violation was based on intentional or reckless conduct. As former PCAOB Board Member Duane M. DesParte suggested, it might not "be appropriate for the Board to hold an associated person accountable for contributory negligent conduct in instances where a firm acts recklessly or knowingly in committing the primary violation."[9] He also said "[a] 'negligence' rule is particularly ill-suited for retrospective judgments about compliance with 'professional standards,' and such a rule would operate as an invitation for after-the-fact attacks on conduct that was, at the time, objectively reasonable."[10] At a minimum, the proposal should explain whether the Board believes it would be appropriate to charge individuals for negligently contributing to a firm's violation, where the firm's violation is based on intentional or reckless misconduct — and if so, assess the benefits and costs of exercising such authority.

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5 *Id.* at 11-12.

6 *Id.* at 14.

7 PCAOB Release No. 2023-007 at 19.

8 *Id.*

9 https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability.

10 *Id.* (citation omitted).

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?

We believe the Board should retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation. These terms generally are clear, understandable and appropriate. As the Board explained when it adopted Rule 3502, these modifiers appropriately make sure that secondary liability attaches only to conduct that "contributed to the [primary] violation in a material or significant way,"[11] and to conduct that "either essentially constitutes the violation"[12] or "is a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation."[13] The Board further noted that secondary liability should not attach to "an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation."[14] These points remain valid, and the proposal does not identify a reason to depart from them.

10. Is the proposed substitution of "any" in place of "that" in Rule 3502 (as seen in Appendix A) clear, understandable, and appropriate?

The proposal does not identify a clear enforcement prerogative for the proposed substitution of "any" in place of "that" in Rule 3502. For example, the proposal acknowledges that it would be "rare" for there to be "potential" for "a mismatch to the extent that two people who similarly contribute to a registered firm's primary violation might face different consequences solely by virtue of their 'associated person' status with respect to that firm."[15] We believe the Board should not amend Rule 3502 based solely on a "rare," "potential" fact pattern. One would presume that in most, if not all, cases, if auditors negligently (or recklessly), directly and substantially contributed to the violations of firms with which they *were not* associated, that same conduct also would have negligently (or recklessly), directly and substantially contributed to the violations of the firms with which they *were* associated.

11. Should the Board expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons (i.e., not just by any registered firm)? If so, what (if any) limits or conditions should the Board place on such secondary liability?

We believe the Board should not expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons. At a minimum, it should support such a proposal with an additional cost-benefit analysis. Additionally, in practice, it is difficult to come up with realistic scenarios in which the PCAOB would not be able to hold an individual accountable despite that individual contributing to violations by other associated persons, because that individual neither committed primary violations nor contributed to violations by a registered firm.

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11 PCAOB Release No. 2005-014 at 13.

12 *Id.*

13 *Id.*

14 *Id.*

15 PCAOB Release No. 2023-007 at 20.

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17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

We agree with Chair Erica Y. Williams that there are circumstances where it is appropriate that "there are consequences when associated persons of PCAOB-registered firms contribute to violations committed by registered firms."[16] However, any PCAOB sanction against an individual, including for secondary liability and for simple negligence, can end that individual's career. Accordingly, lowering the threshold to bring enforcement actions against personnel who serve in certain oversight roles will reduce the attractiveness of those roles. As PCAOB Board Member Christina Ho observed, the PCAOB's investor protection mandate would not be served if the proposed change "unintentionally discourage[d] auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals."[17]

Expanding secondary liability to negligent conduct also could discourage individuals from entering or remaining in the accounting profession, out of concern that they could face career-ending enforcement proceedings arising from innocent mistakes while learning on the job. As Board Member Ho observed, there already is a "talent crisis facing the accounting profession,"[18] and "[i]f this Board (or future Boards) decide to routinely sanction associates or senior associates under the proposed negligence standard, the public company auditing profession will become even less attractive."[19] Therefore, if the Board adopts the proposed change from recklessness to negligence, we believe at a minimum the adopting release should reiterate Chair Williams' statement that "these updates are not intended to ensnare junior professionals."[20] Most importantly, the rule itself should make it clear that associated persons cannot be charged for "single instances of negligence"[21] to make sure that the updates do not unfairly "ensnare junior professionals," or professionals at any rank making complex judgments in good faith. Indeed, as former Board Member DesParte suggested, Rule 3502 may not be a "workable and fair framework"[22] if "contributory liability could be imposed on a potentially large number of individuals, including anyone who was in any way involved in the chain of events leading to a firm's primary violation, even if acting in good faith or involved only remotely or tangentially."[23]

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16 https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.

17 https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability).

18 *Id.*

19 *Id.*

20 https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.

21 *Cf.* PCAOB Release No. 2023-007 at 11.

22 https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability.

23 *Id.*

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We want to again thank the Board and its Staff for their consideration of this letter. We would be pleased to discuss our comments with the Board or its Staff at their convenience.

Very truly yours,

Ernst & Young LLP

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Re: Proposed Amendments to Public Company Accounting Oversight Board (PCAOB) Rule 3502 Governing Contributory Liability (Docket 053) ("Proposed Amendments")

Dear Office of the Secretary:

The Accounting Principles and Auditing Standards Committee (the Committee) of the Florida Institute of Certified Public Accountants (FICPA) respectfully submits its comments on specific portions of the referenced Proposed Amendments. The Committee is a technical committee of the FICPA and has reviewed and discussed the referenced Proposed Amendments. The FICPA has more than 18,500 members, with its membership comprised primarily of CPAs in public practice and industry. The Committee is comprised of twenty-two members from local or regional firms, large multi-office firms, sole practitioners, international firms, academia, and industry. The response below reflects only the views of the Committee. The Committee has the following comments related to the responses below.

We support the PCAOB's mission to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports. As part of these efforts, we applaud the PCAOB's initiative to review and modernize auditing standards and in this instance, we support the intent to establish consistency in applying a standard of conduct for individuals and public accounting firms and that generally seems reasonable. However, we have two primary areas of concern with the Proposed Amendments and how they will be implemented.

First, the Board is proposing to "….amend the rule to provide that an individual contributing to a registered firm's primary violation need not be an associated person of the firm that commits the violation so long as the individual is an associated person of some registered firm." Our concern is that this may result in individuals that are marginally involved in an audit being exposed to undue liability risk. Our suggestion would be to limit the statutory circle of liability to only owners or principals of the audit firm formally engaged in the financial statement audit (i.e., signors of the respective audit opinions).

Second, since auditing does require individual judgments, lowering the contributory bar to negligence from recklessness raises concerns about whether individuals acting in good faith could be penalized especially regarding complex and highly judgmental audit areas given the relative ambiguity of both terms. This could result from unfair retrospective criticism and excessive scrutiny of highly technical judgements. Another potential consequence could be the continued dilution of auditing talent, which

should be a concern for regulators as a result of the decreasing enrollment trend of students selecting accounting as a major at accredited universities.

We appreciate the opportunity to share our views. Members of the Committee are available to discuss any questions you may have regarding the responses in this letter.

Respectfully Submitted,

FICPA Accounting Principles and Auditing Standards Committee

Genevieve Hancock, CPA, Chair
Larry Burke, CPA
Michael Jerman, CPA

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November 3, 2023

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Via Email to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 053, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*

Dear Office of the Secretary:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB's) Rulemaking Docket Matter No. 053, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (the Proposal). We support the Board's mission and appreciate its ongoing commitment to investor protection. However, our letter highlights some specific concerns we have with regard to the Proposal, as well as a broader but considerable concern about the cumulative impact the Proposal could have when combined with the potential consequences of other active standard-setting projects. We believe that this combined impact on the profession as a whole could affect auditors' ability to sufficiently carry out their responsibilities within the financial reporting chain. We respectfully submit our comments and recommendations for the Board's consideration.

Firm liability versus individual liability

On page 7 of the Proposal, the PCAOB states that "there exists an incongruity between the respective requisite mental states for liability of a registered firm resulting from an associated person's conduct and for liability of the associated person." We do not think this difference is problematic and believe that it strikes an appropriate balance. We agree that it is reasonable to hold firms responsible for negligence and that a firm acts through its individuals. Nevertheless, a firm's system of quality management is complex and contains various interdependent parts, including personnel with overlapping responsibilities. In our opinion, the fact that a firm's actions

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are taken by individuals forms the very basis for the construct within extant Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*. Further, we do not believe it is appropriate to hold individuals to a negligence standard for their execution of a broad, diverse set of responsibilities that require judgment.

Need for change

We are concerned that the Proposal does not clearly set forth a sufficient basis for the proposed rule changes and believe that certain points made in support of the Proposal seem to be contradictory to others. For example, the discussion on page 8 of the Proposal describes the Board's inability to charge Rule 3502 violations, and how the current threshold prevents the Board from executing its mandate of investor protection to the fullest extent. However, the economic analysis on page 25 states that the PCAOB staff "estimates two to three instances in 2022 where an amended Rule 3502 would have prompted staff to recommend a Rule 3502 charge." The discussion further indicates that the 2022 estimate "is likely a fair average representation across other years."

Based on this discussion, the perceived gap in the PCAOB's current regulatory framework appears minimal at best. It does not appear to be the type of gap that warrants a stark expansion of the enforcement-related tools that the Board currently possesses.

We also believe that the proposed QC 1000, *A Firm's System of Quality Control*, provides clearer expectations with regard to individuals in quality control roles, rendering the need for revisions to Rule 3502 unnecessary, given the various other enforcement tools currently at the Board's disposal. We supported the Board's intention to modernize and streamline the standards and rules, as described in the Board's 2022-2026 Strategic Plan, and agree that change may be necessary to meet today's needs, as the Board notes on page 11 of the Proposal. However, we believe the Board's expectations and intentions remain unclear with regard to the need for rulemaking concerning contributory liability, and we are unaware of significant changes in legal precedent regarding negligence standards over the last several years that would necessitate the proposed changes.

Costs of unintended consequences

In considering how these changes will be brought to bear in the profession, we believe the potential costs of the unintended consequences of the proposed amendments cannot be overstated. Our two most significant concerns are as follows:

- The caliber of individuals willing to serve in quality control roles will likely suffer if the rule is approved as proposed. In our comment letter on proposed QC 1000, we expressed concerns that firms might have difficulty filling the roles specified in the proposed standard. We believe proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, QC 1000, and the proposed amendments to Rule 3502 could have a compounding impact on the profession's and on individual firms' ability to attract and retain qualified individuals to assume key roles in systems of quality control. We feel that Rule 3502 is particularly problematic in this regard because, under the proposed standard, individuals serving in a quality

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control function could be held liable for an honest mistake that results in a quality control violation against the firm. This no-margin-for-error scenario will certainly have a chilling effect on the number of qualified individuals willing to assume a quality control role, which of course runs counter to the point for the PCAOB's new initiatives.

- When combined with the various other standard-setting changes the Board has undertaken recently, the proposed amendments to Rule 3502 could drive smaller firms away from auditing public companies, thus reducing competition. Similarly, the cumulative impact of the Proposal and other recently proposed standards could also reduce the number of foreign firms that are willing to perform procedures in support of international public company audits.

If the Board elects to move forward with amending Rule 3502, we believe aligning Rule 3502 more closely with the provisions of SEC Rule 102(e) would be more appropriate. While such an approach would not eliminate the potential unintended consequences described above, we believe it could provide clearer expectations of when liability for an error might arise and help to mitigate the impact of such consequences.

Effective date

While we do not disagree with the Board's basis for proposing an effective date of 60 days from the date of SEC approval, we ask the Board to again consider the interrelationships of the proposed changes and the other open standard-setting projects. We do not believe it is yet clear how Rule 3502, as proposed, would interact with the final versions of QC 1000 or AS 1000. It may be appropriate to have a longer effective date in order to give adequate time for the Board to make further progress on those projects and evaluate the interactions and potential unintended consequences of the various proposed changes in standards and rules.

****

We would be pleased to discuss our comments with you. If you have any questions, please contact Jeff Hughes, National Managing Partner of Audit Quality and Risk, at (404) 475-0130 or Jeff.Hughes@us.gt.com.

Sincerely,

/s/ Grant Thornton LLP

November 2, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Re: PCAOB Rulemaking Docket No. 053

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society ("Committee" or "we") appreciates the opportunity to respond to PCAOB Rulemaking Docket Matter No. 053, *Proposed Amendments to Rule 3502 Governing Contributory Liability,* dated September 19, 2023. The organization and operating procedures of the Committee are reflected in Appendix A attached to this letter. These comments and recommendations represent the position of the Audit & Assurance Services Committee of the Illinois CPA Society rather than any members of the Committee, the organizations with which such members are associated, or the ICPAS Board.

GENERAL COMMENTS:

We support the PCAOB's efforts in protecting the public interest and promoting audit quality; however, we have certain concerns regarding the necessity, application, and overall impact of the profession of the amendments as proposed. The consequences of the proposed amendments may have significant impacts on the profession as a whole (see further discussion below). While we responded to select questions found in the proposal, some of these concerns may address other requests for comment as well. The Committee represents a diverse group of auditors with respect to firm demographic and role, including members of academia and the consulting profession. As such, we feel that we bring a unique perspective to respond to this proposal and appreciate your consideration of our thoughts herein.

PCAOB QUESTIONS AND COMMITTEE RESPONSES:

Question 1: Are the regulatory concerns discussed above clear and understandable?

Response: Yes, we believe the regulatory concern related to Rule 3502's inconsistency between the liability threshold for firms (negligence) versus that of individuals (recklessness) and its connection to the ability to pursue enforcement actions against individuals associated with a firm's negligence is clear. Additionally, the issue related to a contributory individual's association with "any" registered public accounting firm makes sense.

We agree with the PCAOB's statement that, "[i]t logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person's negligence." The firm is the sum of its parts, but it is likely that the action of one or more individuals as opposed to the firm as a whole contributed to or allowed the violation to occur. We do not necessarily believe, though, that the individual or individuals are solely responsible for such violations when negligence is the standard, which is articulated in our responses below.

Question 3: Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms?

Response: Though the proposed change may address an inconsistency within the extant rule, we do not believe it would necessarily further incentivize individuals.

As firms only function through individuals who ultimately act of their own accord, we agree with the PCAOB's premise that negligence links back to associated individuals who do not exercise reasonable care. However, we also know that the firm has an integral role in shaping the auditor through its training, quality control program, the tools and methodology it requires adherence to, and its internal monitoring efforts. As such, we believe that the firm should be held to a higher standard as it sets the "tone at the top," no different than the relationship between management and employees in the entities that we audit. The ultimate failure or negligence likely stems more from the actions of the firm as a whole with its training and monitoring of its audits vs. the negligence of any individual auditor (national office or client server). In fact, during the conduct of an audit, engagement team members are using the firm's policies and tools and there may even be instances in which the engagement leader is required to act or conclude in a certain manner as a matter of firm policy. Thus, we question if there is a need to decrease the threshold for individual liability when the individual is ultimately linked to the audit and the firm.

When a firm violates its professional standards, it is subject to findings in PCAOB inspection reports and, when negligent, potential charges, fines, and sanctions from the PCAOB. These are public information and, specific to PCAOB inspection reports, the recent changes made to the format and presentation provide the public with detailed information related to the findings identified on individual audits. To the extent that Part II findings are disclosed, it provides even further insight into the firm's quality control program and more holistic issues present at the firm with respect to audit quality. PCAOB inspection reports have the potential to significantly impact the reputation of the firm both positively and negatively, and charges, fines and sanctions generally have an adverse impact. The fact that the PCAOB publicly highlights firm quality control observations in Part II of its inspection reports appears to indicate that there is a higher threshold for competence, quality, and responsibility at the firm level.

Part I.A and Part II findings have an indirect impact on the individuals in the firm, including those that served on those audits, that may take the form of reduced responsibility (e.g., removal of designations, limitations on clients served), lost clients and downgraded performance indicators. Ultimately, the firm's "tone at the top" and preventative measures (e.g., standards compliant tools, required trainings, engagement reviews) generally guard against collective and individual negligence. Therefore, the firm's approach to prevent and actions that respond to instances of negligence may impact the individual more, as the firm's actions may more directly dictate an individual's future. If the intention of increased individual liability is to support a greater commitment to due professional care and audit quality, we propose this can be achieved through holding the firm to the negligence standard and through firm level comments, as remediation efforts often include training, tools, methodology changes, and firm actions specific to individuals to directly respond to the shortcomings.

As such, we question if the decreased threshold from recklessness to negligence will directly impact audit quality in a meaningful manner and if the benefits to the public interest outweigh the costs that we outline below with respect to reputation and appeal of the audit profession.

It is also unclear as to whether there would be instances in which an individual would be subject to liability and not the firm. If that is likely not the case, we feel that the impact of the finding would be felt under the extant standard when the firm is found negligent and takes responsibility to address the violation. The sentiment of many commentors on the original proposed standard stands (refer to FN 17 of the proposal):

> "Their objections were based principally on the view that negligence might be an ill-suited liability standard "in light of the complex regulatory requirements with which auditors must comply" and out of concern that such standard "would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards."

Question 7: Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate?

Response: The Committee acknowledges that the use of *negligence* and *recklessness* differ within the extant PCAOB rule (firm vs. individual) and between the PCAOB rule and the SEC rules and regulations. Nonetheless, we have concerns regarding how the negligence-based standard for individual liability would be applied and how that application may differ from the SEC's application.

The PCAOB standards include many references to *due professional care* and that appears to be foundational to the definition of negligence presented in the proposed rule (underpinned by the discussion of "reasonable care" in the background material). Many firm PCAOB inspection reports, particularly Part II findings, contain reference to the lack of due professional care as being a contributory factor in the violation.

The proposed standard retains the phrase "directly and substantially." We believe this language aims to delineate between any of the violations of the due professional care standards vs. those that would contribute to personal liability in the context of the proposed rule. It is unclear, however, if the application of these terms will be applied differently moving forward in light of the proposed amendments. With many firms having findings related to due professional care that are public through Part II of inspection reports, we are unsure if it is expected that many of those would fall under the category of negligence and result in personal liability. Further, this may be confusing for investors and users, if due professional care findings are significant enough for public disclosure in Part II findings, but not enough to result also in charges, fines, or sanctions.

While our committee is not primarily comprised of legal professionals, it was unclear from the proposal the extent to which legal professionals were consulted when drafting the proposal and the actual impact it would have on the number of violations identified. Once again, with so many references to due professional care in the PCAOB standards and a broad definition of "directly and substantially", we have concerns surrounding the consistency with which the definition will be applied and how the public will be able to understand the difference between due professional care findings that they may see in PCAOB inspection reports and other press releases.

Question 8: Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear, and understandable?

Response: See response above for Question 7 regarding the clarity of "directly" and "substantially" terminology use.

Question 13: Are there other benefits and costs of the amendments that the Board should consider?

Response: The proposal discusses incentivizing appropriate due professional care and behavior, but such *negligent* or *reckless* auditors may in fact be those that are the least risk averse and would be inclined to continue auditing despite this additional personal liability risk. The most risk averse auditors, those who may employ the most due professional care and professional skepticism, may be those that leave or do not enter the profession in the first place. A firm's national office and risk management personnel serve an integral role in developing, training, and monitoring auditors, and to potentially discourage those individuals from serving in such roles if there is the potential for increased contributory liability could have a major impact on audit quality. We encourage the PCAOB to consider this when determining if the amendments are appropriate for the profession at large.

Question 14: Are there any data sources that could provide a quantitative estimation of the expected benefits and costs? If so, please provide the names of such sources.

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Response: While we did not identify additional data sources for use in developing a quantitative estimate of expected costs or benefits, we believe that a more in-depth investigation of available information would better illustrate the actual need for or benefit of any rule change. Table 1 (found within the proposal) illustrates the historic rate of Rule 3502 violations as a percentage of firms sanctioned over the last 13 years. The discussion notes that *"in nearly two-thirds of cases in which a firm was charged with a violation, no contributory actor was held accountable under Rule 3502."* However, though likely presumed, this analysis does not delve into whether the 158 cases without Rule 3502 charges could have merited or supported a Rule 3502 charge associated with individual negligence had the option been available. This evaluation (even if over a shortened period – i.e., over the last five rather than 13 years) would allow an estimate of the actual increase in the number of Rule 3502 charges under the proposed amendments.

Additionally, with the increased focus on firm quality control, information on whether firms themselves took substantial internal action against individuals associated with issues leading to firm sanctions (regardless of whether Rule 3502 charges existed) would be beneficial in determining the need for the expansion of Rule 3502's scope. Consequently, we would encourage the PCAOB to conduct a survey regarding the resulting internal impact of its enforcement actions at the firm level on associated individuals before proceeding.

Finally, absent any measure of the impact on audit quality and the public interest, we do not feel that the proposed change to the extant standard is warranted.

Question 17: As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

Response: It is clear from recent surveys and studies[1] and our own experience in academia and the audit profession that the talent pool and pipeline is a major concern. Notably, enrollments in bachelor's and master's degree programs have been declining over the past decade and experienced a significant decline recently in 2020-2021.[2] As such, any efforts made by standards setters that directly or indirectly impact the appeal of the profession are of interest. We appreciate the need to protect the public interest, but that can only be done with high quality auditors available to execute the audit work. We fear that proposed standards/amendments, such as the recent Noncompliance with Laws and Regulations (NOCLAR; PCAOB Rulemaking Docket Matter No. 051) and the rule change discussed here, may deter qualified and experienced individuals from remaining in the profession or joining the profession as they feel that the personal responsibility and liability is too great in comparison to other career paths.

Board members Duane DesParte and Christina Ho expressed these same concerns about the proposal, particularly that:

> "…the proposal might not present a workable or fair framework for contributors' liability due to unique challenges from the nature of auditing.
>
> Ho said the consequences of the proposed changes could spur junior auditors to leave the profession, prompting less qualified people to rise to fill important audit roles. "I am concerned that a failure to signal audit expectations [about future charges] upfront in the proposal may exacerbate the accounting talent crisis…."[3]

[1] https://www.shrm.org/hr-today/news/all-things-work/pages/the-cpa-shortage.aspx
https://www.journalofaccountancy.com/news/2023/jul/accounting-talent-shortage-is-focus-of-new-advisory-group.html

[2] Association of International Certified Professional Accountants (2023). *2023 Trends Report*. Retrieved from: 2023 Trends Report | Professional Insights | AICPA & CIMA (aicpa-cima.com) 10/24/2023.

[3] https://www.wsj.com/articles/pcaob-proposes-expanded-liability-for-individual-auditors-involved-in-firm-violations-a940f300

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These are the same two individuals that expressed concern regarding and dissented on the NOCLAR proposal. As CPAs, both provide important perspective, insight on how the public accounting profession operates, and what regulations are inherently viable and reasonable. If they, as current, tenured CPAs, have concerns over the reputation of the profession, which could further exacerbate the present talent problem, we feel that their insights should be strongly discussed and considered. The combination of the proposed NOCLAR amendments and this proposed rule change would significantly increase the scope, responsibility, and liability of individual auditors, and may have an overall negative impact on the profession, which could lead into an unintended negative impact on the public at a time when demand for accountants and auditors is expected to rise at a rate greater than the demand for overall workers.[4]

The Committee appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

Michael Ploskonka, CPA
Chair, Audit and Assurance Services Committee

Amber Sarb, CPA
Vice Chair, Audit and Assurance Services Committee

[4] United States Bureau of Labor Statistics (2023). *Occupational Outlook Handbook*. Retrieved from: Accountants and Auditors : Occupational Outlook Handbook: : U.S. Bureau of Labor Statistics (bls.gov) 10/24/2023.

ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2023 – 2024

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education, and public practice. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed, and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:	
National:	
Scott Cosentine, CPA	Ashland Partners & Company LLP
Timothy Delany, CPA	RSM US LLP
Erik De Vries, CPA	CohnReznick LLP
Kara Fahrenbach, CPA	Plante Moran, PLLC
Emily Hoaglund, CPA	KPMG LLP
James R. Javorcic, CPA	Mayer Hoffman McCann P.C.
Kelly Kaes, CPA	Grant Thornton LLP
Michael Potoczak, CPA	Marcum LLP
Jon Roberts, CPA	BDO USA, LLP
Amber Sarb, CPA	RSM US LLP
Regional:	
Elda Arriola, CPA	Roth & Co., LLP
Andy Kamphius, CPA	Vrakas CPAs + Advisors
Genevra D. Knight, CPA	Porte Brown LLC
Matthew Osiol, CPA	Topel Forman LLC
Michael Ploskonka, CPA	Selden Fox, Ltd.
Local:	
Kelly Buchheit, CPA	ORBA
Lorena C. Engelman, CPA	CJBS LLC
Mary Laidman, CPA	DiGiovine, Hnilo, Jordan & Johnson, Ltd.
Carmen F. Mugnolo, CPA	Mugnolo & Associates, Ltd.
Jodi Seelye, CPA	PKF Mueller, LLP
Industry/Consulting:	
Sean Kruskol, CPA	Cornerstone Research
Educators:	
Meghann Cefaratti, PhD	Northern Illinois University
Staff Representative:	
Heather Lindquist, CPA	Illinois CPA Society

JOHNSON GLOBAL Accountancy

November 3, 2023

Ms. Phoebe Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K St, NW
Washington, DC 20006-2803

PCAOB Release No. 2023-0007, September 19, 2023: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability

Dear Secretary Brown and PCAOB Board Members:

Johnson Global Accountancy is pleased to submit its comments on the proposed amendments to PCAOB Rule 3502, Responsibility Not to Knowingly or Recklessly Contribute to Violations, the Board's rule governing the liability of associated persons who contribute to a registered public accounting firm's primary violation.

Johnson Global Accountancy's mission is to be the most innovative and technically excellent advisory firm at the intersection of companies, auditors, and regulators, which improves investor decision-making confidence. We serve a diverse group of audit firms ranging from single office firms to more complex regional firms and the top 20 firms. We help firms interpret, respond, and comply with global auditing and financial reporting standards and regulatory requirements, including those standards set by the PCAOB. Our team of financial reporting quality advisors helps prepare firms to perform high-quality audits using innovative tools with a shared commitment to implement effective policies, procedures, and controls. We also provide firms with integrated software and service solutions to help them comply with audit quality standards.

Overall, we support the PCAOB's objective to improve audit quality, enhance investor protection, and further the public interest in preparing informative, accurate, and independent public audit reports. However, we are concerned with the Board's current proposal to expand the contributory liability of individuals involved in audits. We encourage the Board to continue considering the impact of such changes on the audit profession and whether these types of changes will lead to improved audit quality.

Detriment to the Appropriate Functioning of the Audit Team

Quality audits are predicated on a team performing audit work collaboratively. Each person and each step in the process contributes to that goal, with one being dependent on the other and all being important. We express serious concerns about whether allocating liability to one person in a team contributes to audit quality and encourages the brainstorming and sharing of information needed for success. Allocating responsibility to this level would increase risk aversion and can

encourage individualistic behavior; the focus could turn to protecting one's liability versus what is best for the audit.

We are also concerned that this will impede on-the-job training, an important element of building an auditor's professional judgment, due care and professional skepticism. It is not clear in the proposal, for example, whether less experienced staff making unintentional errors would be held to the negligence standard. In our view, the proposal needs to further clarify the definition of "associated persons" and narrow the application to protect the important benefit of on-the-job training. Otherwise, this will continue to contribute to dissuading individuals from entering the profession.

Focus on the Negative Detracts from Improving Audit Quality

Firms often express challenges they experience in hiring and retaining professionals to perform public company audits. This challenge exists today before this proposal – and this proposal has the potential to exacerbate this issue.

In our mentoring and coaching work, audit professionals often cite that they perform certain audit procedures due to the constant scrutiny of their work, regardless of whether it is required or contributes to an improved audit.

We are concerned that the Board's view of increasing "fear" in audit professionals with the threat of negative consequences will not result in more compliance and improve audit quality; rather, the Board should evaluate whether a focus on the growth mindset would much better achieve optimal performance. A focus on every error an audit practitioner makes will encourage auditors to focus on covering their liability and take their attention away from protecting investors' interests. This is an outcome that appears to be contrary of the Board's goal.

Consider Other Alternatives

The Board has many tools available to improve audit quality. We encourage the Board to use those existing tools further. Consider, for example:

<u>Quality Control Proposal, QC 1000</u>

Proposed QC 1000 includes sweeping changes to a firm's quality control system, including expanded and clearer roles and responsibilities. Section IV, C. Roles and Responsibilities on Page 67 states:

> Expectations of individuals within the QC system are established through the assignment of roles and responsibilities that are essential to a well-functioning QC system. This aspect of the QC system is intended to create clearer lines of communication and decision-making authority and greater accountability for those assigned to such roles.

Once finalized, this proposal could address the accountability gap the Board references. We encourage the Board to consider the implications of this proposal and to delay any changes to Rule 3502 until proposed QC 1000 is finalized and implemented.

Root Cause Analysis

We encourage the Board to study the root causes of problematic audit professional actions in inspections and enforcement actions. Understanding these would help design controls or other steps to prevent or detect these actions.

In our work with auditors, they are continuously seeking further clarity and illustrations on how to apply the standards. Illustrating what could go wrong or has gone wrong through enhanced communications would help auditors better understand expectations.

It would be helpful for the Board to further communicate observations from their enforcement activities in a *Spotlight* publication similar to that issued for inspection results. The Board could speak to "close calls" or those actions where the Board could not establish accountability to the associated person. Such communications would aid in educating new or upcoming professionals and informing professions with illustrations.

Impact on the Market Place

We share Board Member Ho's concerns that "*The proposal further recognizes the possibility that some firms could ultimately decide to cease conducting issuer and broker-dealer audits, which "could further consolidate the market for issuer and broker-dealer audit services." I have previously expressed concern that investors and the auditing profession can ill afford a reduction of competition in the audit marketplace."* We hear from clients and the marketplace that firms are deciding to exit the issuer audit work or minimize their issuer audit work due to the ever-increasing risks and punishments. We are observing a reduction in the marketplace. We encourage the Board to further study the impact of audit regulatory changes on the availability of firms to serve the public interest.

We set out our comments on selected questions posed by the Board in the proposal in the attached Appendix.

We appreciate the opportunity to provide our comments and support the PCAOB's efforts to improve auditing standards to enhance audit quality and better protect investors. We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Jackson Johnson, President (jjohnson@jgacpa.com) or Geoff Dingle, Managing Director and Shareholder (GDingle@jgacpa.com) or Santina Rocca, Managing Director (SRocca@jgacpa.com). They may be reached at (702) 848-7084.

Sincerely,

Johnson Global Accountancy

Johnson Global Accountancy

Appendix A

1. Are the regulatory concerns discussed above clear and understandable?

The regulatory concerns regarding the Board's challenge in attributing accountability for violations to specific individuals is clear. The proposal states on page 7 that the incongruity between the negligence standard for a firm and the reckless standard for an associated person has the "potential to dissuade associated persons from exercising the appropriate level of care in their audit work". It is not clear, however, how these two statements are linked and the support for one causing the other.

The proposal indicates that closing this regulatory gap should "incentivize associated persons to be more deliberate and careful in their actions. Indeed, "accountability frequently improves outcomes". It is unclear why this gap would, on its own, incentivize auditors to not exercise the appropriate level of care. Root cause analysis often cites numerous actions that contribute to violations, whether intentional or not.

The proposal refers to Colleen Honigsberg's article, "*The Case for Individual Audit Partner Accountability*" to support that "accountability frequently improves outcomes". Honigsberg's article also explains "why regulatory oversight, private enforcement, and firm-level reputational sanctions are unlikely to induce accountants to take optimal levels of care when auditing corporate financials. Instead, our best chance for improving audit quality lies in establishing a market for individual audit partners' brands – a market that can hold individual auditors responsible for their mistakes". The auditor reporting model and the identification of the auditor in Form AP appear to address that point. The proposal has not explained why the auditor's reporting model and naming auditors in Form AP has not improved the exercise of due care.

3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms?

We do not believe the proposal supports the statement that regulatory concerns would incentivize associated persons to fully comply with the applicable laws, rules and standards. The PCAOB has taken numerous steps over 20 years through robust inspections, enforcement actions, enhanced standards and stakeholder engagement and yet audit deficiencies and enforcement actions continue to increase. In our work with auditors, we see auditors taking many steps to improve their audit quality. Smaller auditors, in particular, express that they are being held to an inspections bar that constantly evolves. Uncertainty over expectations or a bar that keeps moving higher, may lead to apathy rather improved audit quality.

Furthermore, in our experience, nearly all auditors place compliance with laws, rules and standards as their top priority. Unfortunately, errors and mistakes still occur and will inherently continue to occur. Holding auditors negligent for normal expected human error or the exercise of prudent judgments that are subsequently second-guessed will not increase the incentive for

compliance, rather it would decrease the incentive for individuals from entering the auditing and accounting profession altogether. The Board's continued diligent inspections and enforcement programs, when considered together, working in tandem, sufficiently address lapses in compliance. In addition, the Board's outreach and open forum programs are effective in promoting compliance and these activities could be expanded.

4. Are there common types of cases or fact patterns not discussed above in which a negligent standard of liability would be particularly useful to promote greater individual accountability under Rule 3502?

The proposal notes the Board's implementation experience on pages 8 and 9. In the QC context, it cites "Rule 3502 also arises in sole-proprietorship cases, in which the sole owner and sole partner of a firm causes the firm to commit a violation. Yet for some types of violations, there is not always sufficient evidence of reckless behavior". It is not clear how this arises and it would be helpful to cite examples of the Board's experience.

12. Are there scenarios where an associated person's conduct might contribute to another individual's primary violation but the conduct would be outside the scope of any Board standard or rule (current or proposed), including the current and proposed versions of Rule 3502? If so, what are the scenarios?

We encourage the Board to better explain and define an associated person and how one is identified as an associated person and how this amended rule would be applied in practice. It is not clear how the proposed rule would be implemented, and in particular, the effect it would have on training that is "on-the-job" and provides/expects staff to make errors as they build their professional experience and judgment. Consider, for example, a staff with one- or two-years' experience that observes an inventory count and makes, through lack of experience, an unintentional error. It is not clear if such a staff would fall afoul of the proposed rule? In our view, the supervision and review standards and a firm's quality control policies, if followed correctly, should address this issue (i.e. the staff person gets more on-the-job training, and gets reprimanded.) Board member Ho also raised this point: " *If this Board (or future Boards) decide to routinely sanction associates or senior associates under the proposed negligence standard, the public company auditing profession will become even less attractive*." This is a conversation that we are hearing daily as well.

15. Are there other academic studies that would inform our analysis of the expected economic impacts of the proposed amendments? If so, please provide citations for the studies.

We encourage the Board to consider evaluating the results of behavioral studies (including through root cause analysis) to better target the tools of the Board to those actions that will create meaningful audit quality improvements.

19. Are there other regulatory alternatives the Board should consider? If so, what are they?

Yes, we encourage the Board to share its oversight experience and a vision for the profession of what audit quality looks like. Additional illustrations of actions the Board views as effective and

those that are problematic would serve to bolster understanding and compliance. Detailed case studies and application of these examples during the inspection process can be an effective regulatory alternative. We have seen transparency of inspections and interpretation of laws, rules, and standards provide auditors direction in interpreting the guidelines when executing audit procedures.

See suggestions under question 20.

20. Are other regulatory alternatives preferable to the proposed amendments? If so, please explain the reasons.

Expand communications

We encourage the Board to consider expanding its communications to stakeholders to share the types of violations, "close-calls" or other scenarios that were unenforceable because the Board could not obtain evidence to support a "reckless" behavior. Communicating these in *Spotlight* briefs similar to inspections results would be instructive to audit professionals and could be effective in reducing problematic behaviors.

Deepen and share root cause analyses

We encourage deeper analysis and communication of the root causes of problematic auditor actions. Sharing more granular information would aid the profession in addressing some of the more systemic issues.

Define audit quality

The mission to improve audit quality will remain elusive until audit quality is defined and all stakeholders understand the definition and what it looks like.

24. Is the proposed effective date (sixty days after Commission approval) appropriate? If not, what would be an appropriate effective date for the proposed amendments?

We encourage the Board to delay the effective date until further study is performed and proposed QC 1000 is finalized and its effect analyzed. Proposed QC 1000 has the potential to address many of the gaps identified in this proposal and we encourage waiting until that has been implemented.

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November 3, 2023

By email: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket No. 053: *PCAOB Release 2023-007: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*

Dear Office of the Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2023-007, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (the Proposing Release). The proposed amendments to PCAOB Rule 3502 included in the Proposing Release are herein referred to as the Proposed Amendments. We commend the Board's commitment to its mission of protecting investors and promoting high-quality audits which is supported through the Board's actions of holding individuals accountable.

We understand the importance of due professional care, professional skepticism and integrity, which are the values that have always remained at the forefront of our profession. We also recognize the important role the PCAOB plays in driving audit quality and protecting investors, through its unique ability as an independent regulator to hold accountable those firms and individuals who fail to uphold professional standards and ethics. However, we are concerned the practical implications of the Proposed Amendments may not serve to further audit quality, and may, in fact, result in outcomes different than the Board intends. We are providing feedback in this letter indicating those considerations which we believe the Board should evaluate further before adopting final amendments to PCAOB Rule 3502.

The Proposing Release does not give adequate consideration of all costs and unintended consequences applicable to its implementation.

While we recognize the challenges of performing a cost-benefit analysis for the Proposed Amendments, we believe the Board's conclusion that the costs are justified by the benefits does not give adequate consideration to all costs and unintended consequences. There exists a variety of costs, both direct and indirect, as well as unintended consequences that we believe may result from the implementation of the Proposed Amendments.

Uncertainty of the scope and applicability of the Proposed Amendments may lead to a negative impact on the profession.

We believe the uncertainty around the scope and application of the Proposed Amendments may lead to negative unintended consequences for the profession that the PCAOB has not appropriately considered. The Board's lack of specificity regarding the breadth with which a negligence standard would be applied may negatively impact two important classes of individuals: (a) those who are considering whether to enter the profession; and (b) those more experienced audit professionals who should assume greater responsibility within the profession but will be reluctant to do so under the circumstances presented in the Proposed Amendments. We agree with the concern expressed by others that the Proposed Amendments, as currently drafted, may exacerbate the accounting talent crisis and may discourage auditors from taking on more advanced audit roles.

Specifically, we believe the increased risk of personal liability created by a negligence standard will cause seasoned auditors to second-guess taking on more complex audits or greater responsibility with their firms. As the PCAOB recognizes, the audits of issuers and broker-dealers have unquestionably grown more complex and challenging in recent years, driven by changing accounting standards and the issuance of more robust auditing standards. This evolution underscores the necessity of attracting and retaining the best talent to the profession. The Proposed Amendments, on the other hand, will significantly disincentivize individuals from both joining the profession *and* taking on more impactful roles with greater responsibility. At a time when the profession needs more seasoned professionals assuming increasingly critical roles within an audit firm, the Proposed Amendments may create a barrier to access; and, as fewer individuals seek these roles, the potential for audit quality to deteriorate increases over time, causing greater negative impacts for the capital markets. While the Proposing Release contemplates a lack of available resources as an unintended consequence of the Proposed Amendments, it understates the potential harm. We believe the Board should further evaluate the resulting risk to audit quality in its economic analysis.

Lowering the threshold for liability will increase the number of enforcement actions, ultimately resulting in increased costs.

By reducing the threshold for liability under Rule 3502 to a negligence standard, the Board broadens its ability to bring enforcement actions against individuals. Yet, the Proposing Release does not provide the profession with any guidance on how the Proposed Amendments would be applied. The type of conduct the PCAOB would seek to enforce under the Proposed Amendments, the circumstances under which the PCAOB would assert a failure to act with due care or the factors that it would consider when seeking to hold individuals accountable for negligent conduct are not clear. That ambiguity could result in the unintended consequence of sweeping in a broad swath of professionals who may contribute to the conduct of an audit but may not be appropriate targets of an enforcement action. That uncertainty could lead to the expenditure of extraordinary costs in anticipation of a possible action and behaviors that undermine, and do not enhance, delivery of a high-quality audit. The Proposing Release also does not discuss how sanctions will be assessed for negligence. Increased enforcement activity by the PCAOB due to this reduced liability threshold will undoubtedly increase investigation defense and litigation costs. We believe the Board should more clearly address the extent to which it would exercise this proposed enhanced enforcement authority and more clearly articulate how these specifics will influence the assessment of potential costs before any final amendments are adopted.[1]

The Proposing Release does not sufficiently address the potential adverse impact on the willingness of component auditors to participate in global group audits of issuers or broker-dealers and the potential deleterious effect on audit quality.

Audits of global issuers or broker-dealers frequently require the involvement of component auditors, which are often foreign registered public accounting firms. The Proposed Amendments further expand the scope of the Board's enforcement capabilities with respect to those component auditors by reducing the threshold by which the PCAOB's enforcement actions can be brought against them. While the Board explicitly acknowledges a risk of reduced competition in the market due to impacts to 'small and medium-sized firms', the Board does not specifically assess the risk of disincentivizing foreign-registered public accounting firms from participating in group audits of US issuers and broker-dealers. In the Board's own words, the costs to firms and individuals subject to an action based on a negligence threshold "could ... be substantial." The Proposed Amendments increase the potential that foreign audit firms will more often decline to participate in a group audit of an issuer or broker-dealer under threat of increased liability and exposure. When significant components of US issuers and broker-dealers are located in foreign jurisdictions, the inability to retain experienced foreign-registered public accounting firms for component audits will have further deleterious impacts on the quality of global audits. We believe the Board should

[1] While our comment letter does not address this concern, we recognize there may be questions as to the legal basis for enforcing a negligence standard with respect to contributory liability.

address these risks, particularly in an environment where effective coordination and participation in global audits is growing increasingly important.

Clarity is needed with respect to the framework for negligence and how Rule 3502 will interact with other Board proposals that address due professional care and related concepts.

The Board's Proposed Amendments have been issued while other proposed standards, namely PCAOB AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, EI 1000, *Integrity and Objectivity*, and QC 1000, *A Firm's System of Quality Control,* are pending final amendments. These other proposed standards, for which we have previously provided comments to the Board,[2] introduce or modify the definition of certain key concepts that directly or indirectly relate to due professional care and/or intentional acts of misconduct. It is not clear how the concepts of due professional care, integrity, and intentional acts of misconduct used in those proposed professional standards interrelate with the proposed negligence standard in the Proposed Amendments; and indeed, the Board's ultimate decisions in those contexts may impact observers' views regarding the efficacy of the Proposed Amendments. We recommend the Board provide a framework or explanation on how those concepts apply across the proposed standards and interact with a negligence standard in the Proposed Amendments.

* * * * *

The Board will significantly benefit from delaying final amendments to Rule 3502 until after it provides the profession with appropriate guidance related to the scope and implementation of the Proposed Amendments, more fulsomely assesses the costs related to the Proposed Amendments, and considers the impact the Proposed Amendments will have on the profession and audit quality.

We appreciate the Board's consideration of our comments and observations in relation to the Board's efforts to improve its mechanisms to drive enhanced audit quality and appropriate accountability, and we would be pleased to discuss our comments with the Board and its staff at your convenience. We look forward to continuing our engagement with the Board and its staff in support of our shared commitment of investor protection and audit quality.

Sincerely,

KPMG LLP

KPMG LLP

[2] See our comment letter, dated February 1, 2023, RE: PCAOB Rulemaking Docket No. 046: PCAOB Release 2022-006: A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms, and our comment letter, dated May 30, 2023, RE: PCAOB Rulemaking Docket No. 049: PCAOB Release 2023-001: Proposed Auditing Standard - General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards.

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November 3, 2023

By Email: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2023-007 – PROPOSED AMENDMENTS TO PCAOB RULE 3502 GOVERNING CONTRIBUTORY LIABILITY

Dear Office of the Secretary:

Mazars USA LLP ("Mazars USA") welcomes the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") proposed amendments in Release 2023-007 (the "Release") to PCAOB Rule 3502 Governing Contributory Liability; PCAOB Rulemaking Docket Matter No. 053.

Mazars USA has over 100 partners and 900 professionals across the United States and is an independent member firm of the Mazars Group, an organization with over 1,200 partners and 30,000 professionals in over 95 countries around the world, and a member of Praxity, a global alliance of independent firms.

Our view on the proposed amendments is driven by our position in the U.S. marketplace as a medium–sized public accounting firm servicing mostly small to mid-size public and private businesses in a variety of industries and as a member firm in a global network. We are fully committed to the highest levels of audit quality in the execution of our audits and appreciate the efforts the PCAOB invested in the detailed proposal.

General Comments

1. Mazars USA acknowledges and appreciates the Board's assertion that proposed Rule 3502 is broadly intended to better protect investors and promote quality audits. Mazars USA also notes the Board's assertion that academic literature suggests that litigation risk and legal liability are important factors affecting audit quality.[1] We note however, that:

    a. Several of the arguments raised in 2004 and 2005, that led the Board to reject the position it is now proposing, remain unresolved and are not fully answered within this proposal.

    b. The Board is seeking stakeholder response to this rulemaking at a time of significant practice changes posed by the Board's pending rulemaking (particularly, related to QC 1000 and AS 1000).

[1] See PCAOB Release No. 2023-007, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability Footnote 71 in Release: *Excessive litigation risk might bring declining returns or even harm audit quality.*

c. Increased regulation in the accountancy profession is continually cited as a barrier to entry for eligible college graduates and as contributing to departures of experienced auditors from the profession. This Release's proposed rulemaking will likely further contribute to these challenges.

The presence of these conditions makes it difficult for firms, particularly medium-sized and smaller firms, to adequately assess the potential impact this Release's proposed rulemaking could have on their operation and ability to successfully compete in this market and maintain quality. It is against this backdrop that Mazars USA wishes to emphasize and caution against the following specific unintended consequences of this Release's proposed rulemaking when viewed through the lens of a medium-sized or smaller accounting firm.

Specific Comments

Costs of Liability Insurance

2. The Board posits in the Release,[2] its expectations that the economic impact of the proposal will be modest and, specifically, that under the proposed rule, the increase in litigation and liability risk would be modest, but meaningful. We anticipate that this potential "modest but meaningful" benefit would be countered by a disproportionately higher cost to medium-sized and smaller firms, including their ability to absorb the economic impact of insuring against such increased litigation and liability risk relative to larger firms.

Self-Protective Behavior and the Impact on Audit Quality

3. Mazars USA recognizes and supports a robust and substantial investment in audit quality, including the appointment of subject matter experts (including legal experts) and continuing efforts to improve its systems of quality management and audit performance. Yet, as noted by the Board, while the threat of litigation can motivate individuals to act in a manner consistent with their professional and legal obligations, it can also result in excessive monitoring and self-protective behavior, leading to an inefficient allocation of time and resources and would not enhance audit quality.

   Notwithstanding our firm's significant investment in compliance and risk mitigation as of today, Mazars USA is concerned about whether the costs of additional monitoring and self-protective practices that is likely to result from the proposed change would indeed result in a commensurate increase in audit quality. As noted in the Release, time spent on unproductive, self-protective activities may detract from other important obligations, including, but not limited to risk assessment, and directly impact audit quality.

Reduced Competition in the Audit Market

4. We are particularly concerned about this Release's proposed rulemaking (including the points noted in #3 above) relative to the conduct of multilocation issuer audit engagements involving non-US firms with smaller issuer audit practices, and the potential disproportional impact the proposed rule change may have on the audit quality of issuers' operations in these non-US jurisdictions and

[2] See PCAOB Release No. 2023-007, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, at p. 20 and 22, Economic Impact

the ability for medium-sized and smaller firms in those jurisdictions to absorb the increased cost of compliance within their operations.

Mazars USA has observed that these smaller firms, including those registered with the PCAOB, already have concerns about the significant litigation and liability risk and costs posed by the US regulatory regime. A new regulation that provides only modest benefit, but which poses significant and disproportionate costs to these firms could significantly reduce the availability of such non-US PCAOB registered firms to participate in the audits of US issuers with significant operations in these jurisdictions.

We request that the Board further and more thoroughly examine the potential economic impact of this rulemaking on medium-sized and smaller firms, including firms that, although they may not be annually inspected firms, significantly contribute to the overall audit market for US issuers that are multi-national corporations. This should include analysis of the economic impact of any SEC enforcement involving the precise legal area that the PCAOB now believes requires regulatory alignment within its own rules.

Proposed Effective Date

5. We note that the Board proposes that the revision to Rule 3502, if adopted, should be effective sixty days after Commission approval. Because of the potential disproportionate impact to medium-sized and smaller firms and their clients and the significant practice changes posed by other pending PCAOB rulemaking (particularly related to QC 1000 and AS 1000), we recommend that any revision to Rule 3502 be implemented subsequent to the effective dates of the earlier mentioned pending rulemaking (or the Board's determination not to adopt), and with additional time for medium-sized and smaller firms, including those in non-US jurisdictions, to appropriately understand the ramifications and respond to any incremental quality or risk mitigation strategy or investments and practice cost that might be necessitated by this rule change.

We would be pleased to discuss our comments with you at your convenience.

Please direct any questions to:

- Joseph Lanza, Director, Quality & Risk Management (Joseph.Lanza@Mazarsusa.com)
- Wendy Stevens, Practice Leader, Quality & Risk Management (Wendy.Stevens@Mazarsusa.com)

Very truly yours,

Mazars USA LLP

Members of the Investor Advisory Group

Via Email

October 26, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 053, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, PCAOB Release No. 2023-007.

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board (PCAOB or Board):

The Members of the Investor Advisory Group (MIAG)[1] appreciate the opportunity to comment on the PCAOB's "*Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability"* (Proposal).[2] We understand the Proposal would amend PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* (Rule 3502).[3]

Rule 3502 was issued in 2005 and for "well over a decade now, . . . [has served as the Board's basis for bringing] enforcement proceedings against associated persons . . . ."[4] And we agree with the observation of PCAOB Chair Erica Y. Williams that:

> Like many of the standards this Board has voted to modernize, Rule 3502 is nearly 20 years old. Things have changed since it was first adopted in 2005.
>
> The [Securities and Exchange Commission (SEC or Commission)] SEC now has the ability to seek civil money penalties in enforcement actions against associated persons when they negligently cause firm violations. The way that firms operate has changed. And the expert staff at

[1] This letter represents the views of Investor Advisory Group (IAG) and does not necessarily represent the views of all of its individual members, or the organizations by which they are employed. IAG views are developed by the members of the group independent of the views of the Public Company Accounting Oversight Board (PCAOB) and its staff. For more information about the IAG, including a listing of the current members, their bios, and the IAG charter, see https://pcaobus.org/about/advisory-groups/investor-advisory-group.
[2] PCAOB, Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability, PCAOB Release No. 2023-007 (Sept. 19, 2023), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9#:~:text=As%20discussed%20above%2C%20the%20Board,the%20registered%20firm%20that%20has.
[3] Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, PCAOB Release No. 2005-014 at 9 (July 26, 2005), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf.
[4] PCAOB Release No. 2023-007 at 3.

> the PCAOB who have seen how Rule 3502 plays out in the real world are recommending this update.[5]

At the outset, the MIAG notes the role of state accountancy boards, which can discipline accountants for violations of statutory, regulatory and professional standards. Federal securities and state law also provide causes of action that result in sanctions against accountants for related conduct. Therefore, accountants are already subject to liability and disciplinary schemes that encourage them to comply with applicable statutory, regulatory and professional standards.

The MIAG supports the PCAOB's proposed amendments to Rule 3502. We agree that the Proposal would strengthen the existing rule by changing the liability standard for contributory actions by associated persons from recklessness to negligence and by clarifying the relationship between the contributory actor and the primary violator.[6]

We agree with the Board that the proposed amendments would better align Rule 3502 with the scope of the Board's enforcement authority under the Sarbanes-Oxley Act of 2002 (SOX) and address the regulatory gap within the existing framework, which can lead to anomalous results.[7]

As Board Member Kara Stein explained:

> The PCAOB currently cannot bring an action against negligent auditors whose direct and substantial contributions furthered an audit firm's violations. This creates an obvious gap in the Board's ability to protect investors and public markets, as Table 1 in the economic analysis suggests. Today's proposal would close this oversight gap, thus emphasizing the obligations under the auditing standards that auditors act with reasonable care and competence.[8]

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[5] Erica Y. Williams, Chair, PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations.

[6] *See* PCAOB Release No. 2023-007 at 4 ("we detail the reasons for the proposed amendments to modernize and strengthen the rule").

[7] *See* Sarbanes-Oxley Act §105(c)(5)(A)-(B), 15 U.S.C. § 7201 (2002), *available at* https://pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf ("The sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of paragraph (4) shall only apply to— (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."); *see also* S. 2673, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT, S. Rep. No. 107-205, § 105(b) (2d Sess. 2002), *available at* https://www.govinfo.gov/content/pkg/CRPT-107srpt205/html/CRPT-107srpt205.htm ("Section 105(b) authorizes the Board to impose a full range of sanctions if it finds that a registered firm, or its partners or employees, have engaged in any act or practice that violates the Act, the Board's rules, professional standards, or the portion of the securities laws (and SEC rules) relating to audits of public companies . . . [and] the Board's ability to suspend or bar an associated person from the auditing of public companies, and the Board's ability to impose civil money penalties above a certain amount, is limited to situations involving intentional, knowing, or reckless conduct, or repeated negligent conduct.").

[8] Kara M. Stein, Board Member, PCAOB Open Board Meeting, Statement on Responsibility and Accountability for Persons Contributing to a Registered Audit Firm's Violations of Law or Professional Standards, Proposed Amendments to PCAOB Rule 3502 (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-detail/responsibility-and-accountability-for-persons-contributing-to-a-registered-audit-firm-s-violations-of-law-or-professional-standards-proposed-amendments-to-pcaob-rule-3502; *see* Erica Y. Williams, Chair, PCAOB Open Board Meeting, Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Noting that "firms don't make the decisions or take the actions that lead to these violations [of quality control or independence standards] on their own [, p]eople participate in these decisions and actions."); Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations (Sept. 19, 2023), *available at* https://pcaobus.org/news-events/speeches/speech-

We believe updating Rule 3502's liability threshold from recklessness to negligence will bring it in line with the existing requirement for auditors to exercise a standard of reasonable care during the performance of their professional responsibilities.[9] As indicated by Chair Williams' statement, since 1998 SEC rules have provided the Commission the ability to bring enforcement actions against associated persons if they engage in negligent acts that result in a violation of statutory, regulatory or professional standards.[10] And as indicated, since 2002 the PCAOB has the same authority under SOX. We believe this supports the Board's expectation that the economic impact of the Proposal will be modest.[11] And like the SEC has done historically, we believe the PCAOB will exercise its prosecutorial discretion appropriately when the underlying conduct is negligent.

We also believe that the language in SOX was written to be consistent with the SEC's rules. As such, we believe the Board should adopt the following language contained in the adopting release for those rules: "Because of the importance of an accountant's independence to the integrity of the financial reporting system, circumstances that raise questions about an accountant's independence always merit heightened scrutiny."[12] Therefore, if an accountant's conduct with respect to an independence issue, results in a violation of statutory, regulatory or the Board's auditor independence standards, that accountant's conduct may be subject to a disciplinary proceeding under Rule 3502.

Finally, we note that the Proposal includes several questions that appear to be directed at, or otherwise of interest to, investors. Those questions and our specific responses follow:

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detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson ("The PCAOB can hold a firm accountable for negligently violating PCAOB rules and standards; however, an associated person who directly and substantially contributes to such violations is held to a recklessness standard, which is a higher threshold [and] [t]his discrepancy is inconsistent with our investor protection mission.").

[9] *See* PCAOB Release No. 2023-007 at 11 (Noting that the current "liability threshold serves a dual function: It incentivizes auditors to conduct their work knowing that reasonable care is the standard for assessing it . . . .").

[10] *See* Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities Act Release No. 7,953, Exchange Act Release No. 26,929, Public Utility Holding Company Act Release No. 26,929, Trust Indenture Act Release No. 2,639, Investment Advisers Act Release No. 1,771, Investment Company Act Release No. 23,489, 63 Fed. Reg. 57,164, 57,172 (Oct. 19, 1998), *available at* https://www.federalregister.gov/documents/1998/10/26/98-28466/amendment-to-rule-102e-of-the-commissions-rules-of-practice ("§201.102 Appearance and practice before the Commission. . . . (e) Suspension and disbarment. (1) Generally[] (iv) With respect to persons licensed to practice as accountants, 'improper professional conduct' under §201.102(e)(1)(ii) means: (A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or (B) Either of the following two types of negligent conduct: *(1)* A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted. *(2)* Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."). We note that the adopting release for the Amendment to Rule 102(e) states that "most of the accounting and auditing practiced before the Commission is 'conducted by the 'Big Five' firms' and that 'three of the largest five accounting firms * * * suggested that the Commission could appropriately adopt' the Standard." *Id.* at 57,187. We also note that in a 2002 decision of United States Court of Appeals for the District of Columbia the court indicated that even prior to the 1998 Amendment of Rule 102(e) the Securities and Exchange Commission had the authority to bring enforcement actions against individual auditors for negligence. *See* KPMG LLP v. SEC, No. 01-1131 (D.C. Cir. 2002), *available at* KPMG LLP v. SEC, No. 01-1131 (D.C. Cir. 2002) :: Justia ("the Commission properly could use a negligence standard to enforce violations of . . . Commission rules").

[11] *See* PCAOB Release No. 2023-007 at 13 ("associated persons already are subject to potential liability—including money penalties—for negligently contributing to registered firms' violations of numerous laws and rules governing the preparation and issuance of audit reports via the Securities Exchange Act of 1934").

[12] 63 Fed. Reg. at 57,168.

5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors?[13]

We believe it is clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors. We note that our September 2022 letter in response to the PCAOB Draft Plan 2022-2026[14] expressed support for the Board's goal of strengthening enforcement.[15] That letter stated:

> **Goal 3: Strengthen Enforcement**
> **Rigorously Enforce PCAOB and Other Applicable Standards, Laws, and Rules.**
> **Impose More Significant Penalties and Other Relief.**
> **Increase Transparency in Enforcement Actions.**
> **Collaborate With Other Regulators to Bring Concurrent Actions.**
> *We support the Board's inclusion of all four of these objectives, as stated. In fact, these objectives are the most granular steps outlined in the Plan . . . .*[16]

We agree with the PCAOB that the "proposed amendments to Rule 3502 are consistent" with Goal 3.[17]

In addition, we agree with the Board that the Proposal is consistent with the investor protection provision of SOX which "'plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act.'"[18] Moreover, and as indicated, the Proposal brings the PCAOB in line with the statutory provisions of SOX, existing SEC rules with respect to unprofessional conduct, and judicial precedent.[19]

6. Beyond the dual purposes of deterrence and accountability, are there other ways that the proposed amendments would protect investors?[20]

We believe that beyond the dual purposes of deterrence and accountability, there are other ways that the proposed amendments would protect investors. For example, we believe the Proposal will:

- Remove limits to actions the PCAOB may bring under its statutory authority for conduct that results in violations of statutory, regulatory, and professional standards.
- Improve "audit quality as auditors become more careful about their work"[21], and as audit quality improves, the likelihood of auditors being subjected to meritorious litigation, and the risks and costs to

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[13] *See* PCAOB Release No. 2023-007 at 12 (emphasis added).
[14] *See* Request for Public Comment, Draft 2022-2026 PCAOB Strategic Plan, PCAOB Release No. 2022-003 (Aug. 16, 2022), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/2022-003-rfc-draftstrategicplan.pdf?sfvrsn=fdc9859a_4.
[15] Letter from the Members of the Investor Advisory Group to Office of the Secretary, PCAOB 3 (Sept. 15, 2022), https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/strategic-plan-comments-2022/10_iag.pdf?sfvrsn=f24d0e63_4 (emphasis added).
[16] *Id.*
[17] PCAOB Release No. 2023-007 at 11.
[18] Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, at A2-58 (Sept. 29, 2003), *available at* https://pcaobus.org/Enforcement/Documents/Release2003-015.pdf ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act.").
[19] *See* KPMG LLP v. SEC, No. 01-1131, *supra* note 10.
[20] PCAOB Release No. 2023-007 at 12 (emphasis added).
[21] *Id.* at 21.

investors resulting from that litigation, as well as misstatements and omissions in audited financial statements, should be reduced.

- Result in firms that "will be more likely to comply with their respective legal requirements . . . ."[22]
- "[E]nhance investors' confidence in the information provided in companies' financial statements."[23]
- "[H]ave an incremental positive effect on capital market efficiency."[24]

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?[25]

We do not believe the Board should retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation. We note that the modifier does not appear in either the SEC rules or the provisions and related legislative history of SOX that provide the SEC and the PCAOB, with the ability to bring enforcement actions against associated persons if they engage in negligence. As indicated, we believe the Board should bring Rule 3502 proceedings against accountants whose conduct demonstrates their lack of competence and violates applicable statutory or regulatory requirements or the Board's professional standards.

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Thank you for carefully considering the comments of the MIAG and other investors—the primary customers of audited financial reports. If you, any members of the Board, or your staff have questions or seek further elaboration of our views, please contact Amy McGarrity at amcgarrity@copera.org.

Sincerely,

Members of the Investor Advisory Group

Members of the Investor Advisory Group

[22] *Id.* at 22.
[23] *Id*. at 23; *cf.* Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, Board Member Thompson's Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations ("This rulemaking seeks to ensure that persons who orchestrate or facilitate firm violations cannot continue to perpetuate such conduct uncharged and unsanctioned [and] [a]s we know, such conduct can erode investors' perception of the quality of audits and their confidence in the capital markets").
[24] PCAOB Release No. 2023-007 at 24.
[25] *Id.* at 16 (emphasis added).

MOSSADAMS

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999 Third Avenue
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November 3, 2023

SENT VIA EMAIL: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability; PCAOB Rulemaking Docket Matter No. 053

Dear Office of the Secretary:

We appreciate the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Proposed Amendments to Rule 3502 Governing Contributory Liability (referenced herein as proposed Rule 3502, the proposed rule or the proposal).

Moss Adams LLP is the largest accounting and consulting firm headquartered in the western United States, with staff over 4,400, including more than 400 partners. Founded in 1913, the firm services public and private middle-market businesses, not-for-profit, and governmental organizations across the nation. We are an annually inspected Top 15 accounting firm in the US. We audit approximately 108 issuers, including 26 benefit plan issuers filing with the SEC on Form 11-K. Our desire is that our feedback will provide perspectives on the impact that the proposed amendments might have on audits of small and medium-sized entities.

We support the Board's efforts to evaluate how it can best structure its rules and enforcement program in a manner that will protect investors and improve audit quality. We are committed to promoting audit quality and appreciate that the Board's enforcement program plays a role in achieving that outcome.

We believe that any project to modify the framework by which auditors can be held liable for violations of PCAOB rules and standards should include a clear assessment of why that current framework exists and whether, in practical application, the current framework has impeded the PCAOB's effectiveness in bringing enforcement actions to fulfill its mission. This assessment should be performed considering all of the enforcement tools at the PCAOB's disposal and in light of the structure of other enforcement programs such as that of the U.S. Securities and Exchange Commission (SEC or Commission). That exercise is especially important in a situation like this one, where the Board in 2004 and 2005 considered, and then rejected, the negligence standard in the context of contributory liability that it is now proposing.

In our view, the current rule is effective. We share the views expressed in the Center for Audit Quality's letter dated November 2, 2023. In summary:

1. Adoption of the Proposed Rule Could Have Unintended Consequences by Negatively Impacting Audit Quality

We are concerned that the proposal could exacerbate the accounting talent crisis. We believe there is a risk of inefficient and unproductive "self-protective" behavior that will occur if the amendments are approved. Further, the Proposal could have a negative impact on smaller firms and reduce the market for audit services.

We believe smaller firms may be at risk from any misallocation of resources that results from "self-protective" behavior, because highly talented individuals may resist practicing in areas subject to PCAOB Standards as they may perceive the risk as outweighing the opportunity. This would lead to fewer compensating resources to help ensure compliance with PCAOB rules and standards. In a market that has already experienced small to medium-size firms exiting the SEC space citing the burden of compliance with PCAOB regulations, a negligence standard for contributory liability could turn out to be a deciding factor in causing a broader exit by small and medium-size firms in the market for public company and registered broker-dealer engagements, thereby reducing competition and audit quality.

2. The Rationale for the Proposal Is Not Clear

We are concerned the proposal does not have an adequate cost-benefit assessment, as noted below:

- The Commission already has the authority to sanction negligent conduct that contributes to another party's violations. The Board states that the Commission actually exercises this authority in practice to sanction negligent conduct and cites exclusively cases in which the Commission concluded that discipline of an associated person was appropriate under SEC Rule of Practice 102(e) or Securities Exchange Act of 1934 (Exchange Act) Section 4C, neither of which permits the Commission to charge a respondent based on a single instance of simple negligence. To the extent that the Board plans to charge single instances of simple negligence for contributory liability, then, it is proposing to wield a power that its analysis does not demonstrate the Commission having exercised, which causes concern about the costs and benefits that the Board articulates.

- It is difficult to predict what incremental enforcement might result from its adoption of a modified Rule 3502, which in turn presents notable challenges for a thorough cost-benefit analysis. The costs or the benefits of the Board's proposal have not been adequately assessed.

- The true costs and benefits of amendments to Rule 3502 cannot be known until the Board finalizes other proposed standards, especially its quality control proposal given the additional responsibilities and obligations that proposal would place on certain personnel at registered firms.

3. Individual Liability for Single Instances of Simple Negligence Would be Contrary to SEC Practice and Inappropriate

The proposal would permit an individual or entity to be held liable not only directly for a single instance of negligence that violates a Board rule or standard, but also secondarily for a single instance of negligence that is not itself a violation but directly and substantially contributes to the violation of another.[1] Although the Board notes the SEC holds similar power under Exchange Act Section 21C,[2] its conclusion that the proposed modification of Rule 3502 would merely put the PCAOB on par with the SEC is unsupported.

4. The Legal Basis for a Contributory Liability Standard Based in Negligence Is Not Clear

As with any Board action, a modification of Rule 3502 must rest on the foundation of the Board's statutory authority. In its 2005 release adopting Rule 3502, the Board cited two sources: its authority under Section 103 of Sarbanes-Oxley "to set ethical standards;"[3] and the authority "inherent in, and necessary to," the Board's enforcement authority under Sarbanes-Oxley Section 105.[4] However, in approving the Board's adoption of Rule 3502 in 2006, the Commission cited only Section 103 as the statutory basis.[5] In its current proposal, the Board appears to rely again on Sections 103 and 105, though its argument under Section 105 now appears to be that the Board is permitted—in general—to bring enforcement actions based on a single act of negligence.[6] Neither of these provisions provides a basis for the proposed rule.

5. The Board Should Consider Extending the Effective Date of Its Proposal

We recommend that any modifications to Rule 3502 be implemented subsequent to the effective dates of other standards proposed but not yet adopted by the Board (or subsequent to a determination by the Board not to adopt those standards), and with additional analysis by the Board concerning the expected costs and benefits of its proposal in light of those standards.

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[1] Based on footnote 65, the Board even appears to imagine the possibility of tertiary liability, in which one associated person's conduct contributes to the conduct of a second associated person, which in turn contributes to a registered firm's violation. While the footnote appears to recognize that the first associated person's conduct would still have to meet the criteria of "directly and substantially" contributing to the ultimate firm violation, the mere mention of such a scenario suggests that the Board may intend to stretch the definition of "directly" beyond the bounds of common usage.

[2] *See* 15 U.S.C. § 78u-3(a).

[3] 2005 Adopting Release, pages 9-10.

[4] 2005 Adopting Release, page 12.

[5] *See Public Company Accounting Oversight Board; Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules*, SEC Rel. No. 34-53677 (Apr. 19, 2006) ("Proposed Rule 3502 establishes a standard of ethical conduct for persons associated with registered public accounting firms").

[6] Proposing Release, page 12 n.43. The Board also cites Sarbanes-Oxley Sections 101(c)(2), 101(c)(4), 101(c)(6), and 101(g)(1) for authority. *See id.* at 2 n.4. Those provisions speak to the Board's authority to sanction registered firms and associated persons, but not to the availability of contributory liability (let alone negligent contributory liability) as a permissible theory of violation.

MOSSADAMS

We appreciate the opportunity to comment on the Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability. As the Board gathers feedback from other interested parties, we would be pleased to discuss our comments or answer any questions that the Board may have regarding the views expressed in this letter. If you require further information regarding our response, please contact Michael Spencer, Partner in our Professional Practice Group, at 408-916-0589 or by email at Michael.Spencer@mossadams.com.

Sincerely,

Moss Adams LLP

NASBA
National Association of State Boards of Accountancy

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October 24, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Via email: comments@pcaobus.org

Re: **PCAOB Rulemaking Docket Matter No. 053 – Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability**

Dear Members of the Public Company Accounting Oversight Board (PCAOB):

The National Association of State Boards of Accountancy (NASBA) appreciates the opportunity to comment on the PCAOB's Release, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (Proposal).

Founded in 1908, NASBA serves as a forum for the nation's Boards of Accountancy (State Boards), representing fifty-five jurisdictions. NASBA's mission is to enhance the effectiveness and advance the common interests of the State Boards that regulate all Certified Public Accountants (CPAs) and their firms in the United States and its territories, which includes all audit, attest and other services provided by CPAs. State Boards are charged by law with protecting the public.

In furtherance of that objective, NASBA offers the following comments.

General Comments

NASBA commends the PCAOB for their work in protecting the public interest and promoting audit quality, demonstrated by recent efforts to modernize and strengthen auditing standards.

The Proposal provides the background that, through the Sarbanes-Oxley Act of 2002, Congress authorized the PCAOB to investigate, bring charges against, and sanction, when appropriate, registered public accounting firms and associated persons for violations of the laws, rules and standards. The Proposal also notes that, for well over a decade, the PCAOB has brought enforcement proceedings against associated persons pursuant to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.

The qualitative and quantitative analyses and considerations of the economic impacts as presented in the Proposal demonstrates that the current Rule 3502, codified in 2005, has struck the right tone in terms of the level of a legal liability standard and the level of discipline.

At present, a person responsible for issuing a report where there are audit failures in the performance of the audit (and perhaps others in the firm) are subject to the possibility of disciplinary actions instituted by the Securities and Exchange Commission (SEC) and by the individual's State Board or Boards. There are also internal processes within firms to discipline and rehabilitate the individual involved. There is no lack of actions to address discipline.

The PCAOB presently prosecutes only for reckless or egregious conduct. However, the PCAOB always has the opportunity to refer individuals to the SEC for further action. Such referrals would also result in State Board action if the SEC were to discipline the individual.

The Proposal implies that the discipline imposed by a firm (whether financial penalty or even expulsion) is less likely to be an effective deterrent to others as compared to a public sanction. However, evidence is not presented as to that fact nor is there an analysis as to the effectiveness of the discipline and remediation efforts of the firm.

The Proposal also acknowledges that, in making the change from recklessness to negligence in the standard, excessive litigation risk could discourage people from accepting important roles in quality control areas of their firms for fear of being held liable, potentially leaving these roles to be accepted by less cautious or less qualified individuals, which is not in the public interest.

The rationale outlined in the Proposal does not appear to provide adequate evidence or support for changing Rule 3502 and indicates only a modest number of incremental cases would result under the new negligence standard.

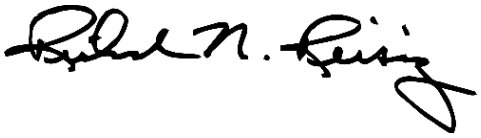
In November 2022, the PCAOB released a proposal for new quality control standards and to create reporting requirements on quality control matters. The new quality control standards have not been finalized so there is uncertainty over the manner in which the new quality control standards are going to be implemented and disciplined. We would recommend time for the maturation of the implementation and inspection of the implementation of those new quality control standards before moving forward with a change to Rule 3502.

Special Consideration for Emerging Growth Companies (EGC)

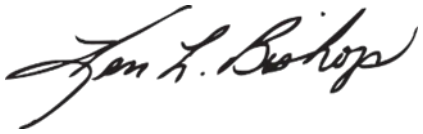
While the risk profile of an EGC is different from more mature entities, we agree that the Proposal should apply to EGCs as applicable. To exclude EGCs from the Proposal would be inconsistent with protecting the public interest.

Again, we appreciate the opportunity to comment on the Proposal.

Very truly yours,



Richard N. Reisig, CPA
NASBA Chair



Ken L. Bishop
NASBA President and CEO

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202-737-0900
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November 13, 2023

Submitted by email (comments@pcaobus.org**)**

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

RE: PCAOB Rulemaking Docket Matter No. 053

Dear Sir or Madam:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to the *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, PCAOB Release No. 2023-007 (the "Proposal"), issued by the Public Company Accounting Oversight Board ("PCAOB") on September 19, 2023.[2] The Proposal would amend PCAOB Rule 3502 governing liability of associated persons who contribute to a registered public accounting firm's primary violation by (i) lowering the threshold for liability under Rule 3502 to negligence (from the current standard of recklessness) and (ii) clarifying that an associated person can be liable if their misconduct contributes to a primary violation at any PCAOB member firm. NASAA supports the Proposal as an appropriate adjustment to the PCAOB's existing enforcement authority under Rule 3502.

Investors rely on audited financial statements to be an accurate and complete representation of a company's financial condition. Federal and state securities laws require many companies to have their financial statements audited by PCAOB member firms. Since the PCAOB's creation, the PCAOB has had the authority to bring enforcement actions against member firms upon a finding that the firm acted negligently. Rule 3502 as adopted by the PCAOB in 2005, though, has had an elevated recklessness standard for violations by associated persons of a member firm. This has led to the incongruous result that the PCAOB can find a member firm liable for violating

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, the U.S. Virgin Islands, and Guam. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] The Proposal is publicly available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf.

PCAOB rules but it cannot also find individuals who participated in the misconduct liable where the misconduct arose entirely through negligence. The Proposal would eliminate this incongruity.[3]

This is an appropriate change. The Proposal would buttress investors' expectation that accountants will be independent and diligent in their audit work. It is consistent with Congress's intent in Section 103(a) of the Sarbanes-Oxley Act that the PCAOB should establish appropriate ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports.[4] Furthermore, by equilibrating the liability standards for PCAOB member firms and their associated persons at negligence, the PCAOB will be aligning its enforcement authority with authority already possessed by the Securities and Exchange Commission in its enforcement actions[5] and by private plaintiffs in civil lawsuits.[6] NASAA accordingly encourages the PCAOB to adopt the Proposal.

Should you have any questions about this letter, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

Claire McHenry
NASAA President and
Deputy Director
Nebraska Bureau of Securities

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3 Proposal at 7.

4 Pub. Law 107-204, 116 Stat. 745 (2002).

5 *See* Proposal at 13.

6 *See* Thomas C. Pearson, *Potential Litigation Against Auditors for Negligence*, 5 BKLYN. J. CORP. FIN. & COM. L. 405 (2011) (discussing civil suits for negligence filed against auditors).

Nov. 2, 2023

Erica Y. Williams, Chair, Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 053

Dear Ms. Williams:

The Accounting & Auditing Steering Committee (the committee) of the Pennsylvania Institute of Certified Public Accountants (PICPA) appreciates the opportunity to provide feedback on the *Proposed Amendments to PCAOB Rule 3502, Governing Contributory Liability.* The PICPA is a professional CPA association of about 20,000 members working to improve the profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. The committee is composed of practitioners from both regional and small public accounting firms and members serving in financial reporting positions. The committee's general comments and comments to selected questions included in the due process document are included below.

General Comments – The committee understands that high-quality audits are the underpinnings to a robust capital market system and is supportive of changes that help achieve that objective. The committee does not believe that the proposed changes will achieve that objective. Rather than work to understand the current challenges that the audit profession faces and adapting the standards to better leverage technological solutions to improve audit quality, the PCAOB is proposing the use of the fear of punitive actions to "incentivize" higher audit quality. The committee does not support this proposal. The committee believes that implementing this proposal would exacerbate the serious staffing pipeline issue facing the audit profession. We are concerned that the fear of punitive actions will incentivize high-quality talent to avoid the audit profession and would contribute to higher turnover of existing audit professionals. This trend would incontrovertibly lead to lower audit quality, higher fees, and a large number of delistings. We believe that this result is completely contrary to the PCAOB's stated objectives.

Comments to Specific Questions

- Question 1. Are the regulatory concerns discussed above clear and understandable?

  The committee finds the rationale for the regulatory concerns in the executive summary and the reasons for the proposed amendments to be questionable. The proposed changes presuppose that accounting firms and audit professionals intentionally fail to meet professional standards and are not exercising reasonable care (the standard for negligence) as indicated by the use of the word "recklessly" in the current standards. Specifically, on page 7, the document notes that auditors "may not exercise reasonable care (the standard for negligence) if they know that they cannot be held individually liable by the PCAOB
  for a firm's primary violation unless an act or omission by them amounts to an 'an extreme

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departure from the standard of ordinary care for auditors' (the standard for recklessness)."

The committee vehemently disagrees with this position and does not agree that assessing additional fines and punishments on individuals will somehow incentivize audit professionals to more fully comply with professional standards. While there is always room for improvement, audit professionals take PCAOB inspection comments and enforcement actions seriously.

Instead, the committee believes that the proposed changes, if enacted, would serve as a catalyst for highly competent auditing professionals and for college students to choose other opportunities outside the accounting profession, further disrupting an already strained pipeline of professionals. This result would have an even greater negative impact on audit quality and likely would result in an increase in audit fees.

Furthermore, the rule says the change would better align with the Sarbanes-Oxley Act, but it does not articulate which issues are being addressed. Are there cases where the language did not suffice to hold persons accountable? Using the current language in the standards, the PCAOB has been able to assess significant fines and penalties against firms and individuals, and these disciplinary actions have resulted in many professionals being terminated from their positions and causing certain firms to forego auditing entities requiring PCAOB-registered auditors.

The proposal says that the PCAOB cannot protect investors to the fullest extent of the Sarbanes-Oxley Act, but it does not provide sufficient detail with respect to the behavior that they are trying to capture. The committee notes that the proposed amendments are "expected to generate efficiencies in enforcement activities … by enabling the PCAOB to bring negligence-based cases against firms and the relevant associated persons, rather than perpetuating the status quo in which only the Commission can bring such cases." Comments on page 20 make it clear that the PCAOB, by proposing these changes, is looking to have jurisdiction over certain matters that currently fall under the Securities and Exchange Commission's (SEC's) jurisdiction. There are also other entities that monitor CPAs, including regulatory agencies in each state. Information on how many of the cases that the PCAOB believes that they do not currently reach are referred to another body for action would be helpful in understanding the rationale for the change. Increasing PCOAB's jurisdiction is not a strong rationale for making a change that could significantly and negatively impact the accounting pipeline.

The committee further questions whether this proposed change would hold accountants more liable than other professionals. If so, why should that be the result?

The committee agrees with the following comments included in KPMG's response to the Feb. 11, 2005, PCAOB Rulemaking Docket Matter No. 017: *Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, and believes they remain applicable in response to this proposal:

> "First, given the vast body of technical rules and guidance to be applied, along with the difficulties inherent in the application of those rules in real time and to complex fact patterns, penalizing negligent conduct would be oppressive and draconian. There is no reason to believe that Congress feels that such penalties are necessary. Simple

negligence as an articulated level of intent justifying PCAOB sanctions appears nowhere in Section 105(c) the source of the Board's authority to sanction persons who violate the Act, certain securities laws, or rules of the SEC or the Board. On the contrary, the only place where the Act discusses levels of intent as prerequisites for the imposition of sanctions is in Section 105(c)(5), where Congress expressly limits the imposition of certain penalties to cases of intentional, knowing, or reckless conduct, or to repeated instances of negligent conduct. The signal from Congress is that the Board should be wary of imposing sanctions not grounded on intentional conduct.

Second, the practical implications of incorporating a negligence standard into the Final Rule would be sweeping and severe. Such a standard would expose hundreds of thousands of individuals in the accounting field to the risk of severe sanctions for actions that might in some remote way be tied to a violation of the Act or of the securities laws. Even a tightly limited negligence standard (which we respectfully suggest the Proposed Rule as drafted is not) would inject a great deal of uncertainty into even the most mundane decisions that auditors make every day, and would place intolerable pressure on the difficult judgment calls that those who operate in this highly technical field must make on a regular basis. A "negligence" rule is particularly ill-suited for retrospective judgments about compliance with "professional standards," and such a rule would operate as an invitation for after-the-fact attacks on conduct that was, at the time, objectively reasonable."

- Question 3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable law's rules and standards that the Board is charged with enforcing against registered firms?

  As discussed above, the committee does not agree that firms need additional "incentives" to more fully comply with applicable laws' rules and standards that the Board is charged with enforcing against registered firms.

  The committee supports the requirement to hold individuals accountable for reckless behavior, but strongly opposes a lowering of the threshold to negligence. If these proposed changes are enacted, the committee believes there would be a significant negative impact on the ability of firms to recruit and retain the talent needed to complete audits. Auditors, in good conscience, try to comply with professional standards, complex rules, and difficult and subjective judgments that require auditors to stand back and look at the audit conclusion as a whole. The committee notes that audit engagements are performed by teams of auditors and subject matter experts; as a result there are many contributing pieces to the overall audit conclusion. The committee believes the onus should primarily be on the firm, as the firm is responsible for designing and implementing a system of quality control to ensure engagements are performed in accordance with professional standards. The committee is also concerned that the proposed changes would open every engagement team member to potential liability. This would have obvious negative effects on the ability of firms to recruit and retain the talent needed to perform high quality engagements. It is also important to keep in mind that high-quality, real-world auditing cannot be learned in a classroom and that there are less-experienced staff on every audit as hands on

PICPA
Pennsylvania Institute of Certified Public Accountants

training and education are an integral part of the auditing firm model. This liability proposal threatens this hands-on learning model and jeopardizes the future of many young accountants.

The PCAOB's inspection process is also a concern. The committee questions the ability of the inspection process to conclude that an associated person has contributed to a firm's negligence-based violation. The determination of whether a deficiency is included in a PCAOB inspection report is often subjective, and the PCAOB inspection process does not include an appeals process to a body that includes current practitioners. In many cases, firms agree with the PCAOB inspectors' findings just to move the process along. In the event that the liability threshold is lowered, changes should be made to the inspection process to ensure a robust appeals process. The comments on page 26 suggest that the revised guidance could result in "excessive monitoring and self-protective behavior, leading to an inefficient allocation of time and resources." The comments go on to note that "individuals may spend more time on a task than is necessary to accomplish it at the appropriate level of due care. Similarly, individuals may excessively document the nature of their task performance to demonstrate compliance in a future proceeding. Time spent on unproductive, self-protective activities may detract from other important obligations and directly impact audit quality." The committee agrees that this would be a likely outcome because in many cases the practitioners and PCAOB inspectors differ in their perspectives on what constitutes sufficient documentation. The committee also notes that this proposed standard would significantly raise the level of audit effort on difficult-to-value items and challenging estimates because inspectors have the benefit of hindsight without being able to evaluate whether a judgment was reasonable at the time it was made.

The committee agrees that audit quality can and should improve, and we do support a PCAOB standard-setting project to identify the barriers to firm use of technology tools on audits (e.g., barriers in the PCAOB audit standards or in the inspection process). The committee believes that technological advancements and audit tools would better assist firms in improving audit quality.

- Question 5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors?

  The committee does not believe the proposed amendments would advance the Board's statutory mandate to protect investors. As previously discussed above, the committee believes that enacting the proposed amendments would be deleterious to the public interest by decreasing the pipeline of qualified auditors and raising audit fees.

- Question 7. Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate?

  The committee does not believe the proposed amendments to Rule 3502's liability language are appropriate. (See additional comments at Questions 1 and 3.)

- Question 8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?

The committee supports retaining the "directly and substantially" modifier to ensure that only those responsible for a violation are held accountable. Without the modifier, the term "contributory" could be interpreted too broadly, potentially encompassing all members of an audit engagement. This would be punitive to those on the engagement team who were otherwise attempting to comply with professional standards.

At the same time the committee finds the meanings of these terms "directly" and "substantially" to be subjective. What does it mean to have a direct contribution to the firm's violation? For example, if a staff person makes a mistake in testing that is not picked up by detail, general or partner review – who had the direct contribution? All of them? The staff? The partner? Similarly, what if the violation is a number of smaller errors throughout the audit? Would everyone be off the hook since no single person or action represented a substantial contribution?

Overall, the committee disagrees with the proposed approach to targeting individuals for punitive actions. Modifiers that attempt to target specific actions would be helpful but the meanings for these modifiers need to be clearly articulated. We recommend limiting the contributory liability to egregious actions.

- Question 9. Are there other phrases or terms that the Board should consider to modify "contribute," or other limitations that the Board should incorporate into the proposed rule? If so, what are they?

  The committee believes that the proposed contributory liability standard should not apply to a professional who spends only a de minimis amount of time on an engagement (e.g., a quality control specialist). The committee supports added language to clarify that the liability would only extend to a professional having a substantive level of participation on the engagement.

- Question 13. Are there other benefits and costs of the amendments that the Board should consider?

  We believe that the proposed revisions would drive firms away from auditing entities that would subject the firm to PCOAB registration requirements. (See additional comments at Question 3.)

- Comment on Questions 13 through 17.

  The committee does not believe that the proposed revisions should move forward without clear data that could provide more clarity with respect to the projected impact of the proposed revisions being requested in questions 13 through 17 (including the impact on the accounting pipeline, the expected cost of additional liability, increase in audit fees, etc.). Further, the PCAOB's arguments that defense costs would be lowered due to an increase in the volume of cases to defend and that the existing SEC liability exposure should be adequately factored into current audit fees are not based in fact.

- Question 16. Are there additional unintended consequences that might result from the proposed amendments?

The committee believes that the number of firms performing audits that would require PCAOB registration would precipitously fall. In addition, those firms that remain would find it increasingly difficult to attract and retain the talent needed to perform these audits.

- Question 17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

  Yes. The committee believes that if the proposed changes are enacted, associated persons would be discouraged from participating.

- Question 22. Would the economic impacts be different for smaller firms or EGCs? If so, how?

  The committee believes that the proposed changes would have a greater impact on smaller firms, which have fewer resources to defend personnel and navigate the uncertain liability environment. Therefore, these firms are more likely to cease auditing entities that require PCAOB registered auditors.

We appreciate your consideration of our input to the *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*. We are available to discuss any of these comments with you at your convenience.

Sincerely,

Rebecca Walck

Rebecca Walck, CPA
Chair, PICPA Accounting & Auditing Steering Committee

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November 3, 2023

Sent via e-mail: comments@pcaobus.org
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability; PCAOB Rulemaking Docket Matter No. 053

Dear Office of the Secretary:

Plante & Moran, PLLC and Plante Moran, P.C. (collectively, "Plante Moran") appreciate the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed amendments to PCAOB Rule 3502. Plante Moran has approximately 3,000 professionals, maintains offices in four states (Michigan, Illinois, Colorado, and Ohio), and is a significant provider of audit and other professional services to middle market companies.

We fully support the Board's efforts to improve audit quality and to reevaluate existing rules and auditing standards, including rules related to its enforcement program. As explained in detail herein, however, we are concerned that the current proposal to lower the standard for contributory liability under Rule 3502 from recklessness to negligence will not result in improvements to audit quality or additional protection for investors. We are also concerned that the costs of the proposed amendments—whether or not intended—will outweigh any potential benefits. We encourage the Board to maintain the recklessness standard of contributory liability under the current formulation of Rule 3502.

We share and join in the views expressed in the Center for Audit Quality's letter dated November 2, 2023, regarding the proposed amendments. We write separately, however, to emphasize our perspectives on the proposed change in the contributory liability standard.

I. The Costs of the Proposed Amendments Will Outweigh Any Potential Benefits.

As currently structured, the PCAOB has a suite of tools available to hold audit firms and individual auditors accountable for their actions—i.e., conducting inspections, making remediation determinations, defining auditing standards and PCAOB rules, and bringing enforcement actions for direct violations of auditing standards and PCAOB rules against firms and individual auditors. Rule 3502 is one of the tools at the PCAOB's disposal. As explained herein, we are concerned that amending the rule to lower the contributory liability standard will negatively impact audit quality, especially when considered in the context of the full suite of regulatory tools the PCAOB can access. We are also concerned that the costs of the change will exceed any potential benefits.

Prior to January 2022, it was the PCAOB's considered policy to deal with mistakes in auditor judgment—i.e., negligent conduct—through a robust inspections and remediation program. The inspection program, with its emphasis on root cause analysis and remediation of quality control

deficiencies, has long provided strong incentives for individual auditors and firms alike to meet their obligations under professional standards and applicable rules. The policy of relying on the inspections program and incentives to remediate quality control deficiencies was sensible in the context of regulating audits. Auditing requires firms and their associated persons to exercise significant professional judgment in complex, nuanced areas. In practice, the potential receipt of inspection comments and the consequences that flow from the receipt of such comments has placed substantial pressure on firms and their partners and staff to make good faith, well-considered auditing decisions. That pressure has in turn led to long-term, sustained improvements in audit quality over the last 20 years. The proposed change to Rule 3502, however, is likely to push audit quality in the wrong direction. We believe that lowering the standard for contributory liability will put an incremental amount of additional and unnecessary pressure on already difficult professional judgments and thereby upset the careful balance the PCAOB has struck in driving audit quality improvements through the inspections and remediation program. Stated differently, the costs of the incremental pressure put on individual auditors under a reformed Rule 3502 will exceed the intended benefits.

First, the contemplated change in the liability standard is likely to further disincentivize qualified and talented individuals from participating in public company and broker dealer audits, whether they are already in the profession or are considering joining. The current talent crisis in the accounting and auditing profession is well documented.[1] The crisis, however, is hitting small and middle-market firms far harder than large, global network firms, causing a re-evaluation of the markets in which they can and should compete. Many talented CPAs in the current environment are unwilling to serve public company and broker-dealer audit clients due to the potential exposure that already exists. This includes CPAs just beginning their careers, CPAs who have been members of the profession for decades, and CPAs in between. Their reluctance or unwillingness to participate in such audits is not unreasonable; the consequences of a PCAOB (or SEC) enforcement sanction can be, for many, career ending. When coupled with the existence of significant professional growth opportunities outside of the public company and broker dealer space, it is understandable that talented and qualified individuals would not want to risk their careers by agreeing to perform work within the public company and broker dealer space. This is particularly true when they can lose their careers over a potentially isolated single good faith mistake in judgment.

Concerns around potential liability exposure are especially acute for individuals serving in roles related to a firm's system of quality control, as such individuals are the most likely potential targets for Rule 3502 violations. The fact that an ordinary mistake made in good faith could end your career—when you potentially make hundreds of significant auditing and accounting decisions across dozens of clients each year—can be paralyzing and intolerable. Board Member Christina Ho well captured these concerns in her statement on the proposing release when she stated, "[i]f this unintended consequence comes to fruition, investors will in the long run be harmed if, as the proposal notes, less cautious or less qualified individuals rise to fill 'important audit roles."[2] In short, the proposed change to Rule 3502's liability standard threatens to further reduce the pool of qualified and talented CPAs to perform audits within the PCAOB's jurisdiction.

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[1] *See, e.g.*, "Why No One's Going Into Accounting", Wall Street Journal (Oct. 6, 2023); "Accounting Graduates Drop by Highest Percentage in Years", Wall Street Journal (Oct. 12, 2023); "The Accounting Shortage Is Showing Up in Financial Statements", Wall Street Journal (July 11, 2023).

[2] Christina Ho, *The Cost of Unintended Consequences: Accounting Talent, Audit Quality, Investor Protection* (Sept. 19, 2023) (available at https://pcaobus.org/news-events/speeches).

Second, we are concerned that the proposal will have a chilling effect on the PCAOB inspections program, arguably the most impactful tool in the PCAOB's toolbox. Take, for example, a situation in which staff from the PCAOB's Division of Registration and Inspections ("DRI") determine that an audit firm incorrectly concluded that a client's accounting treatment for a particular transaction complied with generally accepted accounting principles in a complex, nuanced area. As a result, DRI issues a comment form to the firm. Assume further that the decision at issue was the subject of a consultation involving the engagement partner, the engagement quality reviewer, and one or more representatives from the firm's professional practice group, each of whom directly and substantially contributed to the firm's position on the accounting treatment for the transaction. Assume also that the error was a mistake, made in good faith. Should the firm agree with the comment form DRI issued and the factual basis for it? Under a reformulated Rule 3502, agreeing with the comment form could expose each of the individual auditors who participated in the decision to a contributory liability charge under Rule 3502 for a mistake made in the good faith exercise of their professional judgment. Indeed, an admission by the firm that the decision was incorrect during the inspections process could serve as prima facie evidence of a violation of professional standards in any subsequent matter pursued by the PCAOB's Division of Enforcement and Investigations ("DEI") and provide a clear basis to impose Rule 3502 liability against each of the individuals.[3] That reality could well affect firms' appetite to engage in the type of productive back and forth with DRI that has served as the very foundation for the long-term success of the PCAOB's inspections program.

Third, we are concerned about the potential for an increase in so-called "over auditing" to mitigate actual or perceived risk associated with potential liability under a reformed Rule 3502. Such self-protective behavior is neither productive nor efficient and harms investors through an inefficient allocation of audit time and resources and potential distractions from important audit areas. This concern is particularly acute for smaller and middle-market firms, which overall have less available resources and a reduced ability to command increased audit fees in the marketplace. Such firms will find they are less able to compete, resulting in a further concentration of firms within the marketplace.

For these reasons, and those expressed in the CAQ's comment letter, we do not believe the potential benefits of the proposed change to the liability standard will exceed the costs and that the PCAOB should maintain the current standard for contributory liability.

II. Individual Contributory Liability Charges for Single Instances of Negligence Would be Contrary to SEC Practice.

We are also concerned that the change in the liability standard will put the PCAOB on a different footing than the SEC has historically operated on and that it will have a disparate impact on smaller firms through significantly greater enforcement exposure.

In considering the costs of the proposed amendments, the proposal suggests that because the SEC's existing enforcement authority for contributory liability already captures simple acts of auditor negligence, the Board's proposed changes are unlikely to have significant incremental costs. In practice, however, the SEC has not historically charged auditors with negligence-based contributory liability based on a single act of negligence. To be sure, none of the SEC enforcement cases cited in the proposal

[3] This concern is not merely theoretical. PCAOB Board members and staff have made public statements in recent months indicating that, as a matter of policy, DEI intends to pursue negligence-based enforcement actions. Furthermore, DEI has shown an increased willingness to bring charges against firms based on prior inspection findings, particularly where the firm has admitted to the factual basis that led to the original comment form(s).

involved the SEC charging an individual respondent with contributory liability based on a single act of negligence.[4] Rather, in each case, the SEC alleged multiple, separate acts of negligence by the relevant respondents (e.g., across multiple audits, audit areas, or audit years). To the extent the Board proposes a framework for contributory liability charges against individuals for single instances of negligence and then in fact charges single acts of negligence, doing so would cause it to use an authority the SEC has not used in practice.

Moreover, the impact of the proposed rule change and actions brought pursuant to it would be felt more acutely by non-global network firms. Twenty years of PCAOB enforcement experience has shown that such firms are statistically far more likely to be the subject of PCAOB enforcement investigations and sanctions, despite their miniscule overall share in auditing the market capitalization of U.S. issuers.

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Plante Moran appreciates the opportunity to comment on the Release: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability. We would be pleased to discuss our comments or answer questions from the Board or PCAOB staff regarding the views expressed in this letter. Please address questions to Christina Moser (christina.moser@plantemoran.com) or Jeff Bailey (jeff.bailey@plantemoran.com).

Sincerely,

Plante & Moran, PLLC

Plante & Moran, PLLC

cc: **PCAOB**
Erica Y. Williams, Chair
Christina Ho, Board member
Kara M. Stein, Board member
Anthony C. Thompson, Board member
George Botic, Board member

SEC
Paul Munter, Chief Accountant
Diana Stoltzfus, Deputy Chief Accountant

[4] *See In re David S. Hall, P.C.*, SEC Initial Decision Release No. 1114 (Mar. 7, 2017) (ALJ Op.) (SEC alleged an engagement quality reviewer failed to conduct numerous engagement quality reviews in accordance with applicable professional standards), *decision made final*, SEC Release No. 34-80949 (June 15, 2017); *In re Gregory M. Dearlove*, CPA, SEC Release No. 34-57244 (Jan. 31, 2008) (SEC alleged engagement partner negligently caused multiple violations of securities law by firm's issuer client); *In re Philip L. Pascale, CPA*, SEC Release No. 34-51393 (Mar. 18, 2005) (SEC concluded that auditor failed to comply with GAAS in numerous areas of the financial statements across multiple years).

November 2, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 053

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB's or Board's) proposal, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, included in PCAOB Release No. 2023-007.

We support the Board's continuing effort to promulgate standards and rules that promote audit quality. We also support the Board's efforts to adopt meaningful and effective professional standards designed to hold the partners and other associated persons of public accounting firms to a high standard of professionalism and ethical conduct.

We are concerned, however, that the Board's proposal could shift the liability landscape in ways that will undermine the objectives of the proposal and adversely affect the quality of public company audits. Accordingly, we do not support the proposal as drafted.

Our primary concern is the Board's proposal to reduce the threshold culpability for secondary liability from at least recklessness to simple negligence, a standard that the Board rejected after careful consideration in 2005. While the 2005 Board adopted a heightened standard to charge accountants with contributory liability, the proposal does not present sufficiently compelling reasons to lower that standard to a single act of simple negligence. Moreover, despite this Board's statements to the contrary in connection with the current proposal, adoption of a simple negligence standard for secondary liability would not align with the SEC's enforcement framework for similar conduct by accountants and could have unintended consequences that harm audit quality. If the Board ultimately concludes that the benefits of a change to the standard outweigh potential costs, it should align more closely to the heightened standard that the SEC applies to enforcement proceedings under Rule 102(e) of the Commission's Rules of Practice. As the Board indicates in the proposal, it has other means to hold associated persons accountable for conduct in violation of its rules and standards. We expand on these points in the appendix to this letter.

Separately, these concerns are exacerbated by the proposed amendment to extend potential secondary liability to associated persons regardless of whether they are associated with the registered public accounting firm that committed the primary violation. This change, particularly in combination with a lower threshold for liability, could deter practitioners from collaborating in a proactive way with others within the firm or with other member firms within an accounting network. That deterrence could negatively affect audit quality.

We urge the Board to consider carefully the appropriateness and potential implications of lowering the standard for secondary liability to simple negligence. We also encourage the Board to consider ways it can potentially reduce or avoid the unintended consequences of broadening secondary liability to address primary violations at "any" registered public accounting firm.

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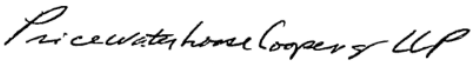
We appreciate the opportunity to provide input and would be pleased to engage in a dialogue with the Board and its staff on this important topic. Please contact Brian Croteau at brian.t.croteau@pwc.com regarding our submission.

Sincerely,



PricewaterhouseCoopers LLP

Appendix

This appendix provides additional details regarding our concerns with key aspects of the proposal.

The Board's proposed amendments to Rule 3502 would have far-reaching unintended consequences

1. *The Board's proposed negligence standard is not appropriate for judging conduct on complex audit engagements and compliance with professional standards and does not align with the SEC's existing framework for sanctioning accountants*.

In 2004, the Board first proposed adopting a negligence threshold for secondary liability. After careful consideration of comments received in response, it determined that a negligence standard was not appropriate and a heightened standard ("knew, or was reckless in not knowing") "strikes the right balance in the context of this rule."[1] In doing so, the Board acknowledged that accountants "must comply with complex professional and regulatory requirements in performing their jobs" and explained that it "does not seek to create through this rule a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner, that in hindsight, turns out to have not been successful."[2] Today's Board has not presented sufficiently compelling reasons to reverse the reasoned judgment of the 2005 Board and to implement a negligence standard for contributory liability.[3] We are concerned that lowering the standard of secondary liability to simple negligence would upend the "right balance" sought by the 2005 Board and have significant negative ramifications to audit quality.

Concerns about applying a negligence standard to accountants in an enforcement context continue to be well justified. It is as true today as it was in 2005 that the nature of auditing and accounting, and the responsibilities of an accountant, strongly support exercising discretion in standard setting related to those responsibilities. Accountants routinely apply independent professional judgment to complex situations in which statutory and regulatory requirements intertwine with applicable professional standards and rules, calling on the support of other professionals with relevant experience and expertise to provide support and collaboration.[4] In fact, as then Board member Duane DesParte observed, "If

[1] See PCAOB Rulemaking Docket Matter No. 017, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees,* PCAOB Release No. 2005-014 (July 26, 2005) (hereinafter "2005 Adopting Release"), at 14.

[2] Id.

[3] While the Board asserts that it has the statutory authority to promulgate a negligence-based contributory negligence rule, that statutory grounding seems to be based on what is implied from interpretations of various provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), rather than any express statutory grounding for such authority (e.g., Section 105(c)(5) of the Sarbanes-Oxley Act indicating that certain sanctions and penalties described in Section 105(c)(4) apply only to intentional, knowing, or repeated instances of negligent conduct, but not limiting other sanctions or penalties).

[4] In this regard, our firm's comment letter to the SEC's proposed amendment to Rule 102(e) of the Commission's Rule of Practice is similarly relevant here. "[GAAP and GAAS] are not like cookbook recipes, where reading words and following directions results in a uniform outcome. Resolution of many auditing and accounting issues requires judgment. Even where there is written guidance, there is often ambiguity. The accountant must attempt to synthesize practice and different pronouncements that may speak ambiguously or indirectly to the issue and that may change over time. What the proposed amendment labels as a 'violation of professional standard' is apt to be, in practice, a difference of opinion between the Commission's staff and the respondent accountant over how a particular pronouncement or pronouncements should be applied." See Comment Letter from PricewaterhouseCoopers LLP to Commission Proposed Amendment to Rule 102(e) of the Commission's Rule of Practice at 6.

anything, audits have become more complex, involve greater judgment, and include more participants than in 2004 when Rule 3502 was first contemplated."[5]

The Commission recognized similar policy concerns when it, like the 2005 Board, also declined to adopt a simple negligence standard for sanctioning accountants under Rule 102(e) of the Commission's Rule of Practice.[6] The Commission determined that "a single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission."[7] In declining to adopt a simple negligence standard for Rule 102(e), the Commission indicated that it "neither accepts nor condones unreasonable, or negligent, accounting or auditing errors" and noted that it had authority under other statutory provisions to address and deter such errors through, for example, Sections 17(a)(2) and (3) of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934.[8] As discussed below, however, the Commission routinely brings enforcement actions involving accountants' violations of professional standards in conjunction with Rule 102(e) proceedings, and therefore regularly exercises its discretion to sanction accountants using a heightened standard of liability.

In proposing to lower the standard for secondary liability for accountants' conduct to simple negligence, the Board observes that associated persons are "already subject to potential liability—including money penalties—for negligently contributing to registered firms' violations governing the preparation and issuance of audit reports" under the Exchange Act.[9] The Board further indicates that the proposed amendments "would not subject auditors to any new or different standard to govern their conduct," pointing to select Commission proceedings under the Exchange Act in which auditors were sanctioned for negligently contributing to primary violations by firms and issuers.[10]

But the Board's observations fail to recognize a critically significant distinction with SEC enforcement practices that would result in a substantial divergence in how the Commission routinely brings enforcement actions against accountants who contribute to a firm's identified deficiencies with audit standards, as compared with how the Board is proposing it be permitted to bring such actions. In particular, the SEC typically brings secondary liability actions against accountants in conjunction with its authority to censure firms and accountants for "improper professional conduct" under Rule 102(e) of the Commission's Rules of Practice.[11] The Board's proposing release, in fact, cites three Commission

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[5] See *Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, Statement by Board Member Duane DesParte, (Sept. 19, 2023), at https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability.

[6] We observe that Congress also adopted similar language under Section 602 of the Sarbanes-Oxley Act (Section 4C of the Exchange Act), which mirrors the language the Commission used when it promulgated Rule 102(e). 15 U.S.C. § 78d–3.

[7] See Amendment to Rule 102(e) of the Commission's Rules of Practice (SEC Release No. 33-7593) (Oct. 26, 1998) (hereinafter "SEC 102(e) Release").

[8] See SEC 102(e) Release. Note also that, to demonstrate a finding under Securities Act Section 17(a)(2), the Commission would have to show that the respondent engaged in an action (1) in the offer or sale of securities, (2) by use of interstate commerce or the mails, (3) to obtain money or property, (4) by use of an untrue statement, (5) of a material fact. This comprises far more pleading requirements than simply showing a primary violation of a rule or standard of the Board. Under Section 17(a)(3), the Commission would have to show that the respondent engaged in any transaction, practice, or course of business (1) in the offer or sale of securities, (2) by use of interstate commerce or the mails, (3) and such transaction, practice, or course of business operates or would operate as a fraud or deceit upon the purchaser.

[9] Proposing Release at 13.

[10] Proposing Release at 14.

[11] See, e.g., In the Matter of Alfonse Gregory Giugliano, CPA, Exchange Act Release No. 98352 (Sept. 12, 2023), at https://www.sec.gov/files/litigation/admin/2023/34-98352.pdf; In the matter of Adam Bering, Esq., Exchange Act Release No. 93749 (Dec. 10, 2021), at https://www.sec.gov/files/litigation/admin/2021/34-93749.pdf; In the matter of Joseph Yafeh, CPA, Inc., Exchange Act Release No. 73770 (Dec. 8, 2014), at https://www.sec.gov/files/litigation/admin/2014/34-73770.pdf.

proceedings in support of its assertion that auditors "would not [be] subject to any new or different standard to govern their conduct" under the proposal.[12] In all three, the Commission not only alleges that the respondents caused the firm's and/or the issuer client's primary violations, but also that the respondents engaged in improper professional conduct under Rule 102(e) of the SEC's Rule of Practice, which does not permit sanctions based on a determination that the respondent committed a single act of simple negligence.

Instead, Rule 102(e) of the SEC's Rules of Practice requires the regulator to demonstrate either "repeated instances of unreasonable conduct" or "a single instance of highly unreasonable conduct" by the respondent to satisfy the minimum threshold for sanctions. In its adopting release for Rule 102(e), the Commission described this standard as "higher than ordinary negligence but lower than the traditional definition of recklessness."[13] As a result, rather than increasing symmetry between the PCAOB and SEC enforcement frameworks, the Board's proposed amendments, which, as drafted, suggest a single act of simple negligence would suffice to trigger liability, would result in conflict between these two frameworks. We note also that recent appellate decisions before the Fifth Circuit (and currently pending before the United States Supreme Court) have held that the SEC is constitutionally precluded from asserting enforcement claims in administrative proceedings rather than in federal court, where defendants can avail themselves of the right to a trial by jury, among other procedural rights.[14]

Just as the SEC has adopted a measured approach that recognizes a single instance of simple negligence should not be enough to bring a claim against an accountant (particularly given the potentially devastating consequences for the accountant's professional reputation), the Board should preserve a heightened standard above simple negligence. We submit that the policy concerns noted in this letter provide more compelling reasons to retain the current rule. If the Board nonetheless is determined to adopt amendments to Rule 3502, it should fully align to the SEC's practices, including adopting the heightened standard that applies to Rule 102(e) proceedings (i.e., requiring "repeated instances of unreasonable conduct" or "a single instance of highly unreasonable conduct").

2. *The Board's proposed negligence standard for secondary liability fulfills no regulatory purpose that is not already fulfilled by the existing enforcement framework and the Board's supervisory function*.

We agree that audit quality and investor protection is best served when the PCAOB holds individual accountants who have violated their professional obligations accountable. We also believe that the Board has used the authority provided to it by the Sarbanes-Oxley Act to promulgate professional standards that promote investor protection and audit quality and rules that allow it to enforce compliance with such standards. In fact, as the Board notes in the Proposing Release, existing Rule 3502 is not the only means by which it can enforce compliance with applicable Board rules and standards.[15] Given the standards and rules that the Board has promulgated and its existing ability to bring cases, impose sanctions to enforce its standards, and bring secondary liability cases under existing Rule 3502, we do not believe that any potential incremental benefits of this proposal would outweigh the potential costs, including unintended consequences, of broadening personnel exposure to contributory liability.

Congress authorized the Board to conduct a program of continuing inspections of registered public accounting firms through Section 104 of the Sarbanes-Oxley Act to "assess the degree of compliance" by firms and associated persons with the Sarbanes-Oxley Act, the Board's rules, standards, and the Commission's rules. Section 104 is separate and apart from the disciplinary functions of the Board set

[12] See Proposing Release at 14, n. 52.
[13] See SEC 102(e) Release.
[14] See *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022).
[15] See n. 31 of the Proposing Release, referencing n. 25 of the 2005 Adopting Release; see also Rules 3100 and 3200, which require associated persons to comply with applicable auditing and related professional practice standards.

forth in Section 105 of the Sarbanes-Oxley Act, which is where the Board's ability to sanction associated persons is described. The Board recognizes that its inspection function serves this oversight process, describing its inspection function as a "process [that] aims to drive improvement in the quality of audit services through a focus on effective prevention, detection, and deterrence of audit and quality control deficiencies—and oversight of firms' remediation of identified deficiencies."[16] Yet the Proposing Release indicates that one of the Board's justifications for the proposal to lower the secondary liability threshold to simple negligence is its enforcement experience with respect to the design and implementation of firm quality control policies and procedures. In this vein, the Board states:

> For example, when dealing with the design and implementation of firm quality control (QC) policies and procedures under applicable QC standards, the Board has observed that registered firms that commit a QC violation often have multiple individuals with overlapping QC responsibility but that no single individual was reckless in failing to act, and thus no individual can be held personally accountable for the firm's QC failure.[17]

We take issue with two facets of this justification for the Board's proposal. First, the Board's inspection function already provides it with transparency into the inner workings of a firm's quality control system; the ability to monitor, detect, and deter deficiencies or non-compliance with laws, rules, and standards; and the ability to remedy any deficiencies on a real-time basis.

Second, the Board makes this statement in support of applying a lower standard of secondary liability as if multiple people with overlapping responsibility for a firm's QC system is an obstacle to investor protection or enhanced audit quality, when input from multiple professionals results in precisely the opposite. The design and implementation of a firm's QC policies and procedures are often quite comprehensive and complex, and often have been constructed over many years with continuous improvement efforts by multiple personnel. To suggest that a single individual needs to be held personally accountable in the absence of reckless behavior for contributing to a firm's violation belies the practical realities of a comprehensive QC system at a large firm. Many people may appropriately have critical and distinct roles, with sometimes overlapping responsibilities, in the design, maintenance, and operation of such systems. Extant QC standards specifically contemplate this fact, describing that the various elements of a firm's QC system are interrelated and should be appropriately comprehensive and suitably designed to account for the nature and complexity of a firm's practice and its size, among many other considerations.[18]

Moreover, the Board's stated justification for the proposal to permit it to hold a single individual accountable for contributing to a primary violation by the firm also appears to misunderstand that audits are not conducted with a top-down compliance model that may be appropriate in corporate organizations with linear decision-making structures. Instead, audits are often large and highly complex undertakings that involve many people (and multiple firms) and require substantial time to complete, particularly when the issuer is a large enterprise with disparate operations and complex accounting issues. On audit engagements, significant judgments and decisions are often made within firms with input from various persons outside of the engagement team. While the engagement leader is ultimately responsible for the overall audit, including communicating the firm's position on accounting, auditing, and reporting matters to the client, engagement leaders are expected, and in certain instances required by firm policies, to consult with other professionals prior to communicating a position to a client on a matter involving significant judgment. For example, engagement leaders are expected to consult with other professionals regarding complex independence issues, or the acceptability of client accounting policies, practices, and footnote disclosures or the form of accountants' report. The proposal appears to substantially discount the

[16] See PCAOB website, *Inspections,* at https://pcaobus.org/oversight/inspections.
[17] See Proposing Release at 9.
[18] See QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* at QC 20.03, .04, and .08.

fact that many firm personnel often play a role in supporting significant judgments and decisions related to an audit engagement.

3. *The proposed amendments would discourage, rather than promote, effective collaboration between and among accountants within the firm.*

We agree with the concern identified in the Proposing Release that "excessive monitoring and self-protective behavior" is a potential unintended consequence of the proposed change to Rule 3502.[19] Even if such a risk exists in the current regulatory framework, as argued in the Proposing Release, this change to Rule 3502 would exacerbate this risk and provide an incremental chilling effect on those professionals who may otherwise be motivated to advise and collaborate with engagement teams of their own registered public accounting firm.

Accountants routinely reach out to other professionals with various experience and expertise to provide support and collaboration when applying independent professional judgment to complex factual situations that require interpretation and application of various statutory and regulatory requirements, along with applicable professional standards and rules. Indeed, reaching out to firm colleagues with varying expertise, including in the firm's national office and independence office, on a range of topics is an important part of our firm's collaborative culture of "leaning in" to help colleagues who should "never go it alone." We frequently encourage our partners and employees who are dealing with complex interpretive issues to ask for help if needed, engage with colleagues, and share knowledge. That approach provides important benefits to audit quality through advice from experienced personnel who have seen a wide range of matters across the firm's clientele. The Board's proposed amendments to Rule 3502, however, could discourage or inhibit these types of discussions between and among professional colleagues and provide unfortunate disincentives to advising peers and sharing professional expertise, by spreading the very "undue fear" with which the Commission was concerned when it recognized: "an undue fear that an isolated error in judgment would result in a 102(e) proceeding could be counterproductive in some limited circumstances."[20]

If firm personnel believe that a single misstep could ensnare them in an investigation into whether their conduct constituted a simple act of negligent behavior, it is rational behavior for such personnel to be more circumspect about putting themselves in a position where their judgment later could be second guessed with the benefit of hindsight. This may also create a deterrent to recruiting experienced personnel to national office or other consultative roles that are critically important to audit quality. If the Board is determined to lower the threshold for contributory liability, it would be beneficial if the Board were to express its intention not to seek sanctions against those who exercise appropriate good-faith judgments based on the facts available to them. In this regard, we note that the Board's 2005 Adopting Release highlighted the Board's intent in adopting Rule 3502:

> It was not the Board's intention to establish a new standard for SEC enforcement of the securities laws and related applicable rules. The Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs. The Board does not seek to create through this rule a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful. Nor does the Board seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation.[21]

[19] See Proposing Release at 26.
[20] See SEC 102(e) Release.
[21] See 2005 Adopting Release at 14.

If it adopts the proposed rule, the Board should encourage collaboration by affirming in its adopting release that a modified Rule 3502 would not be used to second guess reasonable, good-faith judgment calls by associated persons.

4. *The proposed amendments also would discourage effective collaboration between and among accountants at separate network member firms.*

The Board's proposal to expand the scope of secondary liability of associated persons to not only the accounting firm with which they are associated but also to "any" registered public accounting firm could also have significant negative consequences on the extent of collaboration between and among accountants at separate entities within a network. In principle, we recognize that the Board is trying to provide for equal accountability by associated persons as firm structures evolve. However, rather than providing an incentive for associated persons to collaborate, share perspectives and team on complex audit matters and other professional and regulatory issues, all of which increase audit quality, the proposed amendments may instead disincentivize collaborative and teaming behavior by creating an increased risk of subsequent, backward-looking criticism. As a result, the proposal could harm audit quality more than it would benefit it.

Additionally, it is unclear under the proposed rule how the Board will consider limitations on the individual's ability to influence or control the ultimate decision of another registered firm and how the "directly and substantially" language impacts the analysis in that regard. The Board states in the current proposal that it "believes that amending the rule as described would clarify that associated persons of *any* registered firm are potentially subject to liability under proposed Rule 3502, regardless of an individual's formal role or relationship with the firm that commits the primary violation."[22] But an individual's formal role or relationship is intertwined with that individual's scope of responsibility, especially as it concerns a public accounting firm other than their own, and that role or relationship (or the absence thereof) is key to demonstrating a causal relationship between the negligence of the individual and the accounting firm's primary violation. An associated person of one firm may be asked to advise or assist another professional accounting firm but may be unable to control or compel that accounting firm to accept the advice or take certain actions in response, either because of the individual's role, the entities' legal structure, or how the professional standards allocate responsibility. We also note that the PCAOB has proposed to remove Appendix K requirements through the proposed new quality control standard, QC 1000.[23] That change, if adopted, when combined with this proposed change to Rule 3502 could result in firms and their associated persons becoming less likely to engage in the sharing of perspectives.

If the Board intends to expand enforcement authority to include situations in which an associated person's conduct is the de facto cause of another firm's violation, such as a network member firm's conduct causing another member firm's independence rule violation, the rule could be more narrowly tailored to achieve that end. Otherwise, the breadth of the proposed rule and resulting uncertainty of application to assisting firms, entities, and professionals could result in the unintended consequences highlighted above.

Other considerations

- *The Board's proposal puts further strain on the efforts to recruit and retain accountants.*

The Board's proposal, in conjunction with other recent proposals, increases enforcement exposure for all accountants at all experience levels, which likely will further strain efforts to stem the reduction in the

[22] See Proposing Release at 10 (emphasis added).
[23] See QC 1000 Proposing Release at 130.

talent pool for new accountants.[24] As the Board proposal indicates, "excessive litigation risk could unintentionally discourage auditors from accepting important audit roles if they fear being held liable."[25] And the Board's recent proposals, including this proposal, are expressly intended to provide the Board with additional tools to augment its enforcement powers against individual auditors.[26] We also share Board Member Ho's concern that an additional unintended consequence of the Board's proposal is to increase the pressure on retention of audit professionals; that is, the proposal creates disincentives for more junior accountants to rise to more important audit roles, as well as other quality or national office roles, thereby increasing the chance that they may leave the profession altogether.[27] While we support the Board's efforts to hold practitioners accountable and to increase audit quality throughout the profession, the Board should consider how its recent actions could be perceived as making the profession a less desirable occupation for those considering whether to enter or remain in the profession.

- *The Board's economic considerations overstate the potential benefits and understate the costs*.

As described above, we believe that the Board's proposed amendments to lower the standard for contributory liability by associated persons to simple negligence could have far-reaching unintended consequences by incentivizing individual self-protective behavior, disincentivizing collaborative engagement and voluntary informal assistance between colleagues and across registered firms in a network, and increasing stress on formal and informal consultations with and among network member firms to the detriment of audit quality.

Given these unintended consequences, the incremental benefits to the Board's proposal are elusive. For example, the Board indicates that "the purpose is not to cause associated persons for the first time to feel as if they could be subject to liability (i.e., to impose liability for conduct that currently is not subject to enforcement)."[28] Yet, at the same time, the Board states that lowering its contributory liability standard to simple negligence "should incentivize associated persons to be more deliberate and careful in their actions."[29] The Board explains this inconsistency by observing that the PCAOB currently lacks the enforcement authority to charge contributory liability under a simple negligence standard that the Commission currently is empowered to undertake, and therefore the proposed amendments would provide "enhanced incentives for individuals to perform important roles at a reasonable person level of care" as they could be subject to sanction by both the Commission and the PCAOB. But that justification defies normal human behavior, suggesting that people would behave more prudently because they are subject to enforcement action by two agencies, instead of just one. This justification is especially

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[24] See Maurer, Mark, "Accounting Graduates Drop By Highest Percentage in Years," The Wall Street Journal (Oct. 12, 2023), at https://www.wsj.com/articles/accounting-graduates-drop-by-highest-percentage-in-years-5720cd0f; see also Maurer, Mark, "Job Security Isn't Enough to Keep Many Accountants From Quitting," The Wall Street Journal (Sept. 22, 2023), at https://www.wsj.com/articles/accounting-quit-job-security-675fc28f?mod=hp_lead_pos7; see also SEC 102(e) Release ("Likewise, one of these commenters and one other commenter suggested that the proposed rule's use of a negligence standard would discourage competent practitioners from pursuing careers in public company accounting.").

[25] See Proposing Release at 26.

[26] See, e.g., A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules and Forms, PCAOB Release No. 2022-006 (Nov. 18, 2022) (hereinafter the "QC 1000 Proposing Release"), at 75 ("Another key difference is that QC 1000 would impose specific responsibilities on the individuals assigned the specified roles, such that enforcement action could be brought against them individually if they fail to meet those responsibilities.").

[27] See *The Cost of Unintended Consequences: Accounting Talent, Audit Quality, Investor Protection*, Statement by Board Member Christina Ho, (Sept. 19, 2023), at https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability).

[28] See Proposing Release at 20.

[29] See Proposing Release at 7.

confounding in the context of simple negligence, which, by definition, is not intentional conduct. Moreover, auditors face the risk of civil liability for negligent acts, which can involve significant financial and reputational damages. Civil litigation also provides additional investor protection. It is unclear what new benefit the proposed rule would achieve given the existing liability exposures for auditors.

Separately, the Board points to data reflecting those cases in which it brought charges against firms but no Rule 3502 violations were alleged as evidence that "no contributory actor was held accountable *under Rule 3502*" in these cases (emphasis added).[30] We observe that the Board does not state that no contributory actor was held accountable, just that they were not charged with a violation under Rule 3502. In other words, individual actors in these cases may have been charged with primary violations under different Board rules and thus *were held accountable*, just not under the specific charge of secondary liability under Rule 3502.[31]

Notably, the Board does not attempt to quantify the costs that could be imposed as a result of its proposed amendments. Instead, the Board simply states that the amendments, if adopted, "are expected to result in increased costs,"[32] and adding that those costs, in the form of increased enforcement actions, could "be substantial to the firms and individuals involved."[33] In contrast, the PCAOB staff itself estimates only modest enforcement benefits from the Board's proposed change, indicating that that there were only "two to three instances" in 2022 where it would have recommended an incremental charge in an enforcement action under Rule 3502 as proposed to be amended.[34] If the Board's estimate of two to three additional enforcement cases is an accurate prediction of future cases, the Board has not shown a clear need for this proposed change. Conversely, if the Board's estimate is not an accurate prediction of future enforcement matters, its economic analysis of potential costs is incomplete and has not demonstrated a basis to conclude that the benefits of these proposed amendments reasonably outweigh their potential costs.[35]

- *The Board should clarify the distinction between "due professional care" and "reasonable care."*

The Board describes its proposed negligence standard as "the failure to exercise reasonable care or competence."[36] Should the Board determine to go forward with this proposal, it would be helpful if the Board considered how the concept of "reasonable care" as used in this negligence description is

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[30] See Proposing Release at 18.

[31] The Board acknowledged in the Proposing Release that it has other tools at its disposal to hold associated persons accountable for conduct that contributes to a firm's primary violation of Board standards and rules. See Proposing Release at 9, n. 31 ("As the 2005 Adopting Release notes, however, Rule 3502 'is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons.'"). In fact, the Board has brought recent enforcement actions against firms for primary violations, and in those actions has held associated persons of such firms accountable for related conduct. See, e.g., *In the Matter of BDO USA, P.C., Kevin Olvera, CPA, and Michael Musick, CPA,* PCAOB Release No. 105-2023-024 (Sept. 26, 2023) (charging BDO, an assisting partner, and an engagement quality review partner with violating audit standards on an issuer engagement); *In the Matter of KPMG Inc., Cornelis Van Niekerk, and Coenraad Basson*, PCAOB Release No. 105-2022-015 (Aug. 29, 2022) (charging the firm and Van Neikerk with violating audit standards on multiple audit engagements); *In the Matter of Citrin Cooperman & Company, LLP, Joseph Puglisi, CPA, Mark Schniebolk, CPA, and John Cavallone, CPA,* PCAOB Release No. 105-2022-007 (May 11, 2022) (charging the engagement partner and two engagement quality review partners with violating audit standards on a broker dealer examination engagement and the firm with violating quality control standards).

[32] See Proposing Release at 24-25.

[33] See Proposing Release at 25.

[34] See Proposing Release at 25.

[35] See *Mexican Gulf Fishing Co. v. United States DOC*, 60 F.4th 956, 965 (5th Cir. 2023); see also *Texas Independent Ginners v. Marshall*, 630 F.2d 398, 411, n. 44 (5th Cir. 1980).

[36] See Proposing Release at 4 (citing *In re S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 35 n.169 (July 3, 2013).

comparable with, or distinguishable from, the concept of "due professional care" as that concept is proposed to be defined by the Board's AS 1000 proposal. As described in proposed AS 1000, "due professional care" means "what the auditor does and how well the auditor does it. Due professional care means acting with reasonable care and diligence, exercising professional skepticism, acting with integrity, and complying with applicable professional and legal requirements."[37] Given the apparent overlap between the concept of "due professional care" and the description of "reasonable care," the Board should clarify if an individual is found not to have exercised due professional care under proposed AS 1000, would they be similarly liable under an amended Rule 3502 if the action, or inaction, that resulted in the finding of failure to exercise due professional care directly and substantially contributed to a primary violation by any registered public accounting firm.

- *If the proposal is adopted, the Board should consider its other pending proposals when setting the effective date.*

The Board has a number of proposals pending adoption that intersect and overlap, such as the proposal regarding QC 1000 and AS 1000, which, as proposed, would create new obligations on associated persons of registered public accounting firms. Since the Board's proposal on contributory liability may have different repercussions depending on the outcome of these other proposals, it would be beneficial for the effective date of this proposal to be at least for an appropriate period after those other proposals are adopted so firms can consider the implications of this proposal in relation to those other standard settings.

[37] See PCAOB Release No. 2023-001 *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards* (March 28, 2023), at 21, at https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-049/pcaob-release-no.-2023-001-as-1000---proposed.pdf?sfvrsn=28304d26_4.

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November 3, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, D.C. 20006-2803

Re: Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability

Dear Office of the Secretary:

We, RSM US LLP (RSM), value the opportunity to offer our comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (the proposal). RSM is a registered public accounting firm serving middle-market issuers, brokers, and dealers.

As auditors, we are committed to the highest standards of integrity and audit quality, and we are proud to play a role in protecting investors' interests. We believe the proposed rule would do more harm than good in that endeavor, and therefore we request the Board carefully consider the negative consequences this proposal could have on investor protection.

The proposal is a departure from established Securities and Exchange Commission (Commission) precedent acknowledging that it is bad policy to penalize a single error in judgment. The proposal imposes career-ending penalties for associated persons who fail to recognize their conduct may be one of several causes that contribute to a future firm violation of laws or professional standards. The associated person's conduct alone does not need to violate any law or professional standard but merely contribute to a violation. This allows the PCAOB to take severe disciplinary action in a wide set of circumstances, constrained only by its own discretion.

RSM does not support the proposal. Expanding Rule 3502 to target conduct that an associated person "should have known would contribute" to a later-discovered firm violation only creates uncertainty that does not promote compliance with specific laws and standards. We address the reasons for RSM's position below.

The Board Should Not Lower the Liability Threshold for Rule 3502 and Create Disparity with Existing SEC Enforcement Policy

The Board should not lower the existing standard to a single error in judgment. The proposal imposes an overly vague and broad rule that will not further the Board's mandate. Further, it is contrary to prosecutorial restraints that the Commission has imposed on itself in Rule 102(e) proceedings.

The Board proposes to penalize an associated person when the associated person "should have known" that an act or the failure to act "would contribute" to a firm violation of laws or standards. The proposal would allow the PCAOB to second-guess the decisions of associated persons in numerous situations involving the application of professional judgment to general rules, undefined concepts, and new regulator interpretations. Firm personnel apply professional judgment daily in these types of situations. As examples, associated persons (1) are responsible for making judgment calls on fact patterns that implicate the general rule of the independence regulation; (2) design controls to obtain reasonable assurance that the firm is complying with undefined terms in regulations and standards; (3) advise firm

leadership and auditors on the application of novel interpretations of rules;[1] (4) evaluate the effectiveness of controls and corrective measures when controls are not effective; (5) design audit methodology, consultation requirements, and guidance applicable to high-risk decisions, such as evaluation of errors and application of qualitative factors; and (6) consult on the application of Generally Accepted Accounting Principles and PCAOB auditing standards. These decisions are made in good faith and based on knowledge, available information, reasonable inferences from guidance, and professional experience. Yet under the proposal, if a single decision becomes a direct and substantial contributing factor of a firm violation of laws or standards (among other causes), the associated person stands to lose their livelihood.

There are numerous policy reasons for not adopting the proposal, among those are the following.

The proposal exposes associated persons to hindsight second-guessing that may lead to career-ending sanctions. The Board understates this increased liability risk as "modest."[2] Sadly the opposite is true: audit clients will not accept an accountant whose record reflects a Board censure or fine; firms will not risk placing such an individual in client service or in a position to influence firm policy; state boards of accountancy will investigate and potentially take action against the individual's license; and the individual will suffer the collateral consequences of a person who has violated the Securities Exchange Act of 1934.[3]

The proposal does not provide fair notice of specific conduct that violates the rule. Because the proposal does not mandate or proscribe specific conduct, it does not incentivize compliance. Instead, it creates a trap for the unwary. Nor does the proposal effectively deter conduct. Penalties are not an effective method to deter one-time mistakes, inadvertence, and errors in judgment.[4] As long as firm personnel engage in a good faith process employing reasonable diligence to reach a professional judgment, the Board should not second-guess the decision and impose severe penalties.

The proposal does not impose an obligation of due professional care; instead, it imposes a penalty when a person "should have known" action or inaction "would contribute to" a firm violation of law or standards. That is, the associated person's conduct provides a basis for imposing sanctions because of its relationship to the wrongful conduct of the firm. This framework creates unfair and unlawful results. For example, an associated person could be held responsible even though another person intentionally exploited a weakness in Quality Control (QC) designed by the associated person. This is unfair. In tort law, this is referred to as a

[1] *Compare,* Revision of the Commission's Auditor Independence Requirements, 65 F.R. 76008 (Final Rule Dec. 05, 2000) ("One of the so-called 'middle tier' accounting firms expressed concern that the proposed definition would reach the 'alliance' it has arranged with other accounting firms and service providers across the country. In light of these comments and after careful consideration, we have decided not to adopt the definition of 'affiliate of the accounting firm' we proposed."), *with*, *In the Matter of Warren Averett, LLC*, PCAOB Release No. 105-2023-022 (Aug. 29, 2023) ("Warren Averett lacked any policies or procedures designed to detect or prevent auditor independence violations that might arise in connection with its membership in the BDO Alliance or any similar alliance of public accounting firms.").

[2] SOX allows the Board to censure and fine an associated person up to $100,000. 15 U.S.C. §7215(c).

[3] "A violation by any person of . . . any rule of the [PCAOB] shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 . . ., and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations." 15 U.S.C. § 7202(b).

[4] For this reason, "[p]unitive damages are not awarded for mere inadvertence, mistake, errors of judgment and the like, which constitute ordinary negligence." Restatement (Second) of Torts § 908 (1979).

> superseding cause, and such circumstances relieve the negligent party of liability. Also, an associated person could be held responsible when the firm willfully or intentionally violates a law. For example, an associated person who declines to create a policy imposing required consultations for suspected noncompliance with laws may be held responsible if the firm through an engagement leader willfully failed to comply with Section 10A. It is unprecedented (and unlawful) to impose secondary liability for a negligent act when the primary violation involves intentional or willful conduct.[5]
>
> The proposal's broad and vague language could ensnare an audit engagement team member whose conduct alone is not a violation of standards. This is a significant change from current PCAOB enforcement policy. Currently, the mistake of one person that does not result in a violation could be aggregated with the mistakes of others to form the basis of a firm violation. However, that person would not be penalized for the mistake while the firm is held responsible. Under the proposal, an engagement team member, no matter the level of experience, could face severe penalties for a mistake. That is, the proposal, which is intended to reach the conduct of associated persons involved in ensuring compliance with firm-specific standards such as independence and quality control standards, could be applied beyond its intent. There are more narrowly tailored and effective methods to improve the quality of firm personnel involved in the design and operation of a firm's system of quality control.[6]

Recognizing that penalizing singular mistakes may have unintended consequences, the Commission has declined to impose sanctions for improper professional conduct when the conduct involves a single instance of ordinary negligence or a single error in judgment.[7] The Commission found that "[c]reating an undue fear that an isolated error in judgment would result in a 102(e) proceeding could be counterproductive." Therefore, Rule 102(e) "does not permit the Commission to evaluate actions or judgments in the stark light of hindsight." The rule imposes a limitation that the accountant's conduct involve (1) "a single instance of highly unreasonable conduct in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted," or (2) "repeated instances of unreasonable conduct . . . that indicate a lack of competence." 17 C.F.R. § 201.102(e).

The PCAOB should heed the warnings of the Commission and avoid disparity in enforcement. Regulatory restraint is appropriate when harshly sanctioning individuals for failures to comply with rules and standards that are complex, ambiguous, outdated, and the subject of inconsistent and new (sometimes nonauthoritative) interpretations by overlapping regulators. There is a better forum to address errors in judgment of associated persons that do not rise to violations of laws or standards. As former Acting Board Chair Daniel Goelzer aptly put it: "violation-causing conduct that is only negligent can best be dealt with through [the PCAOB's] inspection program and [its] ability to require firms to strengthen

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[5] *See Invs. Rsch. Corp. v. Sec. & Exch. Comm'n*, 628 F.2d 168, 178 (D.C. Cir. 1980) ("Where sanctions can be imposed, the negligence standard provides insufficient protection for those persons whose involvement in securities law violations is in one respect substantial, yet wholly innocent.").

[6] If the PCAOB seeks to regulate the conduct of associated persons involved in designing and operating a firm's system of quality control, it can employ more direct and effective measures to accomplish this goal. The Board can promulgate standards specifically addressing roles of associated persons not directly involved in an audit but involved in designing and monitoring compliance with firm policies. This will create more certainty and provide predictability in enforcement of standards. Further, it will more effectively accomplish the PCAOB's goals of deterrence, accountability, and investor protection.

[7] Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 F.R. 57164 (Final Rule Oct. 26, 1998).

quality control and other internal procedures."[8] For these reasons, RSM recommends that the Board keep the current framework requiring actual knowledge or reckless disregard.

The Proposal Is Different Than Section 21C of the Exchange Act, Which Requires a Finding of Harm

The Board cites Section 21C of the Exchange Act to bolster its argument that associated persons are already subject to sanctions for negligent, violation-causing behavior. *See* 15 U.S.C. § 78u-3. This argument misconstrues the purpose of the statute, the elements, and the history of how the Commission has enforced Section 21C.

In 1990, the Commission sought the authority in Section 21C as part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[9] The purpose of the Commission's newly requested authority was to allow the Commission to quickly impose injunctive relief administratively without the showing of imminent harm necessary in lengthy judicial injunctive relief proceedings.[10]

Importantly, the elements of Section 21C require the Commission to "find[], after notice and opportunity for hearing, that a[] person is violating, has violated, or is about to violate a[] provision of [the Exchange Act], or any rule or regulation thereunder;" after such a finding, the Commission can issue an order against "any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation." 15 U.S.C. § 78u-3(a). That is, there must be harm to the public that was in part caused by a negligent act of a secondary actor and a finding on the primary actor's violation of the law.

Outside of stipulated consent orders, the Commission has used its Section 21C authority in limited situations involving violations of independence rules and other rule violations that directly lead an issuer to make a filing in violation of securities laws.[11] And, the Commission has noted in court filings that Section 21C proceedings are substantially different proceedings than Rule 102(e) actions which levy career-ending penalties, justifying the lower level of culpability.[12]

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[8] Daniel L. Goelzer, Open Meeting: Rules Concerning Independence, Tax Services, and Contingent Fees (July 26, 2005).

[9] *See generally* Andrew M. Smith, *SEC Cease-and-Desist Orders*, 51 Admin. L. Rev. 1197, 1199-205 (1999) (discussing the background and legislative history of Section 21C).

[10] Although Congress later added a penalty sanction for Section 21C, the Supreme Court has granted certiorari to determine whether the penalty section is unconstitutional. *See Jarkesy v. Sec. & Exch. Comm'n*, 34 F.4th 446, 465 (5th Cir. 2022), cert. granted, 143 S. Ct. 2688 (2023) ("The SEC's judgment should be vacated for at least two reasons: (1) Petitioners were deprived of their Seventh Amendment right to a civil jury; and (2) Congress unconstitutionally delegated legislative power to the SEC by failing to give the SEC an intelligible principle by which to exercise the delegated power.").

[11] *See, e.g., KPMG, LLP v. S.E.C.*, 289 F.3d 109 (D.C. Cir. 2002).

[12] "In fact, the nature of the two proceedings is different (one is a professional disciplinary proceeding designed to protect the integrity of the Commission's processes while the other is a law enforcement proceeding), and they involve fundamentally different remedies (Rule 102(e) sanctions include permanent denial of the opportunity to practice before the Commission). *It is not surprising that a lower standard of culpability would govern the milder remedy of a cease-and-desist order*." SEC Br., *KPMG LLP, Petitioner, v. S.E.C., Respondent.*, 2001 WL 36038953, at 46 (C.A.D.C.) (emphasis added).

The differences between Rule 3502 and Section 21C proceedings counsel against using Section 21C to justify lowering the threshold for Rule 3502. Section 21C was intended to quickly enjoin conduct that may lead to securities law violations, not to impose disciplinary action. Section 21C requires a showing of harm to the public through securities law violations. In contrast, a Rule 3502 violation under the proposal could involve a firm violation of QC standards, yet not a material misstatement in a public company financial statement. For these types of violations with no associated harm, the Commission has chosen to use a higher level of culpability under Rule 102(e).[13] The PCAOB should do the same.

* * * * *

RSM addresses certain specific questions presented in Sections II through VI of the proposal in the enclosed Appendix. We would be pleased to respond to any questions the PCAOB or its staff may have about our comments. Please direct any questions to Jamie R. Klenieski, Audit Quality and Risk Leader, at 215.648.3014, or Sara Lord, Chief Auditor, at 612.376.9572.

Sincerely,

RSM US LLP

RSM US LLP

[13] "The Commission does not need to show that the accountant's behavior actually caused harm; an accountant can demonstrate a lack of competence even if his conduct did not result in the filing of a false or misleading document." Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 F.R. 57164, 57168 (Final Rule Oct. 26, 1998).

Appendix

Comments on Specific Questions Posed by the Board

RSM addressed most of the questions posed in the proposal in its comment letter. We submit this Appendix to provide responses to certain specific questions presented in Sections II through VI of the proposal.

3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms?

No. We do not believe there is a gap or incongruity in regulatory enforcement. The PCAOB currently has the authority to discipline violations of its standards. This coupled with standards that impose specific or principles-based obligations on the associated persons will incentivize associated persons to comply with such standards. In contrast to an accountability framework that sets forth clear expectations, the proposal imposes a vague rule that penalizes conduct an associated person "should have known" would contribute to a future firm violation of laws and standards. Because the proposal does not provide notice of specific conduct that may lead to a violation, we do not believe it will incentivize compliance with applicable requirements.[14]

If the Board seeks to promote its mandate of investor protection, there are more narrowly tailored methods it could employ to incentivize quality audits and improved firm quality control. The Board has done just this by recently commencing a standards-setting effort and enhanced inspection process to target audit quality, improved firm quality control, and increased accountability for those responsible for the firm's system of quality control. These include (1) proposed QC 1000, which vests ultimate responsibility over the system of quality control on the firm's principal executive officer, and operational responsibility over the QC system as a whole, over ethics and independence, and over monitoring and remediation on other firm personnel, (2) proposed Auditing Standard (AS) 1000 and other audit standard amendments imposing new obligations on associated persons, and (3) new transparency enhancements to firm inspection reports. The Board should wait for these improvements to operate in practice and evaluate their effect on audit quality and firm quality control before imposing a new vague rule.

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable?

The "directly and substantially" modifier is not defined in the proposed rule itself or in the standards. The Board expressed its views on the modifier in no less than a paragraph. The "conduct must 'either essentially constitute[ ] the [firm's] violation' or be 'a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation;'" "but it need not 'be the final step in a chain of actions leading to the violation.'" And the "conduct must 'contribute[ ] to [a] violation in a material or significant way,' though it need not be 'the sole cause of the violation.'" But, the Board does not intend to "reach an

[14] The Board itself has recognized that vague standards do not incentivize quality audits. *See Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards*, PCAOB Release No. 2023-001 (Mar. 28, 2023) ("Overall, therefore, there is a spectrum of possible approaches to audit regulation that lies between excessively vague principles and excessively specific requirements. In practice, effective auditing standards may fit into the middle of that spectrum by emphasizing core principles while including some specific requirements to help support skeptical judgment and skeptical action.").

associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation."

The Board's view introduces the concepts of materiality, significance, reasonably proximate facilitating event, reasonably proximate stimulus, remote, and tangential, and the meaning of these concepts must be derived from the facts of a limited number of Board orders issued since 2009. This lack of clarity will make the application of "directly and substantial" inoperable. There are established legal doctrines of causation that are better suited, especially considering the administrative and judicial process for subsequent review of Board decisions. These include the substantial factor test, and legal or proximate cause, both of which are restated and analyzed in the Second Restatement of Torts, Sections 430-431 and 435-461. These restated standards address superseding and intervening causes, foreseeability of harm, and other policy reasons to not impose liability for a but-for cause in a chain of events, even when direct and substantial.

9. Are there other phrases or terms that the Board should consider to modify "contribute," or other limitations that the Board should incorporate into the proposed rule? If so, what are they?

The Board should consider imposing a limitation that the conduct of the associated person be a substantial factor in bringing about, and a proximate cause of, the firm's violation of laws or standards. It will help in the scenario of a rogue employee or partner that exploits a gap in controls to engage in intentional misconduct. A proximate cause requirement should prevent the Board from using proposed Rule 3502 to penalize violation-causing conduct in situations where the primary violator engaged in intentional conduct. The Board could also consider specifically exempting violation-causing conduct when a primary violation involves intentional conduct.

11. Should the Board expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons (i.e., not just by any registered firm)? If so, what (if any) limits or conditions should the Board place on such secondary liability?

No. The board should not impose secondary liability for associated persons who contribute to violations by other associated persons for the same reasons stated in our comment letter and this Appendix.

16. Are there additional unintended consequences that might result from the proposed amendments?

The proposal may lead to other unintended consequences not already addressed in our comment letter. For example, a firm may decline to serve as referred-to auditor for a non-substantial portion of the engagement to avoid uncertainty over PCAOB enforcement jurisdiction over associated persons at the firm. Further, a vague standard focused on a hindsight critique of professional judgments creates an uncertain enforcement environment that will lead to inefficiencies, second-guessing, and a dearth of talent necessary in important decision-making roles.

17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession?

Yes. Although the Board references Section 21C of the Exchange Act in its question, this section of the Exchange Act requires a showing of harm to the public not currently required in the proposal, and the section's imposition of penalties and disgorgement has been held unconstitutional. Therefore, at this point, associated persons *do not* face secondary liability from the Commission for a single error in judgment, and certainly not in circumstances where the public was not harmed.

Because of this, the proposal creates a new category of career-ending penalties for a hindsight critique of professional judgment. The fear of entering a perilous occupation will exacerbate an already dire need for public accountants.[15] We agree with Board Member Ho's comments that the Board should not make the audit profession "so risk-ridden that the best and the brightest pursue careers elsewhere," and that doing so, would be "doing a disservice for investors in the long run."

We are also concerned about the potential trickle-down effect this could have on the availability of talent to serve public registrants. The audit profession operates in an apprenticeship model, developing talent for multiple areas of the capital markets ecosystem. Only a minority of accountants hired into the audit profession remain in the audit profession for their entire career. The majority apply the training, skills, and expertise they develop in the audit profession in other roles within the capital markets ecosystem, such as roles in accounting and finance for public registrants. We are concerned that faced with ambiguous judgment and hindsight critique, talented professionals may choose to not only leave the audit profession but also leave the public company accounting ecosystem entirely. Public registrants may be also impacted by the lack of qualified talent to serve necessary roles in the accounting, finance, internal audit, and other departments. Pushing more talented professionals out of the public registrant ecosystem entirely would cause harm to investors.

24. Is the proposed effective date (sixty days after Commission approval) appropriate? If not, what would be an appropriate effective date for the proposed amendments?

No. Given the significant concerns raised by the proposal, we believe the Board must respond to the concerns of stakeholders by redeliberating and re-proposing any amendments to Rule 3502. We believe the proposal in its current form should not be declared effective, thus are unable to comment on an appropriate effective date.

[15] *See* Lindsay Ellis, *Many Accountants Call It Quits*, Wall Street Journal (Dec. 29, 2022).

Office of the Secretary, Phoebe W. Brown October 1, 2023

PCAOB

1666 K Street, NW

Washington, DC 20006-2803

Cf. P.C.A.O.B. Rulemaking Docket Matter 053

Dear P.C.A.O.B. Secretary Phoebe W. Brown :

While it is a great privilege to be able to comment on P.C.A.O.B. Release No. 2023 – 007, "Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability", the present commenter has read P.C.A.O.B. Release No. 2023 – 007 as issued on September 19, 2023, and understands the Board is proposing to amend the P.C.A.O.B. Rule 3502 "Responsibility Not to Knowingly or Recklessly Contribute to Violations" in principally two ways : First, the Board proposes a recklessness criteria be replaced by a negligence conduct criteria; and second, that a person associated with one firm can contribute to a primary infraction of another firm. This commenter also understands that "negligence" encompassed by this Release includes gross negligence, comparative negligence, contributory negligence and vicarious negligence and their various permutations. This commenter has re – printed the question stem in front of answers to questions in the Release for the convenience of the reviewer. Questions and answers are as follows :

1. Are the regulatory concerns discussed above clear and understandable? **Answer** : The regulatory concerns discussed above are valid, clear and understandable, and illustrate the need for additional requirements concerning the auditor's responsibilities not to contribute to violations, knowingly nor by omission.

2. Are there other regulatory concerns related to the current formulation of Rule 3502? If so, what are they and how should the Board address them, if at all? **Answer** : Other regulatory concerns by this writing include the process or levels of analysis that are used to establish intent in the violation(s); e.g., lack of due care, lack of competency, and negligence or contributory negligence inviting the provisions of Rule 3502, and not just the intent in the violations, but the influences and other factors, again according to different levels of analysis that provoke or provoked any violation of governing principles, rules, standards and statutes.

3. Would addressing the regulatory concerns discussed above incentivize associated persons to more fully comply with the applicable laws, rules, and standards that the Board is charged with enforcing against registered firms? **Answer** : Given the impact of Rule 3502 in deterring violations and rules infractions involving, i.e., negligence and omissions, lack of due care and lack of competency; it is foreseeable associated persons are or will be incentivized to more fully comply with the applicable laws, rules and standards that the Board is charged with enforcing against registered firms. Also, to the contrary, Rule 3502 constitutes rulemaking that is a form of regulation as framed in academic studies that affects its subject matter in efforts to deter against violations and encourage compliance, though Rule 3502 as additional regulation or as modified might not change stakeholder behavior nor benefits, and will prove at least marginally more costly to the auditing profession (cf. "Theory of Economic Regulation", Stigler, George J.) Rule 3502, though evidently a deterrent and safeguard against negligence, omissions, lack of due care and lack of competence among other things, might additionally be symptomatic of "regulatory capture" in that this rule is dominated mainly by the unique and special interests of the Board, as valid, and by stakeholders as delineated in the documentation of Docket 053 : It might also be proposed that such rules suffer from agency problems such as benefiting the interests under regulation, engendering additional efforts by stakeholders to influence regulators and the Board, and serving interests dominated by stakeholders and the Board but not the public at large.

4. Are there common types of cases or fact patterns not discussed above in which a negligent standard of liability would be particularly useful to promote greater individual accountability under Rule 3502? **Answer** : This commenter knows that defining, implementing and then enforcing a negligent standard of liability is something that might be unfamiliar insofar as it encompasses additional criteria and requirements that are newly developed and qualitative. Given the newness of the criteria and the requirement of greater accountability of the financial auditor under Rule 3502, this commenter knows of the academic Program of Corporate Compliance and Enforcement at New York University which has been gathering qualitative data on fact patterns in corporate business that relate to this proposed liability standard and greater auditor accountability. New York University's program named hereby has compiled evidential matter on cases and fact patterns that might serve as a resource in confirming and validating the proposed changes to Rule 3502.

5. Is it clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors? **Answer** : Yes, it is clear and understandable how the proposed amendments to Rule 3502 advance the Board's statutory mandate to protect investors in the delineation and illustration of the criteria of negligence, lack of due professional care and lack of competency, and omissions and their consequences in view of rule violations.

6. Beyond the dual purposes of deterrence and accountability, are there other ways that the proposed amendments would protect investors? **Answer** : Rule 3502 as amended comprises a more thorough regulatory measure against misconduct, and a more valid approach to compliance and enforcement against violations involving negligence, omissions, lack of due care, lack of competency and related infractions that can be pervasive in a firm, but do not need to be – a

violation inviting sanctions can be a single unlawful act "directly or substantially" or contributing to such an act.

7. Are the proposed amendments to Rule 3502's liability language (as seen in Appendix A) clear, understandable, and appropriate? **Answer** : Yes. The proposed amendments to Rule 3502's liability language in Appendix A are clear and understandable, valid and appropriate given the purposes of the Board in implementing these changes.

8. Should the Board retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation? Are the meanings of each of "directly" and "substantially," respectively, clear and understandable? **Answer** : The Board should retain the "directly and substantially" modifier to describe the connection between an associated person's contributory conduct and a firm's violation. The meanings of each of "directly" and "substantially", respectively, are also clear and understandable concerning the subject of misconduct in this proposed Release.

9. Are there other phrases or terms that the Board should consider to modify "contribute," or other limitations that the Board should incorporate into the proposed rule? If so, what are they? **Answer** : This commenter believes the Board should consider incorporating the term "influence" into the proposed rule to indicate that a negligence liability, including lack of due care, lack of competency, or omissions, etc.; as the result of misconduct, can also be the result of unlawful "influence" at least as a source of misconduct.

10. Is the proposed substitution of "any" in place of "that" in Rule 3502 (as seen in Appendix A) clear, understandable, and appropriate? **Answer** : Yes. The proposed substitution of "any" in place of "that" in Rule 3502 is clear, understandable, and appropriate.

11. Should the Board expand the scope of Rule 3502 to encompass secondary liability for associated persons who contribute to violations by other associated persons (i.e., not just by any registered firm)? If so, what (if any) limits or conditions should the Board place on such secondary liability? **Answer** : This commenter a priori believes that entity – level violations remain those of the entity, including those violations having to do with errors, acts, omissions, negligence, recklessness and so on as committed by officers representing the entity. To the contrary, a major doctrine in the law that should be written in to Rule 3502 is the "Vicarious Liability", or Park doctrine in which the crimes and any personal wrongdoing of employees within the scope of employment can be considered crimes by the business entity.

12. Are there scenarios where an associated person's conduct might contribute to another individual's primary violation but the conduct would be outside the scope of any Board standard or rule (current or proposed), including the current and proposed versions of Rule 3502? If so, what are the scenarios? **Answer** : This commenter does not know of any scenarios in which an associated person's conduct might contribute to another individual's primary violation but the conduct would be outside the scope of any Board or standard or rule given the current Rule 3502 and modifications thereto, and considerations invited by the answer in question 11 above.

13. Are there other benefits and costs of the amendments that the Board should consider? **Answer** : This commenter knows there are no other benefits and costs of the amendments to Rule 3502 that the Board should consider apart from agency questions that arise in the response to Question 3 hereby.

14. Are there any data sources that could provide a quantitative estimation of the expected benefits and costs? If so, please provide the names of such sources. **Answer** : No. This commenter does not believe there are any data sources that could provide a quantitative estimation of the expected benefits and costs of the amendments to Rule 3502.

15. Are there other academic studies that would inform our analysis of the expected economic impacts of the proposed amendments? If so, please provide citations for the studies. **Answer** : No. This commenter is not familiar with academic studies that would inform an analysis of the expected economic impacts of the proposed amendments to Rule 3502.

16. Are there additional unintended consequences that might result from the proposed amendments? **Answer** : Given the additionally detailed regulatory criteria of the proposed Rule 3502, and any additional related requirements, investigations and enforcement could become at least marginally more costly given enforcement requirements of the negligence and contributory negligence criteria and other provisions of the proposed rule. This evidently will result in additional investigative and enforcement work that will marginally affect the economic costs of enforcement activities.

17. As noted above, associated persons may currently face secondary liability for negligent conduct in actions by the Commission. Notwithstanding that current possibility, could the proposal discourage participation by associated persons in the audit profession? **Answer** : This question does not seem relevant to whether or not the proposed Rule 3502 will be effective, nor does it have to do with the overall efficiencies and deterrence it will create in the audit firms. The consequences of secondary liability for audit firms, including for negligence, might not discourage participation in the profession given assurances of the firms about compliance to incoming personnel, the response of audit firms overall to the rulemaking, e.g., by insuring for liabilities, raising audit fees and so on.

18. Are there additional economic impacts or considerations associated with the two regulatory alternatives discussed above that should be considered? If so, what are those considerations? **Answer** : No. This commenter does not believe there are additional economic impacts or considerations associated with the two regulatory alternatives discussed in the proposed Rule 3502 narrative.

19. Are there other regulatory alternatives the Board should consider? If so, what are they? **Answer** : No. This commenter does not believe there are other regulatory alternatives the Board should consider with respect to proposed Rule 3502.

20. Are other regulatory alternatives preferable to the proposed amendments? If so, please explain the reasons. **Answer** : No. This commenter does not know of any regulatory alternatives preferable to the proposed amendments.

21. What impact would the proposal have on EGCs, and how would this affect efficiency, competition, and capital formation? **Answer** : It is agreed that the current proposed amendments to Rule 3502 would have the effect of implementing higher standards of compliance for emerging growth companies, and the responses of the EGC's to the proposed rules would result in greater audit and financial efficiencies, including presumed increases in the quality of disclosures. This presumably would result in a benefit to EGC's in attracting more investment capital and lowering their costs of capital.

22. Would the economic impacts be different for smaller firms or EGCs? If so, how? **Answer** : This commenter does not know what the economic impacts would be of the proposed rulemaking apart from the smaller scale of any benefits or burdens to smaller firms or EGC's. Despite the importance of this rulemaking for all public companies, and importance overall of smaller firms and EGC's, the related economic effects cannot be foreseen with certainty, nor overall nor severally for these entities.

23. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made to make the proposal appropriate for EGCs? **Answer** : No. This commenter believes the standards of recklessness and negligence, including recklessness and negligence contributing to violations, should be treated equivalently in examinations of firms auditing larger public companies and EGC's alike. The principles, standards, and scope of enforcement against violations involving omissions, negligence, recklessness and so on should be the same regardless of the scale and size of the entity and of the firm.

24. Is the proposed effective date (sixty days after Commission approval) appropriate? If not, what would be an appropriate effective date for the proposed amendments? **Answer** : Yes. This commenter believes the proposed effective date of sixty days after Commission approval is appropriate. Per the discretion of the Commission, attention should be paid to firms who would petition for a more distant effective date and their petitions if reasonable and well – founded should be considered by the Board.

By,

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November 7, 2023

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (PCAOB Release No. 2023-007, September 19, 2023; PCAOB Rulemaking Docket Matter No. 053)

Dear Ms. Brown:

The U.S. Chamber of Commerce ("Chamber") Center for Capital Markets Competitiveness appreciates the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB" or "Board") Exposure Draft on *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (the "Proposal" or "Proposed Rule"). The Proposal is part of the Board's goal to strengthen PCAOB enforcement,[1] which includes revising PCAOB rules to enhance auditor accountability.

The Proposal would revise Rule 3502 to lower the threshold for contributory liability for associated persons from recklessness to negligence.[2] Further, the Proposal would extend contributory liability to violations by associated persons with any firm – not just violations by a firm with which they are associated.[3]

In 2004, the Board initially proposed negligence as the standard of conduct to govern the liability of associated persons who contribute to a registered public accounting firm's primary violation. However, after due consideration, which was informed by public comment, the Rule 3502 unanimously adopted by the Board in 2005,[4] and approved by the Securities

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[1] See the *PCAOB Strategic Plan 2022-2026,* page 13.

[2] The Proposal refers to associated persons as "persons" or "individuals." However, both natural persons and entities can be associated persons, and therefore Rule 3502 charges can be brought against both natural persons and entities, consistent with the meaning of the term "person associated with a registered public accounting firm" (page 3).

[3] The Proposed Rule is as follows (indicating the current language to be deleted and bolding the proposed language to be added):

Rule 3502. Responsibility Not to Contribute to Violations

> *A person associated with a registered public accounting firm shall not directly and substantially contribute to a violation by any registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, by an act or omission that the person knew or should have known would contribute to such violation.*

[4] See PCAOB Adopting Release *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* (PCAOB Release No. 2005-014, July 26, 2005).

and Exchange Commission ("SEC" or "Commission"), rejected negligence in favor of recklessness as the threshold for contributory liability.

In adopting Rule 3502, the Board concluded that a knowing or recklessness standard "strikes the right balance in the context of the rule."[5] In support of this decision, Board Member Goelzer emphasized: "[C]onduct that is only negligent can best be dealt with through our inspection program and our ability to require firms to strengthen their quality control and other internal procedures."[6]

The Board's decision to adopt a recklessness standard has stood the test of time. Rule 3502 has not been an impediment to PCAOB enforcement. Under the existing rule, the Board has expanded the types of cases it pursues, with fines and penalties at all-time highs. Nonetheless, the Board wants to upset the "right balance" in Rule 3502 with a Proposed Rule that would add a blunt and potentially draconian instrument to the PCAOB's already extensive enforcement toolkit to facilitate and further the Board's aggressive enforcement agenda.

The Chamber cannot support the Proposed Rule and the expansion of PCAOB tools for enforcement against associated persons of registered public accounting firms. The Proposal ignores congressional intent for authority granted to the PCAOB in The Sarbanes-Oxley Act of 2002 ("SOX") and legal constraints on PCAOB enforcement authority in accordance with SOX, along with raising other important legal questions. The Proposal lacks any compelling justification for the need to revise Rule 3502 or reasonable support for the claim that the benefits of the Proposed Rule outweigh the costs – for example, it fails to recognize and/or fully analyze significant costs, consequences, and other matters. Overall, the Proposal risks disturbing the PCAOB's inspection process, degrading audit quality, and diminishing investor protection.

The Chamber urges the PCAOB to withdraw the Proposal and maintain Rule 3502 in its current form. We discuss our concerns and recommendations in more detail below.

Discussion

Congressional Intent and PCAOB Authority

The PCAOB's legal authority under SOX for instituting a negligence threshold for contributory liability is not as settled as the Proposal assumes. The PCAOB's enforcement authority is not open-ended. SOX Section 105 articulates conditions for disciplinary actions and sanctions against registered public accounting firms and associated persons. SOX also provides some safe-harbors, including for failure to supervise.[7] Nowhere does simple

[5] Id., pages 12 and 13.
[6] See Statement of Daniel L. Goelzer on *Rules Concerning Independence, Tax Services, and Contingent Fees* (July 26, 2005).
[7] See SOX Section 105(c)(6)(B).

negligence appear in SOX as the level of intent justifying PCAOB sanctions.[8] This absence reinforces the need for caution by the Board before proceeding to adopt a negligence standard for contributory liability.[9] Indeed, as we discuss further below, the Board lacks the statutory authority to impose a negligence standard.

Further, a standard of simple negligence for contributory liability contrasts with existing legal standards for secondary liability. This raises additional legal concerns and reinforces issues of reasonableness and fairness, which we subsequently discuss in more detail.

Otherwise, while SOX gives the PCAOB authority for standard-setting, inspections, and enforcement, Congress did not intend for PCAOB oversight to give equal weight to each. Inspections represent the primary focus of the PCAOB – with the single largest portion of the PCAOB's staffing and resources directed towards inspection-related activities.[10] PCAOB enforcement is "a means of last resort."[11]

As emphasized by Board Member Goelzer, the Board recognized the power and primacy of the PCAOB's inspection process in finalizing Rule 3502, back in 2005. Inspections – along with the myriad of audit firm activities in support of and response to PCAOB inspections – is the PCAOB's most important process for maintaining and improving audit quality. The Chamber cannot support a Proposed Rule that would signal and solidify an elevation of PCAOB enforcement and disturb the PCAOB inspection process.

Unlike enforcement, inspection is not an adversarial process. A cooperative spirit and constructive dialogue between the PCAOB and each of the inspected audit firms and their associated persons are essential elements for the efficacy of the inspection process. Yet, by substantially expanding the scope and increasing the risk of PCAOB enforcement against associated persons for inspection deficiencies, the Proposed Rule would disturb the inspection dynamic and threaten the cooperative and constructive nature of the process that has developed over time.

Legal Authority

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[8] SOX Section 105(c)(5) identifies intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct as necessary for applying various sanctions and penalties under Section 105(c)(4).

[9] The Board also relies on SOX Section 103 as authority for the Proposed Rule. However, Section 103 gives the PCAOB the authority to regulate ethical conduct, which the Board conflates with the statutory authority to punish negligent conduct, including single acts of negligent behavior.

[10] For additional context, the PCAOB's 2023 budget provides more than twice the amount for the Division of Enforcement and Investigations than the Office of the Chief Auditor (Standards). In addition, the budgeted amounts for the Office of Economic and Risk Analysis and the Office of the General Counsel each exceed that of the Office of the Chief Auditor.

[11] The SEC also has enforcement authority over PCAOB registered public accounting firms and associated persons.

The Board lacks the authority to enact the Proposed Rule. The Proposal cites Sections 103 and 105 of SOX in passing, but neither provides authority to impose secondary liability on the basis of a single negligent act. Section 103 allows the Board to set auditing, ethics, and quality control standards, but it is not untethered from the rest of SOX. Section 103 does not impart limitless rulemaking authority on the Board. Section 105(c)(5), which is entitled "Intentional or other Knowing Conduct" limits the Board's ability to levy sanctions and penalties for certain violations of law only to "intentional or knowing conduct, including reckless conduct" or "repeated instances of negligent conduct." While it is true that Section 105(c)(5) does not limit the Board's authority to impose sanctions under paragraphs (D)(ii), (E), (F) and (G) of Section 105(c)(4), it does not logically follow that the Board may impose a negligence standard under those paragraphs.[12]

In *Central Bank of Denver*, the Supreme Court drew a clear distinction between primary and secondary liability, and in the absence of a clear grant of congressional authority, barred courts from implying liability for aiding and abetting under the SEC's general antifraud authority.[13] The Court reasoned that "Congress knew how to impose aiding and abetting liability when it chose to do so."[14] In the context of Section 10(b) of the Securities Exchange Act, the Court was clear that it "is inconsistent with settled methodology in §10(b) cases to extend liability beyond the conduct prohibited by statutory text."[15] The Court was also clear that "it is not plausible to interpret the statutory silence as tantamount to an implicit congressional intent to impose §10(b) aiding and abetting liability."[16]

Moreover, as the *Central Bank* court observed, "Congress has not enacted a general civil aiding and abetting statute."[17] Therefore, the Court continued, "when Congress enacts a statute under which a person may sue and recover damages . . . there is no general presumption that the plaintiff may also sue aiders and abettors."[18] We would also note that prior to *Central Bank*, the prevailing formulation for aiding and abetting liability under the federal securities laws required a showing of scienter.[19]

With this caselaw and these basic tenets of statutory interpretation in mind, and with *Central Bank* less than a decade old at the time of the passage of SOX, there is simply no basis to assume that Congress's silence implied a negligence standard under any part of Section 105. Indeed, Congress used clear and unequivocal language to empower the SEC to

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[12] Further, the Proposal does not distinguish between sanctions awarded under Section 105(c)(4).
[13] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).
[14] Id. at 176.
[15] Id. at 177.
[16] Id. at 185.
[17] Id. at 182.
[18] Id.
[19] See, e.g., *National Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 206 (2d Cir. 1989).

pursue an administrative claim for secondary liability based on negligence under Section 21C of the Securities Exchange Act.

The Proposal's efforts to argue, since the SEC has some authority to pursue secondary liability on the basis of negligence, that the Board has such authority too is misplaced. As a threshold matter, Section 21C applies only to the SEC, not the Board. In any event, what authority the SEC (or any other regulator) may have under its organic statutes is irrelevant to the inquiry of whether the Board has authority under SOX. Further, while the Proposal wrongly conflates the Board's powers with those of the SEC, it does not discuss Rule 102(e) under the SEC's rules of practice.[20]

Rule 102(e) permits the SEC to suspend or disbar an accountant from practicing before the SEC for certain professional misconduct. Notably, Rule 102(e)(A) requires a showing of intentional, knowing, or reckless conduct, and Rule 102(e)(B) requires a showing of negligence under two heightened circumstances. The heightened negligence showing requires either a "single instance of highly unreasonable conduct" or "repeated instances of unreasonable conduct." Thus, under the SEC's rule, a single instance of simple negligence is not actionable.

In adopting the heightened negligence standard, the SEC was clear that the "highly unreasonable" standard is "an intermediate standard, higher than ordinary negligence."[21] Importantly, the SEC reasoned that "a single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and, therefore may not pose a future threat to the Commission's processes sufficient to impose remedial sanctions."[22] The SEC in setting the higher standard was also concerned that "creating an undue fear that an isolated error in judgment would result in a 102(e) proceeding could be counterproductive. . . ."[23] Accordingly, the SEC did not adopt a "simple" or "mere" negligence standard.[24]

Need

The Board argues there is a need to lower the threshold for contributory liability from recklessness to negligence for associated persons because of a "mismatch" between individuals' and firms' respective minimum culpability levels, which limits the ability of the Board to hold individuals accountable.[25] In support of this argument, the Proposal explains

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[20] 17 CFR § 201.102.
[21] Release No. 33-7593, *Amendment to Rule 102(e) of the Commission's Rules of Practice*, 63 Fed. Reg. 57,164, 57,167 (Oct. 26, 1998).
[22] Id.
[23] Id. at 57,168.
[24] *See* id. at 57,169.
[25] See the Proposal, page 19.

that legal entities (i.e., registered public accounting firms) can act only through natural persons (i.e., associated persons) and, therefore, the standards for liability should be aligned.[26]

However, any so-called "incongruity" or "mismatch" was fully understood and considered by the Board in adopting Rule 3502 in 2005. It is neither a new insight nor a new development. Thus, "incongruity" or "mismatch" cannot and does not provide a convincing rationale or justify the need for the Proposed Rule. The Proposal provides no compelling evidence for the existence of a problem that needs solving.[27]

The Proposal states that the "[s]taff estimates two to three instances in 2022 where an amended Rule 3502 would have prompted staff to recommend a Rule 3502 charge."[28] The staff also estimates that this number is likely a "fair average representation across other years." Thus, "two to three" provides an estimate of the additional cases against associated persons that the PCAOB would pursue under the Proposed Rule, ceteris paribus.[29]

Conjecturing two or three additional cases a year (that may or may not be successful) falls far short of justifying the need for the Proposed Rule or meeting any cost-benefit threshold, given the significant costs and consequences that the Proposed Rule would impose. However, the Proposal alerts that ceteris paribus conditions may not apply. The Proposal states that "this estimate may vary to the extent that there are modifications in other Board standards (e.g., adopting and implementing a new quality control standard) or changes in enforcement priorities."[30]

This caveat – that past data may not reflect future application of a revised Rule 3502 – is of overriding concern, particularly because the Board declines to articulate its intent for the use of the Proposed Rule or to specify any limits on its use. The Board's aggressive enforcement agenda and lack of transparency on the intent for approaching enforcement in the future, including under newly revised PCAOB Auditing Standards ("AS"), undermines the propriety of the Proposal and supports that the Proposal is premature and should be withdrawn.[31]

Further, the only quantified data in the Proposal are problematic for establishing a baseline and the need for the Proposed Rule. To explain, the Proposal includes a table

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[26] See the Proposal, page 3.
[27] It is noteworthy the PCAOB does not argue that "bad actors" are escaping PCAOB enforcement. The PCAOB's enforcement tools, including Rule 3502 as currently constructed, are sufficient in that regard.
[28] See the Proposal, page 25.
[29] Id.
[30] Id.
[31] For example, under the QC 1000 proposal, individuals assigned specific responsibilities with respect to the quality control system could be charged with violations if they fail to comply with those responsibilities, as well as for knowingly or recklessly contributing to firm violations or failing reasonably to supervise. However, the Proposed Rule would lower the contributory threshold described to negligence and, thereby, extend the risk of disciplinary actions.

summarizing the number of cases from 2009-2022 with Rule 3502 charges (which total 87), the number of firms sanctioned (which total 245), and the ratio of the two (which is thirty-six percent). Based on these data, the staff concludes that "in nearly two-thirds of cases in which a firm was charged with a violation, no contributory actor was held accountable under Rule 3502."[32]

However, this analysis is mostly beside the point and misleading. Rule 3502 is not the only tool for PCAOB enforcement actions against individuals. The Board has other means of bringing disciplinary actions against associated persons (when appropriate), so there may be no need to revise Rule 3502. Revising Rule 3502 to bring duplicative charges against associated persons would be both unreasonable and unfair. Thus, in assessing the need for revising Rule 3502, an essential question is how many disciplinary actions involved individuals under any PCAOB rule?

In 2022, the Proposal reports six cases with Rule 3502 charges and thirty firms sanctioned overall, for a ratio of twenty percent. However, an analysis of enforcement orders announced in 2022 reveals forty-seven orders, although five are terminations of bars. The remaining forty-two orders involve thirty firms (as reported in the Proposal) and twenty-six individuals (not reported in the Proposal).

Thus, the Proposal fails to disclose that the number of associated persons sanctioned and/or penalized by the PCAOB in 2022 – for violating any applicable rule or regulation – almost equals the number of firms, which supports that there is no need to revise Rule 3502. Also, these data do not consider enforcement actions by the SEC.

Inadequate Economic Analysis

This section overviews the PCAOB's analysis of benefits and costs, which illustrates that the benefits elude; demonstrates how costs and consequences are dismissed; and provides background for a discussion of other inadequacies in the economic analysis, including the failure to consider the practical implications and collateral effects of the Proposed Rule.

Overview

As to the benefits, the Proposal includes a high-level discussion, which lacks any application to the specifics of the Proposed Rule itself. The qualitative discussion mostly focuses on increases in litigation risk and legal liability as benefits of the Proposed Rule – explaining that they improve audit quality by incentivizing compliance and serving as a deterrence against misconduct. The discussion concludes by speculating that "[u]nder the proposed rule, the increase in litigation and liability risk would be modest but meaningful,"[33]

[32] See the Proposal, pages 18 and 19.
[33] See the Proposal, page 22.

which hardly supports the proposed sea-change in liability for associated persons. In addition, litigation risk and legal liability involve costs from the perspective of audit firms and their associated persons, which require due consideration and likely offset any "benefits."

As to costs, the economic analysis recognizes the potential for increases in defense costs, opportunity costs (i.e., PCAOB enforcement diverting individuals from their normal responsibilities), audit fees, and indirect costs (e.g., from changes in individual behavior and additional effort). However, the analysis demurs on quantifying or qualitatively assessing the magnitudes of any of these costs. While the Proposal acknowledges that the costs "could ... [be] substantial to the firms and individuals involved" and "may have more impact on smaller firms,"[34] it does not otherwise analyze, assess, or reconcile them with the purported "modest benefits" of the Proposed Rule. Instead, it appears that the PCAOB believes it is sufficient simply to mention these types of costs.

As to potential unintended consequences, the economic analysis discusses concerns over self-protective behavior (i.e., individuals undertaking excessive and unnecessary procedures in the face of uncertainty over the application of the rule), discouraging auditors from accepting important audit roles (with such roles perhaps going to less cautious or qualified people), and reduced competition in the audit market. However, the analysis dismisses these consequences, too. Yet these concerns are real and require a more substantive consideration by the Board.

Practical Implications

The practical implications of applying a simple negligence standard are sweeping and severe. The Proposed Rule would apply to a violation of any one of the many intricate and complex body of rules and regulations in SOX, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under SOX, and professional standards.

The Proposed Rule would greatly increase the risk of PCAOB disciplinary actions for even the most routine decisions made daily by the thousands of associated persons – both partners and staff – whether serving on audit engagements or in national office, quality control, or other roles under the purview of the PCAOB, including supervisory roles. It certainly would add inordinate pressure on the many difficult, often technical, judgments on accounting, auditing, independence, and other matters that associated persons in these roles are called upon to make on a regular basis related to issuer and broker-dealer audits and reviews, including the quality controls that frame these activities. Given the ever-changing and increasing complexity of all aspects of PCAOB audits since 2005, these judgments and decisions have become even more challenging since Rule 3205 was adopted.

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[34] See the Proposal, page 25.

While it is true that an entity can act only through individuals, nonetheless, it is most often the case that a registered public accounting firms' actions are the result of the confluence of decisions and actions by some number of different individuals. This complexity makes it challenging for any individual to "know or should have known" in advance that their action or inaction was contributing to a violation of any of the many laws, regulations, and standards encompassed by the Proposed Rule.[35]

Thus, the Proposed Rule could implicate any one of thousands of associated persons for engaging in behavior that they neither intended, nor reasonably believed, would contribute to a registered public accounting firm violating any aspect of the complex web of laws, regulations, rules, or standards encompassed by proposed Rule 3502.[36] Mere "foot-faults" could be turned into PCAOB disciplinary actions against associated persons.

Collateral Effects

The Board's objective in revising Rule 3502 is to lower the threshold for contributory liability from recklessness to negligence and increase the likelihood of PCAOB enforcement actions against associated persons, along with increasing the fines, penalties, and sanctions levied by PCAOB enforcement. PCAOB enforcement actions have sweeping and severe implications for registered public accounting firms and their associated persons. It is important to consider the "collateral effects" of the Proposed Rule and whether it is fair and reasonable given these effects, which the economic analysis fails to do.

For example, the Chair suggested that the Proposed Rule could be applied to associated persons for contributing to quality control and independence violations. The Chair used the failure to obtain audit committee pre-approval for (allowable) audit or non-audit services as one example of such an independence violation.[37] But, this example only reinforces concerns about the fairness and reasonableness of the Proposal. Rather than using enforcement under the Proposed Rule, PCAOB inspections (with a process that requires the remediation of such deficiencies) or Rule 3502 as currently constructed (with a recklessness threshold for egregious violations, which the Chair's example is not) are best suited to handle any such violations. A simple negligence threshold is way too draconian.

Moreover, it is essential to recognize that the complex set of rules and regulations encompassed by the Proposed Rule (such as independence rules and rules for filing PCAOB forms, such as Form AP) have no de minimis provisions. The lack of this provision reinforces

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[35] In the Proposed Rule, "directly and substantially" does not qualify the negligence standard of "knew or should have known would contribute to such violation." This represents another important revision in the recklessness standard in Rule 3502, which is not analyzed as to costs or consequences.

[36] See *Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* by Board Member Duane M. DesParte (September 19, 2023).

[37] See *Chair Williams' Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (September 19, 2023).

concerns over the disproportionate effect of a negligence standard, its intended application, and whether the Proposed Rule is fair and reasonable.

Relatedly, forthcoming standards, as part of the Board's agenda to revise and modernize PCAOB Auditing Standards, may put registered public accounting firms and associated persons at greater risk of violations under the Proposed Rule. For example, "more robust" quality control systems, with enhanced monitoring and reporting requirements, under the proposed QC 1000 standard,[38] in conjunction with a negligence standard for contributory liability, would create a trap for the unwary, greatly expand the opportunities for PCAOB enforcement, and impose disciplinary actions on an unfair and unreasonable basis. This reinforces concerns that the Proposal is premature, should be withdrawn, and that the Board needs to delineate its intentions for applying the Proposed Rule or any limits on its application.

The Proposal also fails to adequately consider the cascading consequences of PCAOB disciplinary actions that would put the reputations and careers of associated persons on the line for even unintentional slips, pure errors of judgment, and innocuous errors on "technicalities." While the magnitude of fines, penalties, and sanctions imposed by the PCAOB can reflect the severity of individuals' acts or omissions, **any** PCAOB enforcement action has significant consequences for targeted associated persons, along with their firms. For example:

- The Proposed Rule would make lawbreakers out of individuals caught by the negligence standard, because any violation of Rule 3502 would constitute a violation of the securities laws. The Proposal fails to consider the implications of PCAOB sanctions for federal collateral consequences as they would be considered the same as for securities law violations.[39]

- The Proposed Rule would lead to increased investigatory and sanctioning activity at the state level for associated persons, given notification and investigation requirements of state licensing boards. These activities could result in the suspension or loss of an individual's license and the right to practice as a certified public accountant.

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[38] See *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (PCAOB Release No. 2022-006, November 18, 2022; PCAOB Rulemaking Docket No. 046).

[39] See Section 3(b) of SOX, which provides that a violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934. Although SOX Section 105 limitations on direct sanctions may override this provision, there may be federal collateral consequences to securities law violations that would still apply.

- Audit committees would be unlikely to accept associated persons – whether engagement partners, engagement quality review partners, other partners, or staff – whose record reflects a Board sanction, even for "foot faults."[40] Yet, staffing challenges and the level of staffing and the experience of the engagement team are major concerns of audit committees, and the Proposed Rule would only exacerbate these concerns.[41]

- In emphasizing and expanding PCAOB enforcement, the Proposed Rule may contribute to the decline in the attractiveness of the accounting profession. PCAOB registered public accounting firms are facing talent-related challenges in attracting, retaining, and promoting associated persons at all levels, including people at more senior and experienced levels.[42] While these challenges arise from many factors, a belief that the regulatory environment makes the profession unappealing is a major one.[43] The evidence should give the Board pause and motivate a candid assessment of how it may be diminishing the vibrancy of public company auditing.

  Relatedly, SOX requires that funds generated from the collection of monetary penalties by the PCAOB can only be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs.[44] This is a laudable provision of SOX. Given the cost of higher education, PCAOB scholarships are very welcome – indeed, they can be life-changing for the students that receive them.

  As of December 31, 2022, the PCAOB had $20.4 million in statutorily designated funds from monetary penalties (and investment earnings thereon) – up from $11.7 million on December 31, 2021.[45] Based on public announcements through September 30, 2023, the PCAOB has awarded about $3.7 million in scholarships, while assessing over $7.5 million in monetary penalties. Thus, as of September 30, 2023, the PCAOB has over

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[40] Relatedly, even for disciplinary actions over technical violations or "foot faults," audit firms may remove partners and staff from involvement in issuer and broker-dealer audits, quality controls, or other roles subject to PCAOB oversight.

[41] See the PCAOB *Spotlight: 2022 Conversations With Audit Committee Chairs* (September 2023).

[42] For example, see "Job Security Isn't Enough to Keep Many Accountants from Quitting" in *The Wall Street Journal,* (September 22, 2023).

[43] See *Increasing Diversity in the Accounting Profession Pipeline: Challenges and Opportunities* by Edge Research and the Center for Audit Quality (July 2023), page 31, that reports thirty percent of undergraduate accounting majors who chose not to purse, or are undecided on, licensure as a certified public accountant cite the regulatory environment as a major reason. An additional sixty-four percent cite this belief as part of the reason.

[44] See SOX Section 109(c)(2). The use of these funds is subject to the availability in advance in an appropriations Act.

[45] See the PCAOB 2022 Annual Report, page 34. As of December 21, 2022, Congress had not appropriated $7.3 million (from funds collected in 2017, including investment earnings).

$24 million in statutorily designated funds for scholarships (without considering investment earnings accumulated during 2023).

These data indicate that the PCAOB is falling far short of timely distributing the funds collected as monetary penalties as required by SOX. The data lend support to questioning the need for a Proposal to facilitate an increase in the collection of monetary penalties.

- The Proposed Rule could have additional more nuanced effects. For example, it could facilitate PCAOB enforcement over weaker claims and divert PCAOB resources to low merit or non-meritorious actions.

- The Proposed Rule could change the dynamics of the negotiation process for resolving potential enforcement actions. For example, the Proposed Rule could be used to "tip the scale" to weight the process in the PCAOB's favor and against registered public accounting firms and their associated persons. To illustrate, PCAOB enforcement staff could threatened to use a Rule 3502 for negligence against associated persons to extract settlements and/or higher penalties, fines, and sanctions from registered public accounting firms.

Further, as previously noted, the impact of the Proposed Rule may be greater for smaller firms. The Proposal only mentions this consequence in passing – without any analysis or consideration. Nonetheless, the Proposed Rule adds to the ever-expanding costs being imposed on audit firms by the PCAOB's regulatory activities, which are particularly disproportional for triennially inspected firms (both U.S. and non-U.S.) with a limited number of engagements. The Board needs to consider the effects (both overall and incremental to the Proposal) of the PCAOB's regulatory burden on audit firm deregistrations and the declining number of firms willing to conduct issuer and/or broker-dealer audits.[46]

Other Matters

The Proposed Rule would extend contributory liability to violations by associated persons with any firm – not just violations by a firm with which they are associated (by changing "that" to "any"). The rationale for this change is unclear; and, it receives no attention in the economic analysis in the Proposal. Chair Williams stated:

[46] Based on data available on the PCAOB website, over the last ten years, the number of PCAOB registered and inspected firms that provide audit reports for issuers has declined from about 650 to 450, and the number that provide audit reports for broker-dealers has declined from about 800 to 290. Audit firms that provide both issuer and broker-dealer audits are included in each count. Thus, the current number of unique registered and inspected audit firms is less than 740 (450 + 290), although the count does not include audit firms that only play a substantial role in issuer and/or broker-dealer audits.

> *While instances where auditors negligently, directly, and substantially contribute to the violations of firms with which they are not associated could be rare, arrangements among firms are becoming more and more complex every day. This clarification will ensure more complex firm arrangements, including some that we may not be able to contemplate today, cannot be used to evade accountability in the future.*[47]

However, it seems premature to revise Rule 3502 based on vague speculation about the future – particularly without considering any detrimental effects on the relationships among network/affiliate firms or the use of other auditors on PCAOB engagements.

Concluding Remarks

In conclusion, the Chamber has very deep concerns about the Proposal and its expansion of PCAOB tools for enforcement against associated persons of registered public accounting firms, which is neither fair nor reasonable. The Proposal ignores congressional intent, the lack of statutory authority for the Board to impose a negligence standard, and other legal issues. Further, the Proposal lacks any compelling justification of need and fails to recognize and/or fully analyze significant costs and consequences.

The Chamber strongly urges the Board to withdraw the Proposal.

Thank you for your consideration and we stand ready to discuss these matters with you further.

Sincerely,

Tom Quaadman
Executive Vice President
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce

[47] See Chair Williams' *Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (September 19, 2023).

PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

AMENDMENT TO PCAOB RULE 3502 GOVERNING CONTRIBUTORY LIABILITY

PCAOB Release No. 2024-008
June 12, 2024

PCAOB Rulemaking
Docket Matter No. 053

Summary: The Public Company Accounting Oversight Board (PCAOB or "Board") is amending PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, the Board's rule governing the liability of associated persons who contribute to a registered public accounting firm's primary violation. Specifically, the Board is changing from recklessness to negligence the standard of conduct for associated persons' contributory liability.

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I. INTRODUCTION

In the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), Congress established the Board in the wake of a series of high-profile corporate collapses that laid bare auditor misconduct and the need for a new type of oversight of the public accounting industry.[1] As part of its comprehensive, multipronged approach to such oversight, Congress authorized the Board to investigate, bring charges against, and sanction (when appropriate) registered public accounting firms and associated persons[2] thereof for violations of the laws, rules, and standards that Congress charged the Board with enforcing.[3] That enforcement authority covers a wide array of auditor conduct, including negligent conduct.

Congress also authorized the Board to promulgate rules and standards to govern auditor conduct.[4] To that end, in 2005, the Board codified auditors' longstanding ethical obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.[5] For well over a decade now, the Board has brought enforcement proceedings against associated persons pursuant to Rule 3502.

Yet Rule 3502's current formulation contains an incongruity that places negligent contributors to firms' violations beyond the rule's reach. That incongruity stems from the notion that registered firms, like any legal entity, can act only through natural persons. It

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[1] Pub. L. No. 107-204, 15 U.S.C. § 7201 *et seq.*; *see* S. Rep. No. 107-205, at 3 (2002) ("The purpose of [Sarbanes-Oxley] is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years."). As the Senate Report notes, "the frequency of financial restatements by public companies ha[d] dramatically increased" in the run up to the passage of Sarbanes-Oxley. S. Rep. No. 107-205, at 15; *see id.* ("From 1990-97, the number of public company financial restatements averaged 49 per year, but jumped to an average of 150 per year in 1999 and 2000.").

[2] An associated person is "any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor or entity that, in connection with the preparation or issuance of any audit report . . . (1) shares in the profits of, or receives compensation in any other form from, that firm; or (2) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." PCAOB Rule 1001(p)(i). The definition of an "associated person" does not include persons engaged only in clerical or ministerial tasks. *See id.*

[3] *See* Sections 105(b) & (c) of Sarbanes-Oxley.

[4] *See id.* § 103(a)(1); *see also, e.g.*, *id.* § 101(c)(2), (c)(4), (c)(6) & (g)(1).

[5] *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, at 9 (July 26, 2005) ("2005 Adopting Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf ("The Board proposed [Rule 3502] to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit [ ] violations.").

logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to at least one natural person's negligence.

Rule 3502, however, at present requires a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who directly and substantially contribute to firms' negligence-based violations. Put another way, Rule 3502 requires a showing of more than negligence by individuals[6] for the Board to sanction them for conduct resulting in negligence by firms. Thus, under current Rule 3502, associated persons who do not exercise reasonable care and contribute to firms' violations may escape liability and accountability—even while the firms committing the violations do not. The Board believes that amending Rule 3502 addresses this incongruity, and therefore better protects investors and promotes quality audits.

Accordingly, following notice and comment, the Board is amending Rule 3502 by changing from recklessness to negligence the liability standard for associated persons' contributory conduct. As explained in greater detail below, the Board believes, based on its experience and having considered the comments received, that the amendment better aligns Rule 3502 with the scope of the Board's enforcement authority under Sarbanes-Oxley, thus further advancing the Board's mission of investor protection.

II. RULEMAKING HISTORY

On September 19, 2023, the Board proposed to amend Rule 3502 in two ways: (1) by changing from recklessness to negligence the standard of conduct for associated persons' contributory liability and (2) by providing that, to be charged with violating Rule 3502, an associated person contributing to a registered firm's violation need not be an associated person of the firm that commits the primary violation (i.e., that an associated person of one registered firm can contribute to a primary violation of another registered firm).[7] The Board received 28 comment letters on the Proposal from commenters across a range of affiliations.[8] In general,

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[6] For ease of reference, this release sometimes refers to associated persons who are the contributory actors for purposes of Rule 3502 as "persons" or "individuals." The Board notes, however, that both natural persons and entities can be associated persons, and therefore Rule 3502 charges can be brought against both natural persons and entities, consistent with the meaning of the term "person associated with a registered public accounting firm." *See supra* footnote 2.

[7] *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, PCAOB Release No. 2023-007 (Sept. 19, 2023) ("2023 Proposing Release" or the "Proposal"), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9.

[8] Comment letters on the Proposal, as well as a staff white paper regarding characteristics of emerging growth companies, are available on the Board's website in Rulemaking Docket No. 053, *available at* https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-053/comment-letters. One of the comment letters was withdrawn.

commenters recognized the importance of an effective PCAOB enforcement program and in holding individuals accountable when there are violations of applicable laws, rules, and professional standards. The final rule amendment—which, as detailed in Section V below, does not include the second aspect of the Proposal—is informed by the comments received on the Proposal, which are discussed throughout this release.

III. BACKGROUND

PCAOB Rule 3502 codifies associated persons' ethical obligation not to contribute to a registered firm's violations of the laws, rules, and standards that the Board is charged with enforcing. The rule provides grounds for secondary liability when an associated person of a registered firm acts at least recklessly to directly and substantially contribute to such a violation. Although the rule as adopted in 2005 incorporated a recklessness standard, the rule as proposed in 2004 required that individuals only negligently contribute to a firm's violation to be subject to liability.[9] Whereas negligence "is the failure to exercise reasonable care or competence,"[10] recklessness requires "an extreme departure from the standard of ordinary care" that "presents a danger to investors or to the markets that is either known to the (actor) or is so obvious that the actor must have been aware of it."[11] Indeed, Sarbanes-Oxley characterizes "reckless conduct" as a subset of "intentional or knowing conduct,"[12] whereas negligence is an "objective" standard that is not measured by "the intent of the accountant."[13]

The Board is now adopting negligence as the liability standard for actionable contributory conduct under Rule 3502. And for good reason: A negligence standard is appropriate based on the Board's extensive experience with Rule 3502 since the rule's adoption nearly two decades ago, it closes a gap in the PCAOB's regulatory framework that can lead to anomalous results, and it advances certain objectives in the Board's 2022-2026 Strategic Plan in furtherance of the Board's overall mission.

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[9] *See Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2004-015, at 18 & n.40 (Dec. 14, 2004) ("2004 Proposing Release"), *available at* https://pcaobus.org/Rulemaking/Docket017/2004-12-14_Release_2004-015.pdf.

[10] *In re S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 35 n.169 (July 3, 2013) (citation and quotation marks omitted).

[11] *Id.* at 29 (citation and quotation marks omitted); *see also Marrie v. SEC*, 374 F.3d 1196, 1204 (D.C. Cir. 2004); 2005 Adopting Release at 13 ("[T]he phrase 'knew, or was reckless in not knowing' is a well-understood legal concept, and the Board intends for the phrase to be given its normal meaning.").

[12] *See* Section 105(c)(5)(A) of Sarbanes-Oxley.

[13] *In re Melissa K. Koeppel, CPA*, PCAOB File No. 105-2011-007, at 166 (Dec. 29, 2017) (quoting *In re Kevin Hall, CPA*, SEC Release No. 34-61162, at 12 (Dec. 14, 2009) (quotation marks omitted)).

In the first subsection below, we review the Board's 2004 proposal and 2005 adoption of Rule 3502. Then, we detail the reasons for the amendment the Board adopts today to modernize and strengthen the rule.

A. History of Rule 3502

As part of a package of proposed ethics and independence rules, the Board proposed PCAOB Rule 3502 in 2004.[14] In issuing the proposal, the Board observed that "[w]hile certain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm, the firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm."[15] Accordingly, through Rule 3502, the Board sought to "codify that obligation" and "make it clear that the obligation is enforceable by the Board."[16] Using language "intended to articulate a negligence standard," the proposed version of Rule 3502 subjected associated persons to potential contributory liability if they "knew or should have known" that an act or omission by them would contribute to a firm's primary violation.[17]

Following a public comment period,[18] the Board adopted Rule 3502 with two modifications from the proposal. First, while affirming its authority to promulgate a negligence-based ethics rule prohibiting contributory conduct,[19] the Board revised the liability standard

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[14] *See generally* 2004 Proposing Release at 18-19. As originally proposed (and adopted), Rule 3502 was entitled *Responsibility Not to Cause Violations*. *See id.* at A-4; 2005 Adopting Release at A-5. Shortly after adoption, however, the Board changed the title of the rule to its current title, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*. The Board made the change "[a]fter discussions with the SEC" and "to avoid any misperception that the rule affects the interpretation of any provision of the federal securities laws." *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-020, at 2 (Nov. 22, 2005), *available at* https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket017/2005-11-22_release_2005-020.pdf?sfvrsn=69338fcd_0. In so doing, however, the Board clarified that "[t]he rule, as amended, should be interpreted and understood to be the same as the rule adopted by the Board." *Id.*

[15] 2004 Proposing Release at 18.

[16] *Id.*

[17] *Id.* at 18 n.40; *see id.* at A-4 (proposed rule text).

[18] "Several commenters supported the rule as proposed and noted that they saw the rule as essential to the Board's ability to carry out its disciplinary responsibilities under the Act," 2005 Adopting Release at 9, while others did not fully endorse it. Their objections were based principally on the view that negligence might be an ill-suited liability standard "in light of the complex regulatory requirements with which auditors must comply" and out of concern that such standard "would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards." *Id.* at 9, 13. Certain commenters "also questioned the Board's authority to adopt the proposed rule, or at least the proposed rule with a negligence standard." *Id.* at 9.

[19] *See id.* at 12 n.23; *see also infra* Section IV.D.

from negligence to recklessness, which the Board at that time believed would "strike[ ] the right balance in the context of th[e] rule."[20] Second, the Board modified "contribute"—the verb that describes the connection between the associated person's conduct and the firm's primary violation—by adding the words "directly and substantially."

The latter modification was made due to commenters expressing concern that, because of the collaborative nature of accounting work, each individual involved in formulating a decision or other action that ultimately leads to a firm violation could be held liable for causing the violation.[21] The Board explained that the addition of "directly" means, among other things, that an associated person's conduct must "either essentially constitute[ ] the [firm's] violation" or be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation." But, the Board clarified, "directly" does not place outside the scope of Rule 3502 contributory conduct "just because others also contributed to the violation, or because others could have stopped the violation and did not." "Substantially," the Board explained, means that an associated person's conduct must "contribute[ ] to [a] violation in a material or significant way," though it need not be "the sole cause of the violation."[22]

B. Reasons for the Amendment

As the Board previously recognized, when an associated person causes a firm to commit a violation, such conduct "operates to the detriment of the protection of investors."[23] The following subsections explain why the modification to Rule 3502 is appropriate in furtherance of the Board's mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

1. Aligning Rule 3502 With the Board's Enforcement Authority

As the Board previously has explained, a registered firm "can only act through the natural persons who serve as its agents, including its associated persons."[24] Accordingly, "a natural person's actions may render both the [firm] primarily liable and the natural person secondarily liable."[25] Yet under the current formulation of Rule 3502, an incongruity exists

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[20] 2005 Adopting Release at 13; *see id.* at 12 & n.23.

[21] *See id.* at 9, 13.

[22] *Id.* at 13.

[23] 2005 Adopting Release at 10.

[24] 2004 Proposing Release at 18; *see* 2005 Adopting Release at 12 ("[Registered] firms . . . can only act through the natural persons that comprise them, many of whom are 'associated persons' subject to the Board's ethics standards and disciplinary authority."). Indeed, as one commenter on the Proposal put it, a firm is the sum of its parts.

[25] *In re Timothy S. Dembski*, SEC Release No. 34-80306, at 13-14 n.35 (Mar. 24, 2017) (quoting *SEC v. Koenig*, 2007 WL 1074901, at *7 (N.D. Ill. Apr. 5, 2007)).

between the respective requisite mental states for liability of a registered firm resulting from an associated person's conduct and for liability of the associated person: A firm can commit a primary violation of certain laws, rules, or standards by acting *negligently*, but an associated person who directly and substantially contributed to that violation must have acted at least *recklessly* to be secondarily liable.

This incongruity means that associated persons may have weaker incentives to exercise the appropriate level of care in their audit work. They may not exercise reasonable care (the standard for negligence) if they know that they cannot be held individually liable by the PCAOB for a firm's primary violation unless an act or omission by them amounts to an "an extreme departure from the standard of ordinary care for auditors" (the standard for recklessness).[26] The modification to Rule 3502's liability standard from recklessness to negligence closes this regulatory gap, which should incentivize associated persons to be more deliberate and careful in their actions. Indeed, "accountability frequently improves outcomes."[27]

Numerous commenters agreed with the Board's regulatory concerns noted above. These commenters generally noted that the Board's concerns were valid and clear, and that a negligence standard would better align Rule 3502 with the scope of the Board's enforcement authority under Sarbanes-Oxley and provide a tool to eliminate incongruous results in liability between individuals and firms. Indeed, one commenter characterized the difference between negligence and recklessness as "substantial" and "consequential" and noted that the current gap in liability standards directly impacts the Board's ability to fulfill its statutory mission.[28]

Another commenter remarked that a negligence standard will enable the PCAOB and the U.S. Securities and Exchange Commission (SEC or "Commission") to more efficiently and effectively pursue enforcement cases regardless of which entity has the resources to bring the case.[29] Commenters also stated that a negligence standard would appropriately align Rule 3502's liability threshold with the standard of care that auditors currently should be exercising when performing their professional responsibilities and that both the Commission and civil plaintiffs in private litigation currently can pursue cases against auditors for negligence. In encouraging the PCAOB to adopt the Proposal, one commenter further noted that the change

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[26] *Marrie*, 374 F.3d at 1204; *see* Russell G. Pierce & Eli Wald, *The Relational Infrastructure of Law Firm Culture and Regulation*, 42 HOFSTRA L. REV. 109, 129 (2013) (explaining how rules from the legal industry's governing body that would restrict lawyers' limited liability "will encourage lawyers to devote more energy to maintaining the quality of the firm because they could potentially face personal liability for poor quality services"); *see also* Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 VAND. L. REV. 1871, 1885 (2019) (arguing that "existing deterrence mechanisms have failed to produce optimal audit quality" and "are ineffective").

[27] Honigsberg, *supra* footnote 26, at 1902.

[28] Comment Letter from Better Markets at 3 (Nov. 3, 2023).

[29] *See infra* Section IV.C.

to negligence would bolster investors' expectations that accountants will be independent and diligent in their audit work.

Other commenters, however, believed that the Proposal did not present a sufficient rationale for moving to a negligence standard after the Board previously declined to do so in 2005. These commenters opined that the same concerns about a negligence standard that existed in 2005 exist today and questioned whether there were significant enough developments to merit the change.[30] Indeed, certain commenters acknowledged the incongruity discussed in the Proposal but contended either that it is not significant or problematic, that it is not an impediment to enforcement, or that closing the gap in liability standards would not change auditor conduct.[31] One commenter stated explicitly that no incongruity or gap exists.

Several commenters also stated that auditors are subject to sufficient oversight under the current framework, including via the PCAOB's inspection program, enforcement in Commission proceedings, and enforcement by state regulatory agencies. Certain of these commenters further stated that a negligence standard would risk, among other things, disturbing the PCAOB's inspection process by upsetting inspection dynamics and threatening the cooperative and constructive nature of the process that has developed over time.

The Board is mindful of the efficiencies gained through open dialogue with firms and individuals alike during the inspection process. Given that firms and individuals already are subject to a negligence standard for *primary* violations, however, the Board does not believe

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[30] In support of such assertion, one commenter cited *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009). The rationale articulated in the Proposal and this adopting release, however, more than satisfies *Fox*'s criteria for a conscious change in policy. *See id.* at 515 ("[I]t suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agency *believes* it to be better, which the conscious change of course adequately indicates."). As to auditors' reliance on the standard in the current rule, as in *Fox*, the Board is not "punishing [auditors] without notice of the potential consequences of their action." *Id.* at 518. That is so because the adoption of a negligence standard, by itself, does not impose any civil money penalty or other sanction; rather, sanctions are available only if Rule 3502 is *violated* after the amended rule becomes effective.

[31] One commenter stated that the Proposal failed to articulate how the change to negligence would align Rule 3502 with Sarbanes-Oxley and questioned whether there were cases where the current recklessness standard did not suffice to hold persons accountable. The Proposal, however, made both of these points clear. *See* 2023 Proposing Release at 7 (describing the current misalignment with Sarbanes-Oxley); *id.* at 24-25 (discussing estimated cases in 2022); *see also infra* pages 43-44 (discussing estimated cases for 2023). That commenter and one other also noted that the PCAOB has been able to assess significant penalties under the current Rule 3502 formulation and that the Board's disciplinary proceedings have resulted in collateral consequences for firms and individuals. While that may be the case, the Board is not adopting a negligence standard for the purpose of facilitating an increase in *penalties*; rather, as the Proposal explained, the Board proposed—and is now adopting—a negligence standard to facilitate an increase in *accountability* and *deterrence*. *See* 2023 Proposing Release at 7.

that the incremental change of moving from recklessness to negligence for *contributory* conduct will have a chilling effect on inspections, especially given that the Board will continue to exercise discretion about when to bring Rule 3502 charges.[32]

Commenters also opined that amending Rule 3502 is unnecessary because the Board's then-proposed (now-adopted[33]) QC 1000 standard provides clearer expectations with regard to individuals in quality control (QC) roles.[34] Although the Board agrees that QC 1000 crystallizes the responsibilities of certain individuals serving in QC roles, Rule 3502 applies more broadly than to just those particular individuals. Thus, although QC 1000 and Rule 3502 could overlap to cover the same conduct in some circumstances, there are other circumstances in which there would not be overlap.[35]

Commenters similarly expressed mixed views about whether the change to negligence would incentivize auditors to more fully comply with applicable laws, rules, and standards that the Board is charged with enforcing. Multiple commenters remarked in the affirmative, noting that such incentivization is foreseeable and that a negligence standard will encourage individuals and firms to maintain a high level of quality in their audit work, which in turn benefits investors and financial markets alike. Indeed, one commenter remarked that the current recklessness standard *in*adequately incentivizes associated persons to exercise the appropriate level of care in their audit work. This commenter also noted that, beyond

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[32] One commenter expressed concern over whether the inspection process is sufficiently robust to conclude that an associated person has contributed to a firm's negligence-based violation, and relatedly, another asserted that auditors believe that the Board is holding them to an inspections bar that constantly evolves. Inspection staff's findings, however, are not conclusive for purposes of imposing legal liability under Rule 3502 (or any PCAOB rule). *See PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted?*, *available at* https://pcaobus.org/oversight/inspections/inspection-procedures ("[A]ny references in [an inspection] report to violations or potential violations of law, rules, or professional standards are not a result of an adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability."). Rather, whether there is legal liability for a violation and whether conduct merits sanctions (and if so, what the sanctions are) are determined through the adversarial process involving the Board's Division of Enforcement and Investigations and only after respondents have been afforded the opportunity to present a defense.

[33] This release references several professional standards that the Board has adopted but which are pending Commission approval, and which therefore are subject to change. *See* Section 107(b) of Sarbanes-Oxley.

[34] *See generally A Firm's System of Quality Control and Other Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Release No. 2024-005 (May 13, 2024) ("QC 1000 Release").

[35] *See, e.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983) ("While some conduct actionable under Section 11 may also be actionable under Section 10(b), it is hardly a novel proposition that the 1934 [Securities Exchange] Act and the 1933 [Securities] Act 'prohibit some of the same conduct.' 'The fact that there may well be some overlap is neither unusual nor unfortunate.'" (citations omitted)).

incentivizing individuals' compliance, a negligence standard also would incentivize *firms* to ensure, through training and other measures, that their employees are complying with applicable professional standards.

By contrast, other commenters argued that a negligence standard will not incentivize compliance, for a variety of reasons. Multiple commenters premised such view on the downstream effects that oversight with respect to firms has on individuals. According to certain of these commenters, such effects (e.g., reduced responsibility on audits, compensation- and promotion-related consequences), as well as other firm policies and preventative measures (such as training), are sufficient to guard against negligence and incentivize individual compliance. Another commenter opined that the auditor reporting model and the identification of auditors in Form AP suffice to address individual accountability.

While the Board agrees that each of the above factors may play a role in driving individual accountability in certain respects, none is a form of *regulatory* accountability that is akin to the Board's authority to bring enforcement proceedings and impose publicly a range of disciplinary sanctions as remedial measures. Moreover, the market-driven consequences relating to the auditor reporting model and identification of auditors on Form AP are felt primarily (if not exclusively) by the engagement partner on an audit, while Rule 3502 applies more broadly.

Another commenter questioned whether a negligence standard would have a deterrent effect (or close any gap) given that auditors already are subject to a negligence standard for contributory liability in Commission actions.[36] One commenter noted that, given that auditors already are subject to negligence actions by other entities (including the Commission and state regulators), empirical evidence should be provided to support how auditor behavior would change under a negligence standard for Rule 3502.[37] As the Board previously noted, however, an increase in the *number* of regulators on alert for the same or similar violative conduct increases the likelihood of that conduct being detected and, consequently, the likelihood that the conduct would be sanctioned.[38]

In other commenters' views, a negligence standard would not incentivize compliance because sanctions are ineffective to deter mere errors in judgment. As explained below, however, the amendment does not target mere errors in judgment, but rather *unreasonable* conduct.[39] Multiple commenters also posited that a lower threshold for auditor liability may have a negative impact on audit quality, including at smaller firms. Indeed, one commenter

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[36] *See infra* Section IV.C.

[37] This commenter did not provide the source of any data or propose any methods by which to generate empirical evidence on this subject.

[38] 2023 Proposing Release at 14 n.51; *infra* footnote 107.

[39] *See infra* pages 16-17 and 19-20.

asserted that the impact of the proposed rule change (and proceedings brought pursuant to it) would be felt more acutely by firms that are not affiliated with the largest global networks, despite those firms having a significantly smaller share in auditing the market capitalization of U.S. issuers. These commenters generally attributed what they view as a potential loss in audit quality to several factors, including recruiting, retention, and staffing challenges; reduced collaboration among auditors; and auditors engaging in unproductive, excessive self-protective behavior. The Board addresses below commenters' concerns about the amendment's potential impacts on audit quality and smaller firms, respectively.[40]

2. The Board's Implementation Experience

Although the Board viewed Rule 3502's recklessness liability threshold as "strik[ing] the right balance in the context of th[e] rule" at the time of the rule's adoption in 2005, the threshold had not yet been tested in practice by the PCAOB, and experience has shown that it prevents the Board from executing its investor-protection mandate to the fullest extent that Congress authorized in Sarbanes-Oxley.

In the instances in which the Board has instituted proceedings against firms for negligence-based violations, the Board has not been able to charge Rule 3502 violations against the individuals that negligently contributed to those firms' violations. Although the decision not to bring charges against individuals varies case by case and is at the Board's discretion, it remains that the Board has been legally barred by the current formulation of Rule 3502 from holding accountable under Rule 3502 individuals who negligently, directly, and substantially contributed to the firms' violations.[41]

The Board's application of Rule 3502 in various contexts supplies experience-based reasons for the proposed amendment to the liability standard. For example, when dealing with the design and implementation of firm QC policies and procedures under applicable QC standards, the Board has observed that registered firms that commit a QC violation often have multiple individuals with overlapping QC responsibility but that no single individual was reckless in failing to act, and thus no individual can be held personally accountable for the firm's QC failure.[42] And yet, individuals with QC responsibility at a firm are often in some of the most

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[40] *See infra* Sections VI.C.1, VI.C.2.i & VI.C.3.iii.

[41] As the 2005 Adopting Release notes, however, Rule 3502 "is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons." 2005 Adopting Release at 14 n.25.

[42] The Board's recently adopted QC 1000 standard mitigates this concern to an extent by requiring firms to assign one or more individuals to certain roles with designated responsibilities within a firm's QC system. *See* QC 1000 Release at 82-86. The concern remains, though, because "[a] firm may have multiple individuals or multiple layers of personnel supporting these roles." *Id.* at 83.

important decision-making roles within the firm because a compliant QC system serves as the backstop to ensure that all *other* professional standards are followed.[43]

Multiple commenters suggested that a negligence standard should not apply to enforcement of QC matters because the Board's inspection function already provides it with transparency into a firm's QC system. Inspections (and, relatedly, remediation) of QC matters, however, are distinct from enforcement, including with respect to the available potential consequences for firms and individuals, respectively. Yet Congress also expressly envisioned that the Board's inspections program would inform its enforcement activities.[44] Such entwinement is therefore a feature of Sarbanes-Oxley—not a flaw or a reason not to adopt a negligence standard.

One commenter also appeared to interpret the Proposal as the Board suggesting that having multiple people with overlapping responsibility for a firm's QC system is an obstacle to investor protection or enhanced audit quality and that a single individual needs to be held accountable for a QC violation in the absence of reckless behavior. That was not the Board's intent; rather, the Board meant simply what it said: When there are multiple individuals involved in the QC function, it could be that no individual's conduct rose to the level of recklessness despite a firm's QC failure, thus allowing persons who negligently, directly, and substantially contribute to a QC failure to avoid individual accountability under Rule 3502.[45]

Moreover, the Board did not mean to imply that a single person "needs" to be held individually accountable in all circumstances for negligence contributing to a firm's QC failure.[46] The Board exercises discretion about whom to charge and what charges to bring, and even in the absence of a charge, the *potential* to be held individually liable for contributory negligence may increase the amount of care and attention dedicated to QC by responsible individuals. Indeed, while reflecting only a modest change, the Board anticipates that the amendment will have a positive impact on audit quality as a result of its deterrent effect.

Another comment letter posited that a negligence standard would place an unfair burden on national office partners responsible for a firm's QC functions and engagement quality review partners, who the comment letter asserted typically do not have the authority to

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[43] *See* QC § 20.03, *System of Quality Control* ("A firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality."); QC 1000 Release at 70-71 (setting forth, in QC 1000.05, the objective of a firm's QC system).

[44] *See, e.g.*, Section 104(c)(3) of Sarbanes-Oxley (requiring the Board, "in each inspection," to "begin a formal investigation or take disciplinary action, if appropriate, with respect to any [potential] violation [identified during an inspection], in accordance with this Act and the rules of the Board").

[45] *See* 2023 Proposing Release at 9.

[46] Comment Letter from PricewaterhouseCoopers LLP at A4 (Nov. 2, 2023).

establish firm strategies or allocate resources. This commenter expressed concern that the Board would pursue enforcement actions against a single individual when a firm's partners collectively are responsible for the strategy and resource allocation decisions that led to a firm's violation. Regardless of whether collective responsibility is uniformly the practice, the Board should not be precluded from exercising its discretion to pursue a Rule 3502 charge against an individual who failed to exercise reasonable care and competence, even in cases involving a firm's strategy or resource-allocation decisions that led to a QC failure.

In addition to the QC context, Rule 3502 also arises in sole-proprietorship cases, in which the sole owner and sole partner of a firm causes the firm to commit a violation. Yet for some types of violations, there is not always sufficient evidence of reckless behavior. A negligence standard thus would promote greater accountability by the sole proprietor and prevent that person from being shielded from individual liability under Rule 3502.

One commenter sought clarity regarding how Rule 3502 might be applied to sole proprietors. We note that examples include instances in which firms fail to obtain an engagement quality review[47] or fail to file (or file timely) required PCAOB forms.[48] In each scenario, the respective primary violations can be committed only by a firm because the obligations are imposed solely on the firm,[49] yet a sole proprietor of a firm could negligently, directly, and substantially contribute to the firm's violation of the relevant PCAOB rules and standard.

Another commenter identified independence violations as a common type of case not mentioned above and for which the commenter believes that a negligence standard of contributory liability would promote greater individual accountability. The Board agrees.[50] Another commenter identified a data compilation regarding cases and fact patterns that the commenter said could be a resource in confirming and validating the change to Rule 3502.[51]

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[47] *E.g.*, *In re Jack Shama*, PCAOB Release No. 105-2024-004 (Jan. 23, 2024); *In re Robert C. Duncan Accountancy Corp.*, PCAOB Release No. 105-2022-010 (June 22, 2022); *In re Tamba S. Mayah, CPA*, PCAOB Release No. 105-2021-007 (Sept. 13, 2021).

[48] *See, e.g.*, *In re Jeffrey T. Gross, Ltd.*, PCAOB Release No. 105-2019-016 (July 23, 2019) (primary violation of PCAOB Rule 3211 relating to Form AP).

[49] *See* AS 1220, *Engagement Quality Review*; PCAOB Rule 2200, *Annual Report* (Form 2 filing rule); PCAOB Rule 2203, *Special Reports* (Form 3 filing rule); PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants* (Form AP filing rule).

[50] Indeed, as the Board has previously stated, Rule 3502 is "essential to the proper functioning of the Board's independence rules." 2004 Proposing Release at 19; *see* 2005 Adopting Release at 14.

[51] The resource is available at https://wp.nyu.edu/compliance_enforcement/category/artificial-intelligence. Our review indicates that what the commenter referred to as qualitative data mainly consists of blog posts written on a wide array of legal issues and news articles that are much broader in scope, cannot be analyzed readily in their entirety, and are not directly relevant to our analysis.

3. Advancing the Board's Investor-Protection Mandate

In the Board's 2022-2026 Strategic Plan, the Board expressed a rejuvenated focus on the PCAOB's investor-protection mandate and stated its intent "to modernize and streamline our existing standards . . . where necessary to meet today's needs."[52] The Board also expressed an intent to "engag[e] in vigorous and fair enforcement that promotes accountability and deterrence," including by "tak[ing] a more assertive approach to bringing enforcement actions" and "hold[ing] accountable" those who commit "violations that result from negligent conduct."[53] The amendment to Rule 3502 is consistent with those goals.

When Congress enacted Sarbanes-Oxley, it empowered the Board to promulgate and adopt certain standards and rules, to inspect registered firms for compliance with those standards and rules, and to enforce compliance by firms and their associated persons. Among the tools that Congress provided to the Board for enforcement is the ability to impose certain sanctions for negligent conduct, including single instances of negligence.[54] That liability threshold serves a dual function: It incentivizes auditors to conduct their work knowing that reasonable care is the standard for assessing it (i.e., deterrence), and it allows the Board to publicly discipline auditors who were found to have not exercised an appropriate degree of care (i.e., accountability).[55] Each of those functions—one *ex ante* to auditors' conduct and the other

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[52] PCAOB, Strategic Plan 2022-2026, at 10, *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/strategic-plan-2022-2026.pdf?sfvrsn=b2ec4b6a_4/.

[53] *Id.* at 3, 13; *see also id.* at 8 ("[W]e are focused on aggressively pursuing all statutory legal theories for charging respondents and remedies available in executing our enforcement program, which is central to protecting investors and promoting the public interest.").

[54] *See* Sections 105(c)(4) & (c)(5) of Sarbanes-Oxley; *Rules on Investigations and Adjudications*, PCAOB Release No. 2003-015, at A2-58 (Sept. 29, 2003), *available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_005/release2003-015.pdf?sfvrsn=35827b4_0 ("The Act plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act."). The Board received multiple comments regarding its authority to pursue enforcement proceedings based on single instances of negligence, and we address those comments below at Section IV.D.1.

[55] *See* Honigsberg, *supra* footnote 26, at 1899 ("Individual accountability could provide a counterweight to the current incentive structure. . . . [A]udit partners do not internalize the full consequences of an audit failure. Promoting individual brands will better address this inefficiency and reduce externalities by causing audit partners to internalize these failures."); *see also* Gina-Gail S. Fletcher, *Deterring Algorithmic Manipulation*, 74 VAND. L. REV. 259, 268-69 (2021) ("[I]f the applicable laws are narrow, only capturing the most blatant misconduct, wrongdoers may not be deterred from breaking the law. . . . [D]eterrence is effective if regulators have strong, suitable tools to enforce the regime and market actors know whether they are violating the law.").

ex post—goes to the core of the Board's mission of protecting investors and promoting high-quality audits.

The current formulation of Rule 3502, however, stops short of deploying the Board's authority to sanction negligent conduct to the fullest extent by requiring at least reckless conduct before an associated person can be held secondarily liable. The amendment that the Board is adopting to Rule 3502's liability standard removes this constraint and makes the rule both a more effective deterrent and a more effective enforcement tool, and in so doing, better aligns the rule with Sarbanes-Oxley.[56]

Several commenters stated that it is clear and understandable how the amendment to Rule 3502 advance the Board's statutory mandate to protect investors, including by promoting the twin goals of accountability and deterrence. One such commenter remarked that a negligence standard "may be needed" to enhance accountability to investors,[57] while another noted that such standard "fall[s] squarely" within the scope of the Board's mission and "clearly and unambiguously advances" the Board's cause.[58] Still another opined that the amendment would ensure consistency between the liability standard and investor expectations and that "it makes no sense" to have differing standards for firms and individuals.[59]

As to deterrence, multiple commenters stated that the amendments should result in auditors being more likely to comply with their respective legal requirements. One commenter further opined that a negligence standard "sends a strong message" to auditors regarding the requisite level of care that they should be applying in their work.[60]

Other commenters expressed a different view of the amendments relative to investor protection. One commenter stated that, should the amendment discourage certain individuals from accepting important QC roles for fear of being held liable, the public's interest would not be served by having less cautious or less qualified individuals fill those roles. Another opined that the amendments would incentivize high-quality talent to avoid the audit profession, which could lead to lower audit quality, increased audit fees, and a large number of delistings. As certain other commenters pointed out and as the Board observed in the Proposal, however, auditors already are subject to liability and disciplinary schemes that encourage them to

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[56] *See* PCAOB, Strategic Plan 2022-2026, at 10 ("Effective auditing, attestation, quality control, ethics, and independence standards advance audit quality and are foundational to the PCAOB's execution of its mission to protect investors.").

[57] Comment Letter from Council of Institutional Investors at 5 (Oct. 26, 2023).

[58] Comment Letter from Better Markets at 8.

[59] Comment Letter from Center for American Progress at 2 (Nov. 3, 2023).

[60] Comment Letter from Better Markets at 5.

comply—and not just avoid reckless noncompliance—with applicable statutory, regulatory, and professional standards.

Still another commenter expressed uncertainty about how a change to negligence will achieve further investor-protection benefits. This commenter remarked that the Board currently has means to hold accountable individuals who are negligent in various contexts and that investors are best protected when noncompliance is avoided in the first place. While the Board agrees that avoiding noncompliance in the first instance promotes audit quality and benefits investors, the Board views the addition of another enforcement tool to deter negligent conduct (including conduct that currently is beyond the Board's reach), and to hold accountable those who engage in such conduct, as a complement to—not mutually exclusive from—avoiding noncompliance.

Beyond deterrence and accountability, multiple commenters remarked that the amendments should enhance investors' confidence, both in audits and in the information provided in companies' financial statements. Some commenters noted that a change to a negligence standard would protect investors by encouraging auditors to be more careful about their work and positively affecting capital-market efficiency. Another commenter offered several additional downstream investor-protection benefits, including that as audit quality improves, the likelihood of auditors being subjected to meritorious litigation, and the risks and costs to investors resulting from that litigation (as well as misstatements and omissions in audited financial statements), should be reduced.

IV. DISCUSSION OF THE AMENDMENT

As discussed above, the Board is amending PCAOB Rule 3502 by changing the liability standard from recklessness to negligence. The details of the amendment are discussed in the following subsections.

A. Text of the Amended Rule and the Negligence Standard Generally

As seen in the Appendix, the Board is amending Rule 3502's liability standard as proposed by deleting the phrase "knowing, or recklessly not knowing" (and certain ancillary surrounding text) and inserting elsewhere into the rule the phrase "knew or should have known" (and certain ancillary surrounding text). The outgoing phrase describes conduct that amounts to at least recklessness,[61] whereas the incoming phrase sets a negligence standard using "classic negligence language."[62] Consequently, the Board is changing the standard for

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[61] *See* 2005 Adopting Release at 12 n.23.

[62] *In re KPMG Peat Marwick LLP*, SEC Release No. 34-43862 (Jan. 19, 2001) ("Ordinarily, the phrase 'should have known' . . . is classic negligence language."), *pet. for review denied*, *KPMG, LLP v. SEC*, 289 F.3d 109 (D.C. Cir. 2002); *see also Erickson Prods., Inc. v. Kast*, 921 F.3d 822, 833 (9th Cir. 2019) ("'[S]hould have known' . . . is a negligence standard. To say that a defendant 'should have known' of a

contributory liability from an "extreme departure from the standard of ordinary care"[63] (recklessness) to "the failure to exercise reasonable care or competence" (negligence).[64]

Such a change addresses the incongruity and related issues noted above. Specifically, it aligns the requisite mental states for liability of a registered firm and for liability of an associated person whose conduct directly and substantially contributed to the firm's violation.[65] In so doing, the modification should better incentivize associated persons to exercise the appropriate level of care, thus promoting investor protection.

Numerous commenters remarked that a change to negligence is appropriate, and with limited exception, commenters remarked that the proposed language to effectuate that change—which the Board now adopts—is clear and understandable.

One commenter called the proposed rule text ("knew or should have known") "overly vague and broad" and asserted that, in contrast to an accountability framework that sets forth clear expectations, the proposed rule does not provide notice of specific conduct that may lead to a violation.[66] As the Proposal explained (and as repeated above), however, the "knew or should have known" phrasing is "classic negligence language," and negligence is "the failure to exercise reasonable care or competence."[67] Indeed, one commenter remarked that such language is "familiar in the American legal system."[68] Moreover, as discussed in the 2005 Adopting Release and the Proposal (and as discussed below in Section IV.B), the Board has delineated through its explanation of "directly and substantially" the nexus and magnitude that an auditor's conduct must have to a firm's primary violation to be actionable. The Board is thus satisfied that such a well-known standard in the law, supplemented by additional parameters that have been in place for nearly two decades, is neither vague nor overly broad.

Several commenters sought clarity over how the adopted text of Rule 3502 ("knew or should have known"), as well as the definition of negligence ("failure to exercise reasonable care or competence"), would interact with other standards of conduct applicable to auditors,

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risk, but did not know of it, is to say that he or she was 'negligent' as to that risk."); *KPMG*, 289 F.3d at 120 ("knew or should have known" is language that "virtually compel[s]" a negligence standard).

63 *Marrie*, 374 F.3d at 1204 (citation and quotation marks omitted).

64 *S.W. Hatfield*, SEC Release No. 34-69930, at 35 n.169 (citation and quotation marks omitted).

65 However, the sanctions to which a contributory actor may be subject upon being found to have violated Rule 3502—including whether the Board may impose any of the heightened sanctions in Section 105(c)(5) of Sarbanes-Oxley—depend on the associated person's conduct and not that of the firm that commits the primary violation.

66 Comment Letter from RSM US LLP at 1 (Nov. 3, 2023).

67 2023 Proposing Release at 13 & n.45.

68 Comment Letter from Center for Audit Quality at 11 (Nov. 2, 2023).

and in particular the obligation of exercising due professional care under then-proposed (now-adopted) AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*.[69] To be sure, due professional care and reasonable care and competence are largely overlapping concepts.[70] However, the Board wishes to emphasize three points.

First, while there may be overlap, AS 1000 does not apply to all conduct for which the Board has enforcement authority[71]; thus, there is a need for a separate rule with a negligence standard. Second, because Rule 3502 includes the "directly and substantially" modifier, it will not always be the case that conduct that violates the obligation of due professional care also violates Rule 3502; thus, Rule 3502 is not duplicative of AS 1000, even if conduct violating the latter may also violate the former in certain circumstances. Third, Rule 3502—located within the "Ethics and Independence" section of the Board's rules regarding professional practice standards—reflects an overarching ethical obligation, and the Board believes it appropriate to codify that general obligation, even if it overlaps with more specific provisions in particular professional standards.

A substantial number of commenters did not appear to support the change. In general, these commenters stated that they do not believe that negligence is an appropriate standard for assessing conduct and compliance on complex audit engagements, which commenters said require a wide range of judgments. For instance, one commenter opined that what could be labeled as a "violation" of professional standards instead may be only a difference of opinions between accountants about a particular pronouncement(s). That commenter further opined that, by proposing a negligence standard, the Board misunderstands the nature of audits. Several other commenters opined that it is bad policy to penalize errors in judgment and for the PCAOB to second-guess auditors' good-faith decisions in situations involving the application of professional judgment.

As noted above, however, firms and associated persons already are subject to a negligence standard for their primary violations, including for single instances of negligence

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[69] *See General Responsibilities of the Auditor in Conducting an Audit and Amendments to PCAOB Standards*, PCAOB Release No. 2024-004, at 30-39 (May 13, 2024) ("AS 1000 Release") (subject to Commission approval, *see supra* footnote 33); *see also* AS 1015, *Due Professional Care in the Performance of Work*.

[70] *See* AS 1000 Release at A1-3 ("due professional care" includes "acting with reasonable care and diligence"); *see also* QC 1000 Release at 81 ("We are adopting this provision [QC 1000.10] with modifications to align with the descriptions of due professional care and professional skepticism being adopted in AS 1000.").

[71] *See* AS 1000 Release at 30-31 (delineating the parameters of "all matters related to the audit" to which AS 1000's requirement to exercise due professional care applies).

that violate professional standards.[72] The amendment to Rule 3502 therefore affects only an incremental (albeit important) change, and only for contributory conduct. Given the Board's nearly two decades of experience distinguishing isolated, good-faith errors in professional judgment from conduct that warrants disciplinary action, as well as the modest estimated increase in Rule 3502 cases that would result from the amendment, the Board does not anticipate that a change in the liability standard for contributory conduct will be used to sanction isolated, good-faith errors in professional judgment—let alone be wielded as a "blunt" or "draconian" instrument, as one commenter suggested[73]—including with respect to less senior engagement team members.[74] The amendment focuses on unreasonable conduct; it does not impose strict liability.[75]

One commenter opined that a Rule 3502 charge could cause associated persons to "lose their livelihood" due to "career-ending penalties" under the Proposal.[76] Several other commenters expressed a similar concern about the negligence threshold and the potential collateral effects and impacts on auditors' careers. While the Board appreciates that disciplinary orders have consequences—as they should—research suggests that auditors remain gainfully employed following a culpability finding.[77] And in all events, the Board emphasizes that it is not the Board's intent to pursue, through Rule 3502 charges, what one commenter described as "foot-faults" or "unintentional slips, pure errors of judgment, and

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[72] *See supra* page 14 & footnote 54; *e.g.*, *In re Sassetti, LLC*, PCAOB Release No. 105-2024-018 (Mar. 28, 2024); *In re Berkower, LLC*, PCAOB Release No. 105-2024-016 (Mar. 28, 2024); *see also infra* Section IV.D.1.

[73] Comment Letter from U.S. Chamber of Commerce at 2 (Nov. 7, 2023).

[74] To iterate what the Board said in 2005, Rule 3502 is not "a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful." 2005 Adopting Release at 14.

[75] "Strict liability is imposed upon a defendant without proof that he was at fault. In other words, when liability is strict, neither negligence nor intent must be shown." DOBBS' LAW OF TORTS § 437.

[76] Comment Letter from RSM US LLP at 1, 2.

[77] *See* J. Krishnan, M. Li, M. Mehta & H. Park, *Consequences for Culpable Auditors*, *available at* https://ssrn.com/abstract=4627460. In their working paper studying audit professionals subject to Commission or PCAOB enforcement proceedings between 2003 and 2019, the authors make three key findings:

> First, a substantial number of culpable auditors remain gainfully employed by their firms one year after the enforcement event (26% of Big 4 and 43% of non-Big 4 culpable auditors). Second, culpable individuals leaving Big 4 firms primarily move to the corporate sector and secure senior or mid-level executive positions at private firms. By contrast, culpable auditors departing from non-Big 4 firms tend to join other non-Big 4 public accounting firms, often as partners. Third, . . . the large majority of culpable auditors do not engage in liquidity-increasing real estate transactions around enforcement.

innocuous errors on 'technicalities.'"[78] Nor do the Board's standards require that auditors exercise "perfect judgment at all times," as one commenter put it,[79] to avoid an enforcement proceeding (under Rule 3502 or otherwise).[80]

Some commenters expressed concern over the notion that, as a result of the amendment, the Board would be able to pursue conduct that is not itself a violation but that merely contributes to a violation. One commenter characterized this as a "significant change from current PCAOB enforcement policy,"[81] but in fact it is no change at all; under the current version of Rule 3502, the Board can bring charges for conduct that is not itself a primary violation. The amendment merely changes the standard for when an individual's contributory conduct becomes actionable; it does not alter whether the contributory conduct must be an independent violation apart from the firm's underlying primary violation.

Several commenters expressed concern regarding a negligence standard in Rule 3502 in light of the current regulatory environment—specifically amidst the Board's other standard-setting projects, including the then-proposed (now-adopted) quality control standard, QC 1000. These commenters opined that new requirements in proposed and adopted other standards may put auditors at greater risk of violating Rule 3502, including based on the introduction or modification of key concepts and their interrelation to negligence.

The Board appreciates that audits, especially of large enterprises, have the potential to be quite complex and can require input from various individuals, including individuals not on the engagement team. QC systems likewise can be quite complex and require input from numerous people. And as in 2005, "[t]he Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs."[82] But complexity is not a reason to allow negligent auditors—individuals who by definition have acted *unreasonably*—to contribute directly and substantially to firms' violations without consequence. Indeed, as one commenter noted, the complexity of audits and the

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78 Comment Letter from U.S. Chamber of Commerce at 9, 10.

79 Comment Letter from RSM US LLP at 3.

80 *See* AS 1015.03, *Due Professional Care in the Performance of Work* (quoting a treatise describing the obligation of due care as: "[N]o man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment." (citation omitted)); AS 1000 Release at 31 ("We continue to believe that the description of due professional care in the final standard is consistent with the description in AS 1015.03 (and the reference in the current standard to the legal treatise, *Cooley on Torts*), which uses the terms 'reasonable care and diligence' and 'good faith and integrity but not infallibility' to describe due care.").

81 Comment Letter from U.S. Chamber of Commerce at 2.

82 2005 Adopting Release at 14.

current environment in which companies operate—which is rapidly changing and subject to emerging risks—*supports* amending Rule 3502 because audited financial statements are becoming increasingly important.

The Board also recognizes that it recently has adopted amendments to several standards[83] and has proposed amendments to other standards[84] and to certain PCAOB rules.[85] This is consistent with the Board's Strategic Plan, which states: "We expect to propose and adopt numerous amendments and new standards over the coming years, in accordance with our standard-setting and research agendas. We also plan to evaluate certain existing standards to determine whether they are outmoded."[86] Many of the newly adopted standards, moreover, have staggered effective dates, and thus auditors will not be required to come into compliance with each of them at the same time.[87] And in all events, as firms make efforts to comply with new standards, it necessarily follows that individuals who could be subject to Rule 3502 also would be making such efforts because firms can act only through their natural persons.

The Board does not intend for any of its new or revised standards, either alone or in conjunction with the amendment the Board adopts today, to "create[ ] a trap for the unwary,"

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[83] *See generally Amendments Related to Aspects of Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form*, PCAOB Release No. 2024-007 (June 12, 2024) (subject to Commission approval, *see supra* footnote 33); QC 1000 Release; AS 1000 Release; *The Auditor's Use of Confirmation, and Other Amendments to PCAOB Standards*, PCAOB Release No. 2023-008 (Sept. 28, 2023); *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Release No. 2022-002 (June 21, 2022).

[84] *See, e.g.*, *Proposed Auditing Standard – Designing and Performing Substantive Analytical Procedures and Amendments to Other PCAOB Standards*, PCAOB Release No. 2024-006 (June 12, 2024); *Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments*, PCAOB Release No. 2023-003 (June 6, 2023).

[85] *See, e.g.*, *Proposing Release: Firm Reporting*, PCAOB Release No. 2024-003 (Apr. 9, 2024); *Firm and Engagement Metrics*, PCAOB Release No. 2024-002 (Apr. 9, 2024); *Proposals Regarding False or Misleading Statements Concerning PCAOB Registration and Oversight and Constructive Requests to Withdraw from Registration*, PCAOB Release No. 2024-001 (Feb. 27, 2024).

[86] PCAOB, Strategic Plan 2022-2026, at 10.

[87] *See* PCAOB Release No. 2022-002, at 58 (effective for audits of financial statements for fiscal years ending on or after December 15, 2024); PCAOB Release No. 2023-008, at 96 (effective for audits of financial statements for fiscal years ending on or after June 15, 2025); AS 1000 Release at 96 (with limited exception, effective for audits of financial statements for fiscal years beginning on or after December 15, 2024); QC 1000 Release at 378 (effective December 15, 2025); PCAOB Release No. 2024-007, at 61 (effective for audits of financial statements for fiscal years beginning on or after December 15, 2025).

as one commenter opined.[88] Far from it, the Board's standard-setting agenda seeks to modernize standards in a way that promotes high-quality audits through compliance in the first instance. Enforcement proceedings promote this same *ex ante* focus on compliance insofar as they serve as a deterrent to other auditors from engaging in the same or similar misconduct.

Finally, some commenters expressed concern about whether an associated person could be liable for negligence under Rule 3502 in situations where a primary violation by a firm requires a standard higher than negligence. One commenter remarked that holding an associated person liable in such circumstances would be "unprecedented (and unlawful)" and stated that the Board should consider specifically exempting violation-causing conduct when a primary violation involves intentional conduct.[89] Another commenter sought clarity from the Board on the issue and asked whether the Board believes that individual liability in such a scenario would be appropriate. Although the Board will continue to evaluate whether to bring Rule 3502 charges on a case-by-case basis, when the firm's primary violation requires more than negligence, the Board does not anticipate charging individuals for negligently contributing to such violations.[90]

B. Retention of "Directly and Substantially"

As proposed, the Board has decided to retain the "directly and substantially" modifier to describe the connection between a contributory actor's conduct and a registered firm's primary violation.[91] Thus, for conduct to "directly" contribute to a primary violation, it must "either essentially constitute[ ] the violation"—in which case the conduct necessarily is a direct cause of it[92]—or be "a reasonably proximate facilitating event of, or a reasonably proximate stimulus

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88 Comment Letter from U.S. Chamber of Commerce at 10.

89 Comment Letter from RSM US LLP at 3.

90 *See Howard v. SEC*, 376 F.3d 1136, 1141 (D.C. Cir. 2004) ("Although we held in *KPMG, LLP v. SEC*, that the 'knew or should have known' language in § 21C embodied a negligence standard for purposes of that case, it does not necessarily follow that negligence is the standard" where "scienter [is] an element of the primary violations."); *KPMG Peat Marwick*, SEC Release No. 34-43862 ("We hold today that negligence is sufficient to establish 'causing' liability under Exchange Act Section 21C(a), at least in cases in which a person is alleged to 'cause' a primary violation that does not require scienter.").

91 *See* 2005 Adopting Release at 13. As discussed above, the "directly and substantially" modifier was added in response to commenters' concerns that a negligence standard might sweep too broadly. *See supra* page 6; *see also* 2005 Adopting Release at 13. Because the Board is retaining "directly and substantially," as explained herein, the guardrails that the Board put in place in 2005 in response to such concerns remain in Rule 3502.

92 *Cf. Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980) ("[C]ommon law agency principles, including the doctrine of respondeat superior, remain viable in actions brought under the Securities Exchange Act and provide a means of imposing secondary liability for violations of the Act independent of § 20(a). The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.").

for, the violation"; but it need not "be the final step in a chain of actions leading to the violation."[93] Moreover, "directly" does not excuse an associated person who negligently "engages in conduct that substantially contributes to a violation, just because others also contributed to the violation, or because others could have stopped the violation and did not."[94] Nor would it necessarily excuse an associated person's conduct when another actor engages in intentional misconduct that might otherwise break the chain of causation—in particular where the associated person's conduct is at least negligent and created the situation for the other actor to engage in intentional misconduct, and where the associated person realized or should have realized the potential for, and likelihood of, such third-party intentional misconduct.[95]

For its part, "substantially" continues to require that the associated person's conduct "contribute[ ] to the violation in a material or significant way," though it "does not need to have been the sole cause of the violation."[96] The Board stresses that Rule 3502 is not intended to "reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation."[97]

Commenters generally encouraged the Board to retain the "directly and substantially" modifier, including one commenter remarking that the Board's reasons for retaining it "remain valid."[98] Multiple commenters, moreover, stated that these terms are clear and

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93 *See* 2005 Adopting Release at 13.

94 *Id.*

95 *See* RESTATEMENT (SECOND) OF TORTS § 448 ("The act of a third person in committing an intentional [violation] is a superseding cause of harm to another resulting therefrom, although the actor's negligent conduct created a situation which afforded an opportunity to the third person to commit such a [violation], unless the actor at the time of his negligent conduct realized or should have realized the likelihood that such a situation might be created, and that a third person might avail himself of the opportunity to commit such a [violation].").

96 2005 Adopting Release at 13.

97 *Id.*; *see also id.* at 14 (the Board does not "seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation"). One commenter opined that the distinction between obligations placed on individuals and firms, respectively, should not be disturbed insofar as there may be instances where it is appropriate for a firm to be sanctioned for a violation but where no particular individual played a sufficient role in that violation. This commenter urged the Board to not use Rule 3502 to "collapse this distinction." Comment Letter from Center for Audit Quality at 9. The Board agrees—there are indeed instances where it is appropriate to sanction a firm but not any individual(s) (under Rule 3502 or otherwise). The amendment the Board adopts today does nothing to collapse that distinction: It changes only the actionable standard of conduct, but does nothing to alter the nexus and magnitude requirements of "directly and substantially," i.e., it does not alter the requisite sufficiency of an individual's role relative to a firm's violation.

98 Comment Letter from Ernst & Young LLP at 4 (Nov. 3, 2023).

understandable. One commenter posited that the Board should not retain "directly and substantially" as part of Rule 3502.

Several commenters sought additional clarity around the terms "directly and substantially." For instance, one commenter noted that the terms are not defined in Rule 3502 and claimed that the purported lack of clarity will make the rule inoperable. This commenter suggested that the Board instead import a more established legal doctrine of causation. Another commenter called the terms "subjective" and asked for a clearer articulation of them,[99] and another asked whether the terms "will be applied differently moving forward."[100]

Having considered all commenters' views, the Board is satisfied that the modifier "directly and substantially" is sufficiently clear and operable and believes that no further delineation of the terms is needed at this time. The Board notes that, going back to the 2005 Adopting Release, the explanation of "directly and substantially" includes concepts from established legal principles (e.g., "directly" includes circumstances where an individual's conduct is a "reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the [firm's] violation").

The Board further notes that, based on the amended rule text, "directly and substantially" would apply only to the sufficiency of the connection between an associated person's conduct and a firm's violation. Thus, to be liable under Rule 3502, a person must have known, or should have known, that an act or omission by them would contribute—but not that it would *directly and substantially* contribute—to a firm's violation.

One commenter remarked that the Board failed to explain its intention behind this aspect of the amendment and that the wording creates potential ambiguities and unfairness. The Board, however, sees it differently—by eliminating the need for any inquiry into individuals' mental states regarding the manner in which their conduct contributes to the firm's violation, the Board believes that the rule has the potential to be applied more uniformly (and thus more fairly). Moreover, if an associated person knew or should have known that his or her conduct would contribute to a violation in *any* way, then that individual should not be able to evade liability simply because the individual did not know the extent of the nexus and magnitude of such contribution. But in all events, the Board iterates that, absent conduct "directly and substantially" contributing to a firm's violation, an individual's actions or omissions are not subject to discipline under Rule 3502.

Two commenters opined that the Proposal suggested that the Board was open to a tertiary liability theory, in which a first associated person's conduct contributes to the conduct

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[99] Comment Letter from Accounting & Auditing Steering Committee of the Pennsylvania Institute of Certified Public Accountants at 5 (Nov. 2, 2023).

[100] Comment Letter from Audit and Assurance Services Committee of the Illinois CPA Society at 3 (Nov. 2, 2023).

of a second associated person, which in turn contributes to a registered firm's violation. But as those commenters also recognized, the rule still would require the first person's conduct to directly and substantially contribute to *the firm's* violation.[101] Thus, contrary to those commenters' concerns, the definition of "directly" is not stretched beyond what it would be if there were no second person involved, let alone beyond common usage of the word.

Finally, some commenters suggested other phrases or concepts to incorporate into the rule to modify "contribute." One commenter called for limiting liability to "egregious actions."[102] Such a standard, however, more aptly describes conduct that is reckless (as opposed to negligent),[103] which would be contrary to what the Board intends for the amendment to accomplish.

That same commenter expressed the view that the negligence standard should not apply to a professional who spends only a de minimis amount of time on an engagement, and further suggested that the Board add language to clarify that liability would only extend to a professional having a substantive level of participation on the engagement. Another commenter similarly suggested that the Board require that an associated person's conduct be a "substantial factor" in bringing about the firm's violation.[104] The Board, however, believes that the contours of "substantially" (in "directly and substantially") suffice to help ensure that Rule 3502 is applied only to those individuals with a substantive level of participation or responsibility on an engagement with respect to a firm's violation in connection with an audit. And as the Board previously has expressed—in the 2005 Adopting Release, in the Proposal, and above—Rule 3502 is not intended to reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation.

C. No New Liability Standard in Light of the Commission's Authority

As explained in the Proposal, associated persons already are subject to potential liability—including money penalties—for negligently contributing to registered firms' violations of numerous laws and rules governing the preparation and issuance of audit reports via the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, Section 21C of the Exchange Act authorizes the Commission to institute cease-and-desist proceedings against any "person that

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101 *See* 2023 Proposing Release at 17 n.65; *e.g.*, *In re Shandong Haoxin Certified Public Accountants Co., Ltd.*, PCAOB Release No. 105-2023-045, at ¶ 65 (Nov. 30, 2023) (multiple individuals violated Rule 3502 in connection with the same primary violation by the firm through different (though related) contributory conduct).

102 Comment Letter from Accounting & Auditing Steering Committee of the Pennsylvania Institute of Certified Public Accountants at 5.

103 *See, e.g.*, *In re Gately & Assocs., LLC*, SEC Release No. 34-62656, at 18 (Aug. 5, 2010) ("Recklessness can be established by an 'egregious refusal to investigate the doubtful and to see the obvious.'" (citation omitted)).

104 Comment Letter from RSM US LLP at 7.

is, was, or would be a cause of [a] violation [of the Exchange Act or any rule or regulation thereunder], due to an act or omission the person knew or should have known would contribute to such violation,"[105] and Section 21B further authorizes the Commission to "impose a civil penalty" upon finding that such person "is or was a cause of [such] violation."[106] Section 3(b)(1) of Sarbanes-Oxley, in turn, provides that "[a] violation by any person of . . . any rule of the Board shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder." Thus, the amendment to Rule 3502's liability threshold does not subject auditors to any new or different standard to govern their conduct in light of the Commission's authority.[107]

Numerous commenters seemed to disagree with that proposition for several reasons. Some commenters pointed out that the Commission cases cited in footnote 52 of the Proposal, while each a proceeding under Section 21C of the Exchange Act, were also proceedings under Commission Rule of Practice 102(e), which requires either "[a] single instance of highly unreasonable conduct that results in a violation" or "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards."[108] Sanctions are not available under Rule 102(e) when an auditor engages in a single instance of unreasonable (but

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[105] 15 U.S.C. § 78u-3(a); *see also* 15 U.S.C. §§ 77h-1(a), 80a-9(f)(1), 80b-3(k)(1).

[106] 15 U.S.C. § 78u-2(a)(2). The Commission's Section 21B authority to impose civil penalties for violations in Section 21C cease-and-desist proceedings was added in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Pub. L. 111-203.

[107] Nor does the Commission's authority to sanction associated persons' negligent contributory conduct detract from the proposed amendment's deterrent effect. As previously noted, as an increase in the number of regulators on the lookout for the same or similar violative conduct increases the likelihood of that conduct being detected and, consequently, the likelihood that the conduct would be sanctioned. *See* Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1, 12 (2010) ("One of the most powerful deterrents to misconduct is an increased threat of prosecution. . . . A 'can do' accountant is less likely to provide questionable opinions if there is a substantial certainty that he will be caught and punished."); *see also* Fletcher, *supra* footnote 55, at 268 ("Certainty of punishment"—including "the possibility of detection, apprehension, conviction, and sanctions"—is one of two "primary factors" that drive deterrence.).

[108] 17 C.F.R. § 201.102(e); *see In re David S. Hall, P.C.*, SEC Initial Decision Release No. 1114 (Mar. 7, 2017) (ALJ Op.), *decision made final*, SEC Release No. 34-80949 (June 15, 2017); *In re Gregory M. Dearlove, CPA*, SEC Release No. 34-57244 (Jan. 31, 2008); *In re Philip L. Pascale, CPA*, SEC Release No. 34-51393 (Mar. 18, 2005).

not highly unreasonable) conduct.[109] Thus, certain commenters said that the cases were not "on par" with what the Board intends through the amendment to Rule 3502.[110]

To be sure, those commenters are correct that the cases cited in footnote 52 of the Proposal involve proceedings under Commission Rule 102(e), as well as under Section 21C. Commenters, however, did not appear to contest that the Commission has the authority to bring proceedings for single acts of ordinary negligence under Section 21C, including for civil money penalties (authorized by Section 21B), *without also proceeding under Commission Rule 102(e)*.[111] Rather, commenters instead suggested only that the Commission rarely exercises such authority in practice. While that may be the case, the Board's point nonetheless remains: The amendment to Rule 3502's liability threshold does not subject auditors to any new or different standard to govern their conduct.

The Commission release cited by certain commenters when advancing the contrary argument makes this point abundantly clear. In it, the Commission stated that a single act of negligence "may result in a violation of the federal securities laws" and that "the person committing such an error, though not subject to discipline under Rule 102(e), would be exposed

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[109] *See Amendment to Rule 102(e) of the Commission's Rules of Practice*, SEC Release No. 34-40567 (Oct. 26, 1998) ("[T]he Commission is not adopting a standard that reaches single acts of simple negligence.").

[110] Comment Letter from Center for Audit Quality at 7; Comment Letter from Moss Adams LLP at 3 (Nov. 3, 2023). One commenter observed that the Commission proposed but ultimately declined to adopt an ordinary negligence standard for contributory conduct by accountants under Rule 102(e). But as that commenter also recognized, the Commission did so while expressly acknowledging that an ordinary negligence standard in Rule 102(e) would have been duplicative of authority that it already possessed. *See* SEC Release No. 34-40567 ("Moreover, the Commission possesses authority, wholly independent of Rule 102(e), to address and deter such errors through its enforcement of provisions of the federal securities laws that impose liability on persons, including accountants, for negligent conduct."). The Board, by contrast, lacks ability to pursue contributory negligent conduct based on the current formulation of Rule 3502.

[111] Indeed, civil money penalties are not available under Commission Rule 102(e)—only censure or denial (temporary or permanent) of the privilege of appearing or practicing before the Commission. 17 C.F.R. § 201.102(e). Thus, the Commission would not need to meet Rule 102(e)'s "highly unreasonable conduct" standard to impose a civil money penalty for a single act of negligence under Section 21B of the Exchange Act.

to the sanctions available under [such] other provisions."[112] The Commission noted elsewhere in its release that a single act of ordinary negligence "could have legal consequences."[113]

One commenter suggested that Section 21C proceedings are an inapt analog for charges under Rule 3502 because Section 21C was intended to quickly enjoin conduct that may lead to violations, but was not designed to be a sanctions-imposing provision. Whether that was the original intent of Section 21C,[114] Section 21B now indisputably allows for sanctions (in the form of monetary penalties) in a proceeding under Section 21C when an auditor or any other person was negligent in causing violations by others. Indeed, much like Section 21B's direct-violation provision, the text of the secondary-violation provision in Section 21B expressly contemplates the imposition of a penalty based on conduct that *already* occurred.[115]

This commenter also posited that, in addition to a primary violation, Section 21C also requires a finding of harm to the public that was in part caused by a contributory negligent act. While that may be the case for issuance of a temporary order pursuant to Section 21C(c), no such finding is required for imposition of a monetary penalty under Section 21B.[116] And

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[112] SEC Release No. 34-40567 at n.28; *see also id.* at n.38 ("In other instances, the federal securities laws expressly subject auditors to liability without requiring intentional misconduct. . . . [S]ection 21C of the Exchange Act imposes liability when a person is a 'cause' of a violation 'due to an act or omission the person knew or should have known would contribute to such violation.'").

[113] *Id.* at n.47.

[114] The commenter's cited authority does not appear to support that view. *See* Andrew M. Smith, *SEC Cease-and-Desist Orders*, 51 ADMIN. L. REV. 1197, 1226 (1999) ("The legislative history of the [statute that includes Section 21C] is not clear as to whether Congress intended to require the SEC to find a reasonable likelihood of future violation before imposing a cease-and-desist order, although a strong argument can be made that Congress did not intend to require the SEC to make such a finding. In addition, most, if not all, of the proponents and architects of cease-and-desist authority, and many who have commented on the [relevant statute] and its predecessor legislative proposals, believe that such a finding is not necessary.").

[115] 15 U.S.C. § 78u-2(a)(2)(B) ("In any proceeding instituted under [Section 21C] against any person, the Commission may impose a civil penalty, if the Commission finds, on the record after notice and opportunity for hearing, that such person . . . is *or was* a cause of the violation of any provision of this chapter, or any rule or regulation issued under this chapter." (emphasis added)); *see also* Smith, *supra* footnote 114, at 1199 ("[Section 21C's] plain language—'has violated'—appears to authorize the SEC to base a cease-and-desist order upon a *single past violation*, without any showing that the violator is likely to break the law in the future." (emphasis added)).

[116] *Compare* 15 U.S.C. § 78u-3(c)(1), *with id.* § 78u-2(a)(2). In any event, it would appear that harm to the public interest is sufficient, but not *required*, for a temporary restraining order under Section 21C, as that provision allows the Commission to enter a temporary restraining order "[w]henever the Commission determines that the alleged violation or threatened violation . . . is likely to result in significant dissipation or conversion of assets, significant harm to investors, *or* substantial harm to the public interest." *Id.* § 78u-3(c)(1) (emphasis added).

regardless, although harm is not an element of proof for a Rule 3502 violation, inherent in any proceeding under Rule 3502 is the foundational principle that the Board is bringing the proceeding and imposing sanctions "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[117]

Another commenter remarked that in a Commission proceeding for ordinary negligence under Section 21C (and not also for highly unreasonable conduct under Rule 102(e)), the Exchange Act limits what sanctions the Commission can impose, and in the commenter's view, the Commission lacks the authority to impose certain sanctions that the Board can impose. But while the available sanctions for a single act of negligence might be different in a proceeding under Rule 3502 compared with one under Section 21C—indeed, the Commission can seek certain sanctions that the Board cannot[118]—Sarbanes-Oxley *does* place express limits on what sanctions the Board can impose.[119] In the Board's view, that the limitations on sanctions in the Exchange Act and in Sarbanes-Oxley, respectively, might not be the same in all respects does not render the Board's enforcement authority "unprecedented."[120]

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[117] Section 101(a) of Sarbanes-Oxley. As the Commission has recognized, moreover, even "unreasonable, or negligent, accounting or auditing errors . . . could undermine accurate financial reporting." SEC Release No. 34-40567.

[118] The Commission's authority is more expansive in other ways, as well. For example, as noted in the Proposal, the Commission is not limited to holding accountable auditors for contributory conduct with respect to primary violations committed only by registered firms; rather, the Commission also may hold accountable auditors who cause violations by any other person, including issuers. *See* 2023 Proposing Release at 9 n.33. Additionally, while Rule 3502 applies only to associated persons of registered firms, the Commission's authority under Section 21C is not so limited; it applies to "any person," including nonaccounting professionals. 15 U.S.C. § 78u-3(a); *see also id.* § 78c(a)(9) (defining "person").

[119] *See* Section 105(c)(5) of Sarbanes-Oxley. One commenter sought clarity with respect to footnote 48 of the Proposal, and specifically the circumstances under which the Board would be permitted to impose heightened sanctions. The Board takes this opportunity to clarify that, although the amendment to Rule 3502 allows the Board to sanction single instances of negligent contributory conduct, the heightened sanctions referenced in Section 105(c)(5) of Sarbanes-Oxley—specifically, those sanctions listed in subparagraphs (A) through (C) and (D)(ii) of Section 105(c)(4)—would *not* be available for a Rule 3502 violation absent a finding that the individual who violated Rule 3502 acted at least recklessly or committed repeated acts of negligence each resulting in a violation of an applicable statutory, regulatory, or professional standard.

[120] Comment Letter from Center for Audit Quality at 8. This commenter also sought to cast as inappropriate a negligence standard for Rule 3502 in light of the mental state required for aiding and abetting liability. The Board agrees with the commenter that aiding and abetting generally requires knowing conduct, which is why the Board has not relied on that theory of liability—in 2004, in 2005, in the Proposal, or now—as an analog or basis for Rule 3502. *See, e.g.*, 2005 Adopting Release at 11 n.20 ("Rule 3502, of course, differs from an aiding-and-abetting cause of action in important respects.

D. Authority for the Amendment

Several commenters expressed doubt regarding the Board's statutory authority for the amendment in two respects: They questioned whether the Board has the authority to sanction single acts of ordinary negligence as a general matter (i.e., in cases of direct violations or otherwise), and they questioned the Board's authority to promulgate a contributory liability rule at the negligence standard. In general, these commenters asserted that the Board's authority in these respects is either unclear or rests on questionable interpretations of Sarbanes-Oxley. One commenter further opined that the Proposal ignores congressional intent and that the Board's authority is "not as settled as the Proposal assumes,"[121] and still another comment letter posited that Sarbanes-Oxley is clear that in the absence of repeated negligence, sanctions should not be imposed.

Although the Board believes that its authority in both respects is well-settled for reasons the Board has previously explained,[122] the Board nonetheless addresses these commenters' views.

1. Authority to Sanction Single Acts of Negligence Generally

The text of Section 105 of Sarbanes-Oxley plainly permits the Board to impose liability for single acts of negligence. Specifically, Section 105(c)(4) authorizes the Board to impose an array of sanctions—listed in subparagraphs (A) through (G)—upon finding that a registered firm or associated person engaged in violative conduct, without reference to the level of culpability required but "subject to applicable limitations" in Section 105(c)(5). Section 105(c)(5), in turn, provides that "[t]he sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of [Section 105(c)(4)] shall only apply to [ ] intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct each resulting in a violation of the applicable statutory, regulatory, or professional standard." Section 105(c)(5) thus does not restrict the Board's authority to impose for single acts of negligence certain sanctions—those in subparagraphs (D)(i) and (E) through (G) of Section 105(c)(4).

Among other things, the rule does not apply whenever an associated person causes another to violate relevant laws, rules and standards. Rather, Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated.").

[121] Comment Letter from U.S. Chamber of Commerce at 2.

[122] *See* 2004 Proposing Release at 18; 2005 Adopting Release at 10-12; *see also* 2023 Proposing Release at 12 n.43.

The Board has long recognized this grant of authority,[123] as did multiple commenters. One commenter agreed that the Board has had authority to bring enforcement proceedings for negligence "[s]ince the PCAOB's creation,"[124] and another posited that Congress "clearly" intended for the Board to sanction associated persons for negligent conduct.[125] Still another asserted that Sarbanes-Oxley "empowers" the Board to sanction associated persons in instances "when their conduct was not intentional or reckless."[126] Indeed, this latter commenter opined that the Proposal created a "misimpression" that associated persons currently can *only* be sanctioned for intentional or reckless misconduct.[127] This of course was not the Board's intent.

Other commenters, however, took the opposite view. One comment letter opined that, when read together, the provisions of Sections 105(c)(4) and (c)(5) discussed above make clear that unless negligent conduct is repeated, sanctions and penalties "should not be applied."[128] If Congress had intended for *all* sanctions listed in Section 105(c)(4) to be unavailable absent reckless conduct or repeated acts of negligence, however, then it would have had no reason to make the specific carve-outs that it did in Section 105(c)(5); there would be no point to them. Such an interpretation thus runs contrary to both Section 105(c)(5)'s text and the bedrock principle of statutory construction to not read a statute in a way that renders language superfluous.[129]

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123 Two decades ago, the Board stated:

> The Act *plainly contemplates that disciplinary proceedings can be instituted for a violation based on a single negligent act*. Section 105(c)(5) of the Act provides that the Board may impose the more severe sanctions authorized by section 105(c)(4) only in cases that involve intentional or knowing conduct (including reckless conduct) or repeated instances of negligent conduct. Implicit in that provision is that *a violation based on a single instance of negligent conduct is sufficient to warrant a disciplinary proceeding to impose lesser sanctions*.

PCAOB Release No. 2003-015, at A2-58-59 (emphases added); *see also id.* at A2-76 ("[S]ection 105(c)(5) of the Act requires scienter or repeated negligence for imposition of the most severe sanctions. The Act does not limit the standard that must be met for imposition of other sanctions."); 2005 Adopting Release at 12 n.23.

124 Comment Letter from North American Securities Administrators Association, Inc. at 1 (Nov. 13, 2023).

125 Comment Letter from Center for American Progress at 3.

126 Comment Letter from Ernst & Young LLP at 2.

127 *Id.*

128 Comment Letter from Eight Accounting Professors (Cannon, et al.) at 4 (Nov. 2, 2023).

129 *See, e.g.*, *FCC v. NextWave Personal Cmmc'ns Inc.*, 537 U.S. 293, 302 (2003) ("[E]ven § 525(a) itself contains explicit exemptions for certain Agriculture Department programs. These latter exceptions

2. Authority for a Negligence-Based Contributory-Conduct Rule

Congress intended to grant to the Board "plenary authority" to establish or adopt ethics standards.[130] To that end, Section 103(a)(1) of Sarbanes-Oxley mandates that the Board

> shall, by rule, establish . . . and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, such ethics standards, and such independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports . . . as may be necessary or appropriate in the public interest or for the protection of investors.[131]

As the Board twice recognized nearly two decades ago—once when it proposed Rule 3502 and again when the Board adopted it—a contributory liability rule merely codifies auditors' longstanding ethics obligations.[132]

Some commenters nonetheless expressed doubt about whether the statutory authority to regulate ethical conduct equates to a statutory authority to sanction negligent conduct. In doing so, one such commenter appeared to interpret the Proposal's discussion of the Commission's authority under Section 21C of the Exchange Act to mean that the Board was relying on that provision as authority for the amendment. The Board, however, did not rely (and is not relying) on Section 21C of the Exchange Act as a source of authority for its negligent contributory-liability standard; rather, the Board agrees with the commenter that such provision applies only to the Commission. The Proposal's discussion of Section 21C instead was

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would be entirely superfluous if we were to read § 525 as the Commission proposes—which means, of course, that such a reading must be rejected."); *see also TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) ("[W]ere we to adopt [respondent's] construction of the statute, the express exception would be rendered insignificant, if not wholly superfluous." (citation and quotation marks omitted)).

130 S. Rep. 107-205, at 8.

131 *See also* Section 101(c)(2) of Sarbanes-Oxley.

132 2004 Proposing Release at 18; *see* 2005 Adopting Release at 9. Beyond codifying auditors' ethics obligations, Rule 3502 is also "essential to the proper functioning of the Board's independence rules." 2004 Proposing Release at 19; *see also* 2005 Adopting Release at 14. As the Board previously explained:

> For example, Rule 3521 provides, in part, that a registered firm is not independent of its audit client if the firm provides that audit client with a service for a contingent fee. When an associated person causes . . . the registered firm to provide that service for a contingent fee, Rule 3502 would allow the Board to discipline the associated person for that conduct.

2005 Adopting Release at 14.

meant to show that, by adopting a negligence threshold in Rule 3502, the Board would not be subjecting auditors to any new standard to govern their contributory conduct.[133]

As the Board previously explained, "an associated person's ethical obligation is not merely to refrain from knowingly causing a violation but also to act with sufficient care to avoid negligently causing a violation."[134] Such obligation has deep historical roots. For instance, the AICPA's Code of Professional Conduct at the time that Sarbanes-Oxley was enacted (and still today) made it an "act discreditable to the profession"—and therefore a violation of its ethics rules[135]—for a member accountant to "*permit[ ] or direct[ ] another* to make[ ] materially false and misleading entries in the financial statements or records of an entity" "*by virtue of his or her negligence*."[136] Just the same if a member were to "*permit[ ] or direct[ ] another* to sign[ ] a document containing materially false and misleading information" "*by virtue of his or her negligence*."[137]

Congress clearly had in mind the AICPA Code of Professional Conduct when it authorized the Board to promulgate ethics standards. The AICPA had a prominent presence during the drafting of Sarbanes-Oxley and in the run up to its passage,[138] and beyond Congress empowering the Board to write its own ethics standards, it also empowered the Board to "adopt as its rules[ ] . . . any portion of any statement of auditing standards or *other professional standards*" and to "modify, supplement, revise, or subsequently amend,

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133 2023 Proposing Release at 14 (discussing Section 21C and concluding: "Thus, the proposed amendment to Rule 3502's liability threshold would not subject auditors to any new or different standard to govern their conduct.").

134 2005 Adopting Release at 9.

135 The AICPA's *Ethics Rulings* are a body of decisions made by the AICPA's professional ethics division's executive committee that "summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances." Introduction, Code of Professional Conduct (as Adopted January 12, 1988), *available at* https://us.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014december14codeofprofessionalconduct.pdf; *see also* AICPA Code of Professional Conduct § 0.500.01 (updated June 2020) ("The code is the only authoritative source of AICPA ethics rules and interpretations." (italics omitted)).

136 AICPA Code of Professional Conduct, ET § 501.05(a), *Negligence in the Preparation of Financial Statements or Records* (emphases added), *recodified at* Section 1.400.040.01.

137 *Id.* § 501.05(c) (emphases added).

138 During committee hearings for Sarbanes-Oxley, the Senate heard testimony from five individuals who were serving, or previously had served, in leadership roles within the AICPA (including the AICPA's then-current Chair and its former Chair), and also relied on data provided by the AICPA. *See* S. Rep. 107-205, at 3-4, 61, 63; *see also* H.R. Rep. No. 107-414, at 19 (2002) (noting that the AICPA's then-President and CEO provided testimony to a House of Representatives committee on a related bill).

modify, or repeal, in whole or in part, any portion of any [such] statement."[139] In other words, Congress authorized the Board to adopt (and later amend or modify) parts of the AICPA's Code of Professional Conduct as the Board's ethics standards, and at the time of Sarbanes-Oxley's enactment, that Code included prohibitions on negligent contributory conduct.

One commenter cited a provision of the AICPA Code of Professional Conduct that has a "knowingly" standard for contributory conduct (Section 0.200.020.04). This commenter also cited the Board's then-proposed (now-adopted) EI 1000, *Integrity and Objectivity*, to note that the definition of "integrity" in that standard includes "[n]ot knowingly or recklessly misrepresenting facts," without reference to negligence.[140] However, this commenter did not acknowledge that the AICPA Code also has contributory-conduct provisions at the negligence standard, as discussed above.

Certain commenters compared the Board's authority for a contributory negligence standard in Rule 3502 to private plaintiffs' inability to bring suit under Section 10(b) of the Exchange Act[141] for aiding and abetting securities fraud. To be sure, in *Central Bank of Denver*, the U.S. Supreme Court held that "there is no private aiding and abetting liability under § 10(b)" "[b]ecause the text of § 10(b) does not prohibit aiding and abetting."[142] But that holding regarding an implied private right of action has little bearing on the Board's authority for the amendment.

The Board draws its authority for the amendment from different text in a different statute. As explained above, Congress empowered the Board to promulgate ethics standards pursuant to Section 103(a) of Sarbanes-Oxley, which is distinct from any congressional grant of authority to the Commission, including those in Sections 10(b) or 21C of the Exchange Act.[143]

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139 Section 103(a)(3) of Sarbanes-Oxley (emphasis added). In 2003, the Board adopted parts of the AICPA Code of Professional Conduct as its interim ethics standards, *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006, at 10 (Apr. 18, 2003), and the Commission approved such adoption "as consistent with the requirements of [Sarbanes-Oxley]," *Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002*, SEC Release No. 34-47745 (Apr. 25, 2003).

140 QC 1000 Release at A4-1.

141 15 U.S.C. § 78j.

142 *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

143 Section 105 of Sarbanes-Oxley also supplies authority to adopt the proposed amendment. *See* 2005 Adopting Release at 12; 2023 Proposing Release at 12 n.43. As the Board previously explained, "Section 105 authorizes the Board to investigate and, when appropriate, discipline registered firms *and* their associated persons," and because (1) "[c]ertain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm," and (2) "[s]uch firms . . . can only act through the natural persons that comprise them," it follows that (3) "[w]hen one or more of those associated persons has caused that firm to" commit a violation, "it is appropriate, and consistent with the Board's duty to discipline registered firms and their associated persons under Section 101(c)(4) of the Act, that

There is no analogous statutory mandate for the Commission to "establish . . . ethics standards" in the area of auditors' professional responsibility.

The Board, however, indisputably *does* have such a mandate in Section 103(a)(1) of Sarbanes-Oxley,[144] and with that distinct mandate comes distinct authority.[145] Indeed, as the Commission recognized when approving the Board's adoption of Rule 3502 in 2006, "the rule is within the scope of the PCAOB's authority, particularly its authority to establish ethical standards."[146] Section 103(a)(1), moreover, is an enabling (or authorizing) statute that permits the Board to establish standards to govern the preparation and issuance of audit reports "as may be necessary or appropriate in the public interest," which text provides broad rulemaking authority.[147]

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the Board be able to discipline the associated person for that misconduct." 2005 Adopting Release at 12.

[144] One commenter remarked that Section 103 "is not untethered" from the rest of Sarbanes-Oxley. Comment Letter from U.S. Chamber of Commerce at 4. The Board agrees: Section 103 tethers *directly* to Section 101(c)(2), which mandates that the Board "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards . . . in accordance with section 7213 [103] of this title." Indeed, doing so is an express "Dut[y] of the Board" under Section 101(c). Section 101(c)(2) is thus another source of authority for the Board's amendment.

[145] Nor does Section 103(a) of Sarbanes-Oxley include the telltale terms of a statute that requires a mental state higher than negligence, as does Section 10(b) of the Exchange Act. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) ("Section 10(b) makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance' in contravention of Commission rules. The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."); *id.* at 199 ("The argument simply ignores the use of the words 'manipulative,' 'device,' and 'contrivance' [are] terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.").

[146] *Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules*, SEC Release No. 34-53677, at 9 (Apr. 19, 2006).

[147] *See, e.g.*, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 377-78 & n.5 (1999) (construing a provision allowing the FCC to "prescribe such rules and regulations as may be necessary in the public interest to carry out" the relevant statute as a "general grant of rulemaking authority" sufficient for the FCC to promulgate the regulations at issue); *Metrophones Telecommc'ns, Inc. v. Global Crossing Telecommc'ns, Inc.*, 423 F.3d 1056, 1068 (9th Cir. 2005) ("Given the reach of the [FCC's] rulemaking authority under § 201(b)"—which granted to the FCC the "broad power to enact such 'rules and regulations as may be necessary in the public interest to carry out the provisions of this Act'"—"it would be strange to hold that Congress narrowly limited the Commission's power to deem a practice 'unjust or unreasonable.'"); *Brown v. Azar*, 497 F. Supp. 3d 1270, 1281 (N.D. Ga. 2020) ("[W]hen an agency is authorized to 'prescribe such rules and regulations as may be necessary in the public interest to carry out the

So, too, is Section 101(g)(1) of Sarbanes-Oxley—yet another source of authority for the amendment. That provision authorizes the Board to promulgate rules to "provide for . . . the exercise of its authority, and the performance of its responsibilities under this Act," which include "enforc[ing] compliance" with applicable laws, rules, and standards; "conduct[ing] investigations and disciplinary proceedings"; and "impos[ing] appropriate sanctions where justified."[148] Section 101(g)(1) thus empowers the Board to implement the Board's "ultimate purposes" under Sarbanes-Oxley of "protect[ing] the interests of investors and further[ing] the public interest in the preparation of informative, accurate, and independent audit reports."[149] The amendment, and Rule 3502 generally, do precisely that.

V. STATEMENT REGARDING THE PROPOSED AMENDMENT TO CLARIFY THE RELATIONSHIP BETWEEN CONTRIBUTORY ACTOR AND PRIMARY VIOLATOR

As noted above in Section II, in addition to proposing a change in Rule 3502's liability standard, the Proposal also contemplated amending Rule 3502 to provide that an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation (i.e., that an associated person of one registered firm can contribute to a primary violation of another registered firm).[150] Specifically, the Board proposed changing the word "that" to "any" immediately before the reference to the registered public accounting firm that commits the primary violation. After due consideration, the Board has decided not to adopt any changes to Rule 3502 to implement this aspect of the Proposal, for two primary reasons.

First, as the Proposal explained, the Board's rules already contemplate that associated persons can be associated with more than one registered firm at the same time.[151] Specifically, PCAOB Rule 1001(p)(i)'s definition of an "associated person" provides that if a firm reasonably believes that one of its associated persons is primarily associated with another registered firm, then that person is excluded from the definition of an "associated person," but only "for purposes of completing a registration application on Form 1, Part IV of an annual report on

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provisions of the Act,' Congress' intent to give an agency broad power is clear."), *appeal dismissed as moot*, 20 F.4th 1385 (11th Cir. 2021) (mem.).

148 Sections 101(c)(4) and (6) of Sarbanes-Oxley.

149 Section 101(a) of Sarbanes-Oxley; *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 780 (1968) ("We are, in the absence of compelling evidence that such was Congress' intention, unwilling to prohibit administrative action imperative for the achievement of an agency's ultimate purposes."); *see Doe v. FEC*, 920 F.3d 866, 870-71 (D.C. Cir. 2019) ("When an agency's 'empowering provision'" permits the agency "'to make, amend, and repeal such rules … as are necessary to carry out the provisions of'" the statute, "the courts will sustain a regulation that is 'reasonably related' to the purposes of the legislation." (citations omitted)).

150 *See* 2023 Proposing Release at 16-17.

151 *See id.* at 10 n.36.

Form 2, or Part IV of a Form 4 to succeed to the registration status of a predecessor." For all other purposes, that carveout does not apply, thus underscoring that, in the context of Rule 3502's reference to an "associated person," a person can be associated with two or more registered firms at once.

Second, an individual who "directly and substantially" contributes to a firm's violation (consistent with the meaning of that phrase in Rule 3502, as described above) in all instances likely also will have "participate[d] as agent *or otherwise on behalf of* such [ ] firm in *any* activity of that firm" "*in connection with* the preparation or issuance of *any* audit report," and thus be an "associated person" of that firm.[152] In the Board's view, this definition of "associated person," in combination with the notion that a person can be associated with multiple firms at the same time, renders unnecessary the proposed change from "that" to "any" in Rule 3502.

The Board appreciates commenters' feedback on this aspect of the Proposal. As one commenter surmised, this aspect of the Proposal was aimed at providing for equal accountability by associated persons as firm structures evolve. Based on the two points noted above, however, the Board believes that such accountability currently exists.[153] It was not the Board's intent through this aspect of the Proposal to deter collaboration or the sharing of perspectives between firms. And, to the extent that commenters believe that this aspect of the Proposal would exacerbate their concerns with respect to a negligence standard, the Board's decision not to adopt any amendment in this regard should help to alleviate those concerns.

VI. ECONOMIC ANALYSIS

The Board is mindful of the economic impacts of its rulemaking. This section describes the baseline for evaluating the economic impacts of the amendment to Rule 3502, the need for rulemaking, its expected economic impacts (including benefits, costs, and potential unintended consequences), and reasonable alternatives considered. Due to data limitations, much of the economic analysis is qualitative; however, it incorporates quantitative information, including PCAOB enforcement data and academic and industry research, where feasible.

The Board sought information relevant to the economic analysis throughout this rulemaking and has carefully considered the comments submitted, including the data and studies suggested by the commenters.

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[152] *See* Section 2(a)(9) of Sarbanes-Oxley (emphases added); PCAOB Rule 1001(p)(i).

[153] Beyond these two points, one commenter opined that "in most, if not all, cases," an auditor's direct and substantial contribution to a primary violation by a firm with which the auditor is *not* associated also would have at least negligently, directly, and substantially contributed to a primary violation by a firm with which the auditor *is* associated. Comment Letter from Ernst & Young LLP at 4. This proposition further underscores the point that no clarifying amendment is needed given the current regulatory framework.

A. Baseline

Section III describes the important components of the baseline against which the amendment's economic impacts are considered, including the current formulation of Rule 3502 and the Board's implementation experience. We discuss below the Board's enforcement activities. Table 1 presents PCAOB enforcement data on Rule 3502 charges from 2009-2024.[154] This table provides historical information on how frequently individuals have been charged under the current formulation of Rule 3502.

Table 1. Number and Incidence of Rule 3502 Charges, 2009-2024

Year	Cases with Rule 3502 Charges (A)	Firms Sanctioned (B)	Incidence of Rule 3502 Charges C = A / B
2009	2	5	40%
2010	0	2	0%
2011	2	6	33%
2012	3	4	75%
2013	5	10	50%
2014	2	20	10%
2015	17	37	46%
2016	14	30	47%
2017	15	42	36%
2018	8	13	62%
2019	8	19	42%
2020	2	13	15%
2021	3	14	21%
2022	6	30	20%
2023	5	43	12%
2024	4	20	20%
Total	**96**	**308**	**31%**

Source: Settled and Adjudicated Disciplinary Orders Reported by the Board to the Public Pursuant to Section 105(d) of Sarbanes-Oxley, *available at* https://pcaobus.org/oversight/enforcement/enforcement-actions

Column A shows the number of cases in which associated persons were found to have violated Rule 3502 (includes settled and adjudicated cases); column B shows the number of cases in which registered firms were sanctioned (for any violation); and column C is the ratio of

[154] Table 1 contains data through April 30, 2024. The Board brought the first Rule 3502 charge in 2009 for conduct committed after the effective date of Rule 3502 in April 2006.

the two, expressed as a percentage to reflect the proportion of firm cases when an associated person was charged with Rule 3502 by the Board.

From 2009 through April 30, 2024, there have been a total of 96 cases with Rule 3502 violations. At an average of six per year, the number of Rule 3502 cases was highest in 2015 at 17 and lowest in 2010, when no Rule 3502 violations were found.[155] The 96 cases represent 31 percent of the total number of cases in which the Board sanctioned firms for violations from 2009-2024. The data presented in the table does not predict how many Rule 3502 violations the Board might find because of the amendment; it indicates that in over two-thirds of the cases in which a firm was sanctioned, no contributory actor was held accountable under Rule 3502.[156]

Commenters suggested alternative means of assessing the baseline for this amendment. Some commenters suggested that the Board consider the Commission's enforcement data. However, PCAOB enforcement data is a more relevant comparison because this data is limited to cases brought by the PCAOB, offering a more precise perspective for understanding the baseline of the amendment. Although the Commission's enforcement data is valuable, it is impacted by various factors, including the Commission's case mix, prosecutorial discretion, resource allocation decisions, and enforcement priorities. While the Commission and the PCAOB coordinate enforcement efforts as required by Sarbanes-Oxley, their respective mandates are separate from each other. Given these separate mandates, inclusion of the Commission's data herein would not contribute to a fuller understanding of the PCAOB's historical practices.

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[155] Column Year refers to the year the firms were sanctioned. Column A reflects Rule 3502 cases involving sanctions of one or more respondents as one instance. Some firms were sanctioned in different years than associated persons were sanctioned for the corresponding Rule 3502 violations. In such cases, Rule 3502 violations by associated persons are counted in the same year the firms were sanctioned. Therefore, column A can be interpreted as a subset of cases in Column B.

[156] One commenter asserted that Table 1 in the Proposal did not illuminate whether the cases without Rule 3502 charges would have merited or supported a Rule 3502 charge for individual negligence had that option been available, and suggested that the PCAOB perform that analysis, even if for a shortened period of 5 years. Another commenter also suggested that this analysis does not indicate cases where a Rule 3502 charge would have been inappropriate or where the absence of charges was supported by the Board's exercise of prosecutorial discretion. However, we note that staff has already performed an analysis of that nature for the immediately preceding two years, which forms the basis of the estimated increase in the number of cases discussed in Section VI.C. *See infra* pages 43-44 (providing estimate for 2022 and 2023); *see also* 2023 Proposing Release at 24-25 (providing estimate for 2022). Performing an analysis for additional older years may be potentially less robust, given the extremely fact-based nature of the evaluation; staff recollections of whether all of the available investigatory evidence could have supported a negligence claim are naturally less reliable for older matters; and relevant staff may have since departed the PCAOB.

Other commenters suggested that, rather than the comparison provided in Table 1 of individual Rule 3502 cases to firm cases, a more relevant comparison would be PCAOB enforcement proceedings against firms to PCAOB enforcement proceedings against individuals (under Rule 3502 and otherwise). One of these commenters acknowledged, however, that such a comparison would not shed meaningful light on the need for the proposed change, and we agree. Because contributory liability under Rule 3502 is distinct from primary liability, aggregating individual liability for all types of violations would not contribute to an understanding of the PCAOB's historical application of Rule 3502. Column A in Table 1 focuses on contributory liability only and therefore more clearly illuminates the baseline of the PCAOB's use of Rule 3502 as currently formulated.

Another commenter suggested conducting a survey regarding the resulting internal impact of PCAOB enforcement proceedings at the firm level on associated individuals. While a well-designed survey may provide additional insights, we believe that staff analysis based on PCAOB enforcement activities provides a sufficiently reliable basis for assessing the need for and scope of the amendment to Rule 3502.[157]

B. Need

This section discusses the problem the amendment intends to address and how the amendment addresses the problem.

1. Problems to Be Addressed

The need for the amendment arises from a current gap in the PCAOB's regulatory framework. Specifically, as described in detail in Section III, the gap in the PCAOB's regulatory framework relates to a misalignment between the liability standard for firms that commit violations resulting from an associated person's conduct and the liability standard for the associated person who contributes directly and substantially to the firm's violation. Under the current formulation of Rule 3502, while firms can be held accountable by the PCAOB for violations due to negligence, individuals can be held liable for their contributory conduct only if their conduct was at least reckless, a more stringent standard than negligence. That is, Rule 3502's current formulation places negligent individual contributors to firms' violations beyond Rule 3502's reach.

The gap discussed above creates regulatory inefficiency and undermines the PCAOB's regulatory objectives, including furthering the public interest in the preparation of informative, accurate, and independent audit reports. Inefficiency arises under the current regulatory framework because the PCAOB cannot hold individuals accountable for negligent contributory conduct while the Commission can, and therefore the PCAOB would have to refer one part of a

[157] Further, the suggested survey would have shed light on firms' internal disciplinary measures taken against associated individuals, which, as discussed in Section VI.C below, are important but not equivalent in effect to public proceedings.

broader case to the Commission to take action (as it deems appropriate) against the negligent individual. If the Commission decided to move forward with a separate case against the individual, Commission staff may need to familiarize themselves with the case, potentially reinterview witnesses, and undertake (as needed) additional investigative steps. This could result in delays and, given that these activities would relate to substantially the same set of facts that the PCAOB is seeking to establish with respect to the firm, would render duplicative the PCAOB's prior work in these areas, thereby creating inefficiencies. Moreover, if the Commission chooses not to pursue the case (for example, due to resource constraints or competing priorities), the individual's negligent conduct may go unsanctioned.[158] This lack of individual accountability could hinder the effectiveness of the PCAOB's enforcement proceedings and may lead to under-deterrence among individuals within the industry, as they observe only the firm being penalized without consequences for the individuals responsible for the negligent conduct.

2. How the Amendment Addresses the Need

The amendment to Rule 3502 addresses the need by aligning the liability standards for firms and associated persons. It changes the liability standard for individual contributory conduct from recklessness to negligence. Doing so closes the regulatory gap described above and allows the Board to hold individuals accountable when they directly and substantially contribute to a firm's violation if their contributory act or failure to act was negligent but not reckless. By closing the gap, the amendment eliminates the obstacles in the public enforcement framework and helps improve regulatory efficiency.

The amendment does not result in a novel expansion of liability to reach conduct that is currently not subject to enforcement, as the Commission already has authority to discipline associated persons who negligently cause a firm's violation. Instead, it merely provides the PCAOB with the ability to hold individuals accountable similar to the Commission.

Some commenters agreed that the amendment would address the regulatory gap within the existing framework. However, other commenters challenged the need for the amendment. Some commenters asserted that the PCAOB already has tools for disciplining individuals and that the absence of Rule 3502 charges does not imply a lack of individual accountability. To be sure, the PCAOB currently has the authority to hold individuals accountable for violations of rules that contemplate individual responsibility, and the Board actively brings cases to hold individuals accountable for wrongdoing. But Rule 3502 is a distinct authority that creates and enforces a distinct obligation, and currently, the PCAOB is unable to

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158 *See, e.g.,* Samuel B. Bonsall IV, Eric R. Holzman & Brian P. Miller, *Wearing out the Watchdog: The Impact of SEC Case Backlog on the Formal Investigation Process,* 99 ACCT. REV. 81, 81 (2024) ("We find that higher office case backlog decreases the likelihood of an investigation into a restating firm. . . . Backlog also impacts pursued investigations, leading to more prolonged investigations, a lower Accounting and Auditing Enforcement Releases likelihood, and smaller SEC penalties. Our evidence suggests that busyness undermines the SEC's investigation process.").

hold individuals accountable under that rule when they act unreasonably but not recklessly. The amendment thus is not "duplicative," as some commenters suggested,[159] and our analysis therefore centers on the need to close this particular regulatory gap to give the PCAOB the appropriate tool for these sets of circumstances.

Other commenters asserted that the PCAOB's need was not sufficient to justify the amendment to Rule 3502 that these commenters considered profound, with its attendant costs and consequences. Certain of these commenters suggested that any change in auditor behavior that the PCAOB hopes to accomplish has already been accomplished by the Commission's ability to bring cases for negligent conduct, and that therefore the PCAOB has not shown a convincing need. As discussed in Section IV.C, the amendment to Rule 3502 is not a significant shift in the liability landscape. Rather, it allows the PCAOB to discipline associated persons for negligently contributing to firms' violations, which is misconduct that the Commission currently can pursue. We recognize, however, that this incremental increase in the PCAOB's enforcement capability may in turn generate certain incremental effects on auditor behavior, as discussed further in Section VI.C below.

Some commenters also asserted the absence of adequate evidence to support the need for the amendment. However, the comments received did not offer data that can be used to supplement the analysis meaningfully, and we are not aware of additional data or quantitative analysis that could be performed. Thus, as noted at the outset, we have performed limited quantitative analysis where possible but rely largely on qualitative analysis to inform this rulemaking.

One comment letter noted that the PCAOB's current inspection program is effective in enhancing audit quality, citing academic research to support that view.[160] While we acknowledge that the PCAOB's inspection program plays a vital role in enhancing audit quality, the PCAOB's enforcement program plays a distinct but complementary role in holding firms and associated persons accountable for violations, and thereby sanctioning and deterring unlawful conduct. The amendment aims to fill a gap in that latter program by helping to ensure that individuals negligently contributing to a firm's violations are held accountable and that the integrity of the audit process is strengthened. The continued persistence of a high rate of audit deficiencies also suggests that, while the inspections and enforcement processes may be

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[159] Comment Letter from U.S. Chamber of Commerce at 7; Comment Letter from Center for Audit Quality at 6.

[160] For example, the commenter cited Lindsay M. Johnson, Marsha B. Keune & Jennifer Winchel, *U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination*, 36 CONTEMP. ACCT. RES. 1540, 1557 (2019) ("Overall, participants described substantial modifications in their audit approach in response to inspection findings and the anticipation of inspections. These modifications are consistent with auditors and their firms actively working to comply with PCAOB expectations . . . ."). This behavioral study examined auditors' observations and behaviors in response to the PCAOB inspection process, focusing on factors such as perceived power and trust in the regulatory body.

effective at enhancing audit quality, as the commenter describes, additional efforts are needed, including through this rulemaking.[161]

In general, commenters did not introduce arguments or data that caused us to rethink our assessment of the need: there is a regulatory gap, the gap is small because the Commission already has the ability to bring negligence-based secondary-liability cases, but the gap can nonetheless result in regulatory inefficiencies or an incremental absence of deterrence and accountability, respectively. The amendment would close this gap, yielding the economic impacts discussed further below.

C. Economic Impacts

This section discusses the expected benefits and costs of the amendment and potential unintended consequences.

A critical component of our assessment of the economic impacts of this amendment is our assessment of the likely number of PCAOB enforcement cases that would be brought under the amended rule. For the Proposal, staff examined enforcement matters from 2022 to assess the potential increase in recommended cases had Rule 3502 included the proposed amendment. Staff estimated two to three instances in 2022 where the amendment could have prompted staff to recommend a Rule 3502 charge.[162] Staff also indicated that, based on its expertise, that number would be broadly consistent with other years.

For this release, staff updated its analysis to include an additional year (2023); for 2023, staff also believes that, had negligence been the standard in Rule 3502, two or three instances could have prompted staff to recommend a Rule 3502 charge.[163] We continue to note that this

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[161] *See, e.g.*, *PCAOB Report: Audits with Deficiencies Rose for Second Year in a Row to 40% in 2022* (July 25, 2023), *available at* https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-report-audits-with-deficiencies-rose-for-second-year-in-a-row-to-40-in-2022.

[162] *See* 2023 Proposing Release at 25. This is an estimate of cases in which staff would likely have recommended Rule 3502 charges against natural persons. Because Rule 3502 charges can be brought against associated persons, which include both natural persons and legal entities, it is possible that the estimate could be higher if it were to include potential additional cases against legal entities. However, due to the complexity of the fact patterns presented in such cases, staff could not estimate the number of additional cases that would have been brought against such entities. Additionally, although the Proposal's estimate included the second aspect of the Proposal, staff has confirmed that the estimate remains appropriate without that aspect.

[163] Staff were limited in the ability to perform further analysis given the intensively fact-specific nature of investigatory and charging decisions. Further, the availability (or unavailability) of potential charges can itself shape the investigatory process. Finally, determining whether all the available facts and circumstances would have supported a staff recommendation against an individual for negligent contributory conduct also depends on an intimate familiarity with the entire investigatory file as it

estimate may vary to the extent that there are modifications to other Board standards or changes in enforcement priorities.

This analysis influenced, and continues to influence, our assessment of the likely benefits, costs, and potential unintended consequences of the amendment—namely, that auditors are already held to a contributory negligence standard, that the change here is only adding the PCAOB as an enforcer, and that this change therefore would have meaningful but incremental benefits. As discussed further below, it would result in more efficient enforcement in specific cases, and it may prompt individuals to exercise the appropriate level of care and to make firms more efficiently allocate resources, which would raise audit quality. It would also have some incremental anticipated costs, and unintended consequences that parallel the anticipated costs, including litigation, liability, and opportunity costs, and potential inefficiencies in terms of self-protective behavior.

One commenter agreed with the Board's expectation that the economic impact will be modest while others challenged this analysis. They took issue with the estimate of only a few additional cases for 2022 resulting from the amendment, questioning the basis and relevance of this prediction. Based on extensive experience, staff believes that this number is a fair average representation across other years and provides an estimate of the additional cases resulting from the Board pursuing charges under the amendment. In fact, as discussed above, staff updated its analysis to include data from 2023 and that analysis generated an estimate of two to three additional cases in 2023, consistent with that for 2022. Overall, the estimation approach espoused here (with respect to both 2022 and 2023) applies expert judgment to the PCAOB's recent case data to offer a pragmatic perspective.[164]

Moreover, the PCAOB has existing authorities to bring charges against individuals—both for primary violations and for at least reckless contributory conduct;[165] the amendment therefore would close a gap regarding one particular type of conduct (negligent contributory

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pertains to that individual's conduct and the relevant standard of care. As recollections fade over time, a case-specific analysis of what charges could have been supported becomes less reliable. Other staff have moved to different roles within the PCAOB or departed the organization entirely. We therefore focused our analysis on the most recent time period where relevant staff members are available and their knowledge is the freshest, and then confirmed staff's view of whether it has any reason to believe that this time period would not be representative of the broader trend.

[164] An alternative approach would involve providing an upper bound of the number of cases, i.e., the total number of firm cases that were brought each year. This can be easily derived from Table 1. However, not every firm case would be associated with individual contributory liability, and some cases would involve individual primary liability too. Therefore, we declined to engage in this alternative approach and rather relied on staff's expertise in terms of providing a more pragmatic perspective on the additional number of cases under the amendment.

[165] Here, we agree with commenters who pointed out that the PCAOB has alternative means of bringing charges against individuals.

conduct) rather than supplanting these other forms of accountability. Staff's estimate of two to three additional cases thus appears objectively reasonable.

In terms of the potential variability in the future of other standards, including QC 1000 and AS 1000, commenters took issue with the uncertainty that poses. But standards and regulatory priorities are always evolving in a bid to keep pace with developments in the relevant environments (e.g., developments within the regulated industry, legal developments, etc.). Indeed, there could be benefits to amending Rule 3502 in tandem with other standards if it means that individuals, in determining how their registered firm should implement the new standards, are more sharply aware of the standard of care that is expected of them and can design their firm's implementation strategies accordingly. Moreover, if we assume that the number of Rule 3502 cases increases more significantly in the future because the facts and circumstances of those matters show that individuals are failing to act reasonably under newer PCAOB requirements, and thereby contributing to firms' violations of other standards, then we expect that both the benefits and costs of Rule 3502 would be higher.[166]

Some commenters posited that the amendment would represent a profound change in liability and have significant impacts on the profession and far-reaching unintended consequences. As previously discussed, the amendment does not effectuate a fundamental shift in the liability landscape, but rather aligns the PCAOB's secondary liability standard with that of the Commission. And thus, as discussed below, we have assessed that there would be recognizable but not significant benefits, or costs, attributable to enhanced compliance with other PCAOB rules and standards.

We have considered this discrepancy between commenters' assertions of the significance of the amendment and our analysis of the amendment's incremental effect. This discrepancy could be the result of unstated assumptions on commenters' parts:

- One possibility is that commenters are aware of (but do not acknowledge expressly) a more significant deficit in associated persons failing to act reasonably, which we have not detected through our oversight, such that there will be considerably more opportunities for enforcement under the amended rule than we have assumed in our analysis. In that case, we would expect to see more cases potentially being brought, with more benefits from enhanced compliance with PCAOB standards, and more costs from the actions that individuals would take to come into compliance and demonstrate the reasonableness of their actions if challenged.

- Another possibility is that commenters believe that the PCAOB would exercise its discretion under the amended rule irresponsibly—choosing to pursue cases against

[166] Conversely, if the number of additional cases declines over time due to changes in auditor behavior in response to the Rule 3502 enforcement risk, this may translate into an increase in benefits discussed in Section VI.C.1.

individuals over differences in reasonable judgments, or cases where an individual had only a remote connection to, or was responsible for only a small fraction of, the decision-making process that led to a firm's violation—and thus they believe that the unintended consequences (e.g., self-protective behaviors) would be more significant than staff estimates. We do not believe that commenters' concerns are warranted. As described, the Board intends to deploy its prosecutorial discretion responsibly, informed by the recommendations of its staff, and any sanctions imposed by the Board are subject to de novo review by the Commission,[167] all of which guides the Board's exercise of discretion in determining what matters to pursue.

We discuss these points in more detail below.

1. Benefits

This subsection presents the expected benefits of the amendment, particularly enhancements in regulatory efficiency and individual accountability, as well as positive impacts on capital markets. Several commenters agreed with our analysis, while others disagreed with certain aspects of our assessment of the benefits. We discuss these in more detail below.

One commenter asserted that the benefits discussion in the Economic Analysis section of the Proposal is high-level and lacks application of the specifics of the amendment. The benefits discussions—in the Proposal and in this release—however, touch upon a crucial aspect of the amendment, which involves expanding the PCAOB's enforcement authority to discipline associated persons for negligently contributing to violations of a firm. While the discussion may appear broad, it is intended to highlight the overarching benefits of this expansion, including enhancing individual accountability, strengthening investor protection, and promoting greater adherence to applicable laws, rules, and professional standards.

The following sections discuss regulatory efficiency and individual accountability and expected impacts on capital markets.

i. Regulatory Efficiency and Individual Accountability

The amendment can improve regulatory efficiency by enabling the PCAOB to bring a case involving negligence against a firm and the responsible relevant associated person(s), rather than referring part or all of the case to the Commission or charging only the firm. Under the status quo, the Commission (as well as other authorities such as a state board of accountancy), but not the PCAOB, can bring such cases. By contrast, the PCAOB can only

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[167] *See* Section 107(c) of Sarbanes-Oxley; *see also, e.g., S.W. Hatfield, C.P.A.*, SEC Release No. 34-69930, at 2-3.

sanction the firm and defer to the Commission to take action against the negligent individual (as the Commission deems appropriate).

By enabling the PCAOB to address violations by a firm and contributory violations by its associated persons concurrently, the amendment ensures that individuals who fail to meet their responsibilities with reasonable care are held accountable. This method of reinforcing individual accountability and facilitating improvement among practitioners elevates overall audit quality, benefiting both firms and investors by reducing the likelihood of negligent conduct.

a. Effects on Associated Persons

Enabling the PCAOB to hold individuals accountable can lead to more deterrence among all individual associated persons. Currently, individuals may act inappropriately if they discount the likelihood of public sanction because the PCAOB lacks the ability to bring charges for negligent contributory conduct, although they may not be able to avoid sanction by the Commission or private sanction by their firms. However, the imposition of a firm's disciplinary action against individuals depends on the detection and investigation of the individuals' misconduct. Detection, in turn, may depend on the frequency and efficacy of external review processes, e.g., PCAOB inspections. Additionally, without a noncompete agreement, a firm cannot prevent a partner from associating with a different registered public accounting firm and performing issuer or broker-dealer audit work, or from becoming employed by an issuer or broker-dealer in an accountancy or financial management capacity; in contrast, a PCAOB sanction may do so.[168] Finally, a firm cannot suspend an individual's CPA license, but a PCAOB sanction can lead to collateral consequences with relevant state accountancy authorities.[169]

Because of the reasons discussed above, adding the PCAOB as an additional enforcer may increase auditors' perception that negligent conduct may be detected, investigated, and effectively sanctioned; doing so therefore can provide additional deterrence against misconduct, even though the risk of liability resulting from the additional deterrence is not a

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168 *See* Section 105(c)(7) of Sarbanes-Oxley.

169 *See, e.g.*, N.Y. State Rules of the Board of Regents § 29.10(f); *see also* Section 105(d)(1) of Sarbanes-Oxley (requiring the Board to report disciplinary sanctions it imposes to, among others, "any appropriate State regulatory authority or any foreign accountancy licensing board with which [a sanctioned] firm or person is licensed or certified").

Also, a firm may expel a partner, but such an action is unlikely to be public (e.g., a private settlement may contain nondisclosure and antidisparagement clauses) and thereby is less likely to be an effective deterrent to associated persons of other firms as compared to a public sanction. Similarly, a firm may be able to inflict a private financial penalty (e.g., through a claw-back or forfeiture of paid-in capital or deferred compensation). However, a firm may not have effective provisions in its partnership agreements or may view enforcing those clauses as uneconomical if forced to litigate them as a contractual dispute.

large one insofar as the Commission currently has the authority to discipline associated persons for negligently causing a firm's violations. Academic literature also suggests that public authorities' sanctioning tools (e.g., public censure, fines, associational prohibitions) deter future misconduct more effectively than private reprimands by a firm.[170]

By increasing individual accountability and the potential for liability, the amendment can provide incremental deterrence against future violations and, hence, enhance incentives for individuals to perform important roles with reasonable care. Individuals that exercise reasonable care, in turn, may contribute to better compliance practices in their firms. This change is expected to lead to more diligent adherence to professional standards. In fact, in support of the amendment, one commenter contended that the heightened level of deterrence would reduce the risk of substandard audits by encouraging auditors to adhere to professional standards and regulations to avoid liability.

The amendment's effect as a deterrent to auditor misconduct generated different viewpoints from commenters. Some commenters indicated that reducing the liability threshold from recklessness to negligence would deter misconduct, lead to more careful work by auditors, and enhance audit quality. These commenters also indicated the proposed change in liability would boost public confidence, increase investors' confidence in financial statements, and strengthen the financial markets. One commenter suggested that improvements in audit quality will reduce financial misstatements and omissions as well as auditor litigation risk and costs to investors resulting from such litigation. This is consistent with our analysis presented here.

By providing incremental deterrence and, hence, enhancing individual auditors' incentives in the performance of their audits, the amendment can improve audit quality. Academic literature suggests that auditors' incentives to perform high-quality audits can increase with greater enforcement.[171] Furthermore, in general, academic research provides

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[170] *See, e.g.*, John T. Scholz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253, 265 (1997). Scholz states:

> When corporations have the means of punishing subordinates for illegal behavior, punishing the corporation rather than individuals responsible for wrongdoing may serve to strengthen the corporation's private enforcement system. Criminal prosecution of individuals will be necessary, however, whenever the potential gains to the individual from illegal behavior far exceed the worst punishment the firm could impose.

See also Michelle Hanlon & Nemit Shroff, *Insights Into Auditor Public Oversight Boards: Whether, How, and Why They "Work",* 74 J. ACCT. & ECON. 1, 4 (2022) ("We find that the majority of respondents think that POB [Public Oversight Board] inspectors have greater authority (enforcement options) than peer-reviewers and that the culture at POBs is more conducive to detecting auditing deficiencies.").

[171] *See, e.g.,* Ralf Ewert & Alfred Wagenhofer, *Effects of Increasing Enforcement on Financial Reporting Quality and Audit Quality*, 57 J. ACCT. RES. 121, 123 (2019) ("Our main finding is that auditing

evidence that enforcement proceedings have a deterrent effect[172] and can potentially improve audit quality of non-sanctioned entities that are aware of sanctions imposed on others.[173] Other related literature also discusses the role of regulation in providing auditors with incentives for improving audit quality.[174]

By contrast, one commenter asserted the amendment does not deter conduct because penalties are not an effective method to deter one-time mistakes, inadvertence, and errors in judgement. Another commenter expressed a concern that the PCAOB did not explain how the amendment would result in Rule 3502 becoming a more effective deterrent than the current formulation of Rule 3502. Other commenters expressed skepticism that the amendment will incentivize individuals or change behavior. One commenter expressed concern that the amendment may not incentivize the negligent or reckless auditors as intended because those individuals may be the least risk averse. We considered these commenters' perspectives as well as academic research noted above that suggests enforcement proceedings have a deterrent effect.[175] We believe that there is sufficient support for our belief that the amendment would enhance deterrence (albeit incrementally) and that the deterrence would lead to benefits.

One commenter stated that the Proposal implied that "the discipline imposed by a firm (whether financial penalty or even expulsion) is less likely to be an effective deterrent to

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and enforcement are complements in a low-intensity enforcement regime but can become substitutes in a strong regime. The auditor's incentives to perform a high-quality audit increase with greater enforcement because the expected penalty rises, and they decrease with lower anticipated earnings management.").

[172] *See* Robert H. Davidson & Christo Pirinsky, *The Deterrent Effect of Insider Trading Enforcement Actions,* 97 ACCT. REV. 227, 227 (2022) ("Insiders who have witnessed [a Commission] enforcement action have a lower probability for future conviction than their unexposed peers.").

[173] *See, e.g.,* Phillip Lamoreaux, Michael Mowchan & Wei Zhang*, Does Public Company Accounting Oversight Board Regulatory Enforcement Deter Low-Quality Audits?* 98 ACCT. REV. 335, 339 (2023) ("We find that audit firm responses to PCAOB enforcement only occur following sanctions of like-sized firms. That is, small firm responses only follow sanctions of small firms and large firm responses only follow sanctions of large firms. Specifically, following the PCAOB sanction of a small audit firm, the likelihood of misstatement is 2.2 percentage points lower for clients of competing non-sanctioned small audit firm offices in the same [Metropolitan Statistical Area]. In contrast, following PCAOB sanctions of a large audit firm, the likelihood of misstatements decreases by 2.6 percentage points for clients of non-sanctioned audit offices within the sanctioned audit firm.").

[174] *See, e.g.*, A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19, 19 (2006) ("Audit quality is promoted by three incentives: reputation, regulation, and litigation.").

[175] *See, e.g.,* Ralf Ewert & Alfred Wagenhofer, *Effects of Increasing Enforcement*; Robert H. Davidson & Christo Pirinsky, *The Deterrent Effect of Insider Trading Enforcement Actions*; Lamoreaux, et al., *Does Public Company Accounting Oversight Board Regulatory Enforcement Deter Low-Quality Audits?*

others'" misconduct compared to public sanction, but that there was a lack of evidence in the Proposal to support such a claim.[176] Unlike internal disciplinary measures, public sanctions are visible to everyone, including potential clients and employers.[177] This public visibility may result in all associated individuals exercising greater care while carrying out their responsibilities. Therefore, as discussed in more detail above, we believe that public discipline can enhance the deterrence effect beyond what internal discipline can achieve, making it a key tool for enforcing accountability and upholding high standards in the audit profession.[178]

b. Effects on Firms

Some firms choose to invest in staffing and resources voluntarily to comply better with regulatory requirements. Yet, competitive pressures from other firms that prefer not to make similar investments may lead these firms to reconsider their investment decisions. With the amendment, however, all firms lacking adequate staffing and resources would now face enhanced possibility of sanctions of their associated persons, prompting them to make additional investments. This change is expected to improve audit quality by counteracting underinvestment of staffing and resources, thereby reducing noncompliance by audit firms. This collective uplift mitigates any single firm's competitive concerns and promotes broader

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[176] Comment Letter from National Association of State Boards of Accountancy at 2 (Oct. 24, 2023). Another commenter expressed that the firm's approach to prevent and respond to instances of negligence in response to inspection findings may impact the individual more, as the firm's actions may more directly dictate an individual's future. But as we discussed in Section VI.B.2, while we acknowledge that the PCAOB's inspection program plays a vital role in enhancing audit quality, the PCAOB's enforcement program plays a distinct but complementary role in holding firms and associated persons accountable for violations, and thereby punishing and deterring unlawful conduct. In other words, there is a distinction to be made between firm's quality control and private sanctions deterring misconduct.

[177] On one hand, if a person receiving a private sanction remains an associated person of the same firm, such a firm may have incentives (e.g., to win new business or keep existing business) not to disclose the private sanction to clients, prospective clients, or the public, or may have agreed not to do so. On the other hand, if a person receiving a private sanction leaves the firm, whether as part of the sanction or voluntarily, and then seeks, for example, to join a new firm (or an issuer or broker-dealer in an accountancy or financial management capacity), the prior firm might not disclose details about the sanction to the new prospective firm or employer, whether per nondisclosure or anti-disparagement provisions or as a matter of general policy.

Furthermore, the sufficiency of private sanctions is hard to square with the PCAOB's authority to discipline *formerly* associated persons of firms, as provided by Section 929F of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Section 2(a)(9)(C) of Sarbanes-Oxley. If a private sanction (i.e., expelling the associated person from the firm) were sufficient, Congress presumably would not have given to the PCAOB the power to impose a public sanction against an individual who is no longer associated with a registered firm.

[178] *See, e.g.*, Scholz, *Enforcement Policy and Corporate Misconduct* 265.

societal benefits by fostering a more robust and reliable compliance environment resulting in improved overall audit quality.

Individual auditors, perceiving greater litigation and liability risks, are likely to change their behavior and take their professional responsibilities more seriously, ensuring that their actions are objectively reasonable under the circumstances. This shift in individual behavior can lead to greater compliance by firms with their respective legal requirements, including auditing standards, quality control standards, and ethics and independence standards, which were enacted to promote audit quality and investor interests. In other words, by preventing individual negligence, the amendment can also mitigate firm negligence, as individuals' actions directly impact firm actions, such as implementing better quality control systems.[179] One commenter agreed that the amendment will result in firms being more likely to comply with their respective legal requirements.

ii. Capital Market Impact

As explained above, the amendment can introduce an incremental deterrent effect, which could lead to improvements in audit quality. Increased audit quality can improve financial reporting quality and enhance investors' confidence in the information provided in companies' financial statements. Because auditors have a responsibility to provide reasonable assurance about whether the financial statements are free of material misstatement, higher audit quality could increase the likelihood that the auditor would discover a material misstatement or would qualify its audit opinion when a material misstatement exists and is not corrected by management. If a Commission registrant were to include such a qualified audit opinion in a filing with the Commission, then Commission staff may deem the registrant's filing to be deficient.[180] Furthermore, a qualified audit opinion may evoke negative market reactions. For these reasons, higher audit quality could incentivize issuers to take steps to ensure their financial statements are free of material misstatement. Issuers could take these steps proactively, prior to the audit, or in response to adjustments requested by the auditor.

Financial statements that are free of material misstatement are of higher quality and more useful to investors. In particular, more reliable financial information allows investors to improve the efficiency of their capital allocation decisions. Investors may also perceive less risk

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[179] Quality control systems play a fundamental and widespread role in overall audit quality. These systems are essential in ensuring the audit process adheres to professional standards. A robust quality control system can help firms to detect and address factors that compromise audit quality.

[180] *See* Article 2 of Regulation S-X, 17 C.F.R. § 210; *see also Financial Reporting Manual* § 4220, Division of Corporation Finance, SEC, *available at* https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

in capital markets generally, leading to an increase in the supply of capital.[181] An increase in the supply of capital could increase capital formation while also reducing the cost of capital to companies.[182] A reduction in the cost of capital reflects a welfare gain because it implies investors perceive less risk in the capital markets.

Commenters agreed that the amendment will enhance investors' confidence both in audits and in the information provided in companies' financial statements, as well as have an incremental positive effect on capital-market efficiency.

2. Costs

This section discusses the expected costs of the amendment. Because the amendment is expected to lead to an increase in the number of enforcement cases by the PCAOB, we discuss costs to firms and individuals, and costs to issuers.

Our assessment of the degree of the anticipated costs is affected by our estimate of the number of additional cases to be brought, as discussed at the outset of this section. As discussed there, the amendment is expected to result in a slight increase in the number of PCAOB enforcement cases (two to three per year) due to the changed liability threshold. Any additional cases due to the amendment will involve legal costs, which could result in substantial costs for the firms and individuals involved. Staff could not provide an estimate for the per-case cost; however, the small number of incremental cases could limit the aggregate cost of the amendment, in particular, when the total number of issuers and broker-dealers is taken into account.

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[181] *See, e.g.,* Hanwen Chen, Jeff Zeyun Chen, Gerald J. Lobo & Yanyan Wang, *Effects of Audit Quality on Earnings Management and Cost of Equity Capital: Evidence from China*, 28 CONTEMP. ACCT. RES. 892 (2011); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. ACCT. RES. 385 (2007).

[182] Cost of capital is the rate of return investors require to compensate them for the lost opportunity to deploy their capital elsewhere. Equivalently, cost of capital is the discount rate investors apply to future cash flows. Cost of capital depends on, among other factors, the riskiness of the underlying investment. Accordingly, the rate of return required by equity holders—cost of equity capital—and the rate of return required by debt holders—cost of debt capital—may differ to the extent equity and debt securities expose investors to different levels of risks. For theoretical discussion on the link between the greater availability of information to investors and cost of capital, see, for example, Richard A. Lambert, Christian Leuz & Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 REV. FIN. 1, 16-18 (2012); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1571 (2005); and William Robert Scott & Patricia C. O'Brien, *Financial Accounting Theory* 412 (Prentice Hall 3d ed. 2003).

i. Costs to Firms and Individuals

With the anticipated increase of enforcement proceedings of two to three per year, certain firms will incur direct and indirect costs with respect to those proceedings as a result of the amendment. These costs include legal costs and broader financial and operational impacts.

Direct costs include increased hours and resources (including attorneys, experts, and other personnel) to prepare for, respond to, and defend against investigations and charges—actual or anticipated. The Board expects that, in most cases, the costs of defending associated persons who have negligently contributed to a firm's violation will be borne by the firm.[183] The direct defense costs can be grouped into two categories based on the stage of the matter:

- First, during the investigative stage, staff works to determine whether it is likely that a primary violation occurred and if so, whether an individual directly and substantially contributed to the violation. Because this inquiry already takes place (albeit to determine whether someone acted recklessly rather than negligently), the incremental resource cost to firms at the investigative stage will not be significant.

- Second, staff works to determine whether the individual acted negligently and notifies the potential respondent of that determination. After this point, the direct costs of the amendment to firms may increase more significantly.[184] Staff lacks sufficient data to reliably estimate the costs of each matter because the costs depend on numerous factors, including the duration of the matter,[185] the

[183] That is, we believe that the firm would have advancement and indemnification agreements in place with relevant firm personnel. In certain circumstances, it is possible that an individual respondent that is found liable would have to reimburse the firm (or the firm's insurer) for defense costs, but the extent and nature of that obligation depends on the facts and circumstances as applicable to the terms and conditions of the indemnification and insurance agreements.

[184] One commenter expressed concern that the PCAOB's investigations and enforcement could become at least marginally more costly given enforcement requirements of the negligence criteria. We agree; there could be incremental costs to the PCAOB of pursuing negligence-based cases. We expect these would be generally proportional to the costs discussed above for potential individual respondents (e.g., both sides may need to hire expert witnesses to litigate whether conduct met the standard of care). Another comment letter expressed doubt that the firm would cover an individual's defense costs if the individual chose to mount a defense that involved attributing responsibility to the firm. We believe that in these circumstances, it is more likely that the firm would nonetheless have to continue abiding by its advancement and indemnification obligations, but that the firm might then have to retain separate counsel for the individual, which would increase the overall costs as discussed (given an increase in complexity and number of counsel).

[185] As set out in the PCAOB rules, a PCAOB enforcement case has numerous stages where the proceedings might halt. For example, a persuasive Rule 5109(d) submission may convince the staff not to

complexity of the matter (e.g., a complex audit case versus a simpler case of noncompliance with PCAOB filing requirements), the number and nature of counsel and expert witnesses retained, and so forth.[186]

Apart from these direct defense costs, if the individual is adjudicated as having acted negligently and a sanction is imposed, the individual would incur potential financial costs of having been found liable for failing to act with reasonable care and thereby contributing to the firm's violation. To the extent that there are civil money penalties, they would be assessed against the individual.[187]

A firm that has indemnification agreements in place that would compel it to bear the financial burden of defending or indemnifying associated persons may choose to purchase insurance to help alleviate the contingent financial burden. If so, it would have to buy insurance in the market, and the pricing of such insurance may depend on the risks of loss identified by the underwriting process. Or a firm may self-insure against such liabilities, in which case the amount held in reserve or reinsurance may vary based on anticipated losses.

There may also be opportunity costs as enforcement proceedings distract individuals from their everyday responsibilities. The opportunity costs relate to diversion from engagement tasks and other work.

Further, an individual may incur reputational costs, such as adverse employment or career events. Commenters asserted that the effects of the Proposal would include causing harm to individuals' careers (e.g., by being removed from issuer client service roles or being demoted) and collateral consequences (e.g., follow-on proceedings by state boards of accountancy or disciplinary measures by other regulators) consistent with having been found to have violated the Board's standards, and hence the federal securities laws. We agree and recognize that these costs could exist in any proceeding brought under the amendment.[188]

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recommend proceedings; the Board may determine not to institute proceedings under Rule 5200; the Hearing Officer might dismiss the matter; the matter might end with a Hearing Officer's initial decision; or the initial decision might be appealed to the Board, the Commission, or the courts. The longer the litigation, the greater the costs (e.g., attorney fees, expert witness fees, and opportunity costs).

[186] These factors make it impracticable to construct a quantitative estimate of the anticipated cost—there is no "typical" case that we could use to construct an estimate that would be extensible across the two to three cases per year anticipated here. While we requested information about costs, including relevant data, commenters did not provide specific data about defense costs that would permit us to construct a quantified estimate. Our analysis therefore continues to be qualitative in nature.

[187] If not foreclosed from doing so, individuals might seek to have their firm bear these financial costs pursuant to indemnification agreements, insurance agreements, or otherwise. However, such agreements or arrangements might not cover civil money penalties.

[188] *See* Krishnan, et al., *supra* footnote 77.

While the Board may consider the relevant facts and circumstances in determining the sanction it believes appropriate in the public interest, we recognize that additional consequences beyond the sanctions imposed in the case frequently occur. We acknowledge that these consequences could be significant to the individual against whom they are imposed. However, we also believe that these consequences would not be significant in the aggregate, taking into account the number of associated persons across all registered firms and in light of the anticipated number of additional proceedings likely to be brought as a result of the amendment.

Certain commenters raised concerns about the potential increase in legal costs for firms. In particular, they noted the increased legal liability that associated persons might face under the amendment, which may result in higher costs of firms defending their associated persons and liability insurance for firms. Other commenters voiced concerns about the potential for increased state-level investigations and disciplinary proceedings against individuals, which could lead to the suspension or revocation of professional licenses. However, another commenter asserted the amendment's contributory negligence standard would better align the PCAOB's liability approach with the majority of the states' liability approach, which does not limit individual liability for negligent conduct.

We agree that the amendment could increase legal and liability insurance costs, as well as the number of state investigations. Those incremental costs, however, would not be significant based on the two to three additional cases expected per year.

Several commenters highlighted that the amendment could significantly increase audit firms' litigation risk and legal liability for small firms. They indicated that increased costs, encompassing defense expenditures and opportunity costs, are expected to disproportionately affect small firms, which may lack the resources and market influence to offset these expenses. The commenters cautioned that small firms with a limited capacity to absorb these costs or demand higher fees could face significant challenges.

The Board acknowledges that litigation risk and legal liability involve costs, and those costs may have a greater impact on small firms, where direct costs and distractions are less absorbable by firms' other activities or personnel. For example, small firms are especially vulnerable to increases in legal costs, as small firms may disproportionately bear the burden of insuring against the risk. However, we believe certain features of the market and this amendment would limit these effects.

First, smaller firms typically have simpler supervisory structures that may make it easier for these firms to supervise their partners to help to ensure that partners are acting with reasonable care.[189] They also may be less impacted by the concern raised by other commenters

[189] We acknowledge that smaller firms may have fewer resources to invest in dedicated supervisory structures. However, given that their respective QC systems oversee a smaller number of engagements,

that responsibility for firm compliance could be divided up among many individuals, with accountability for any one act of negligence being more difficult to establish. Second, in assessing insurance costs, we distinguish between market-wide effects (i.e., a market-wide increase in directors & officers or professional liability coverage) and specific-firm effects (i.e., a specific firm experiencing an increase in the cost of insurance if it has a specific claim brought against its associated persons). We believe the market-wide effects are likely to be smaller: Again, the Commission already has the authority to bring negligence-based cases, and the staff has estimated that the amendment would result in an average of two to three more cases per year. We believe it less likely that the amendment or resulting incremental claims experience would cause a significant shift in underwriters' perception of risk and thus the availability or pricing of insurance for smaller firms in general. However, we acknowledge that the impact on a specific firm that is involved in a specific matter could be more significant; an increase in its individual claims experience could cause an increase in the cost of coverage and/or retention amounts in the future or make it more difficult to secure acceptable coverage.

In addition to the direct costs described above, the amendment could result in indirect costs as individuals adjust their behavior and put forth additional effort to ensure they do not contribute to a firm's violation through their negligence. However, to the extent that these indirect costs are incurred to bring previously negligent conduct up to a level of reasonable care, these costs are properly allocable to the underlying law, rule, or standard that the firm is alleged to have violated, as those provisions each assume a level of costs necessary for the firm to comply.

One commenter expressed concerns about a requirement in the Proposal that involves the application of "directly and substantially" only to the sufficiency of the connection between an associated person's conduct and a firm's violation. The commenter asserted that this is an important change from the present rule, under which an alleged violator must know (or recklessly not know) not only that they are contributing to a violation, but also that the contribution is direct and substantial. We note that our analysis, which includes staff estimate of two to three additional cases per year based on the Proposal, takes into account the application of "directly and substantially" only on the sufficiency of the connection between the associated person's conduct and a firm's violation. We do not believe that this change would be a significant driver of costs to individuals or firms in the aggregate.[190]

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the same level of resources may not be necessary for the firm to nonetheless obtain reasonable assurance that their personnel comply with applicable professional standards and regulatory requirements.

[190] Nor would it be a significant contributor to costs in particular cases; indeed, it might save costs by avoiding effort seeking to establish the reasonableness of the individual's belief as to the directness and substantialness of the participation or lack thereof where a direct and substantial connection in fact has already been established.

ii. Cost to Issuers (Audit Fees)

To the extent that firms pass on some of the costs to their audit clients, the amendment could result in audit fee increases to cover firms' compliance costs related to the amendment. Consistent with this notion, academic studies find that increased enforcement intensity can lead to temporary increases in audit fees for some issuers.[191] Further academic research provides evidence that audit fees increase with the auditor's assessment of business risk, which includes risk of regulatory sanctions, among others.[192] The findings indicate that the increases in audit fees are due to the increase in the number of audit hours, but not hourly rates.

3. Potential Unintended Consequences

The following discussion describes potential unintended consequences that the Board considered and, where applicable, factors that mitigate the adverse effects, such as the steps we have taken or the existence of countervailing forces.

i. Self-Protective Behavior

We recognized in the Proposal that auditors might engage in self-protective behavior.[193] Specifically, while the threat of enforcement action can motivate individuals to act in a manner consistent with their legal obligations, it can also result in excessive monitoring and self-protective behavior, leading to an inefficient allocation of time and resources. The effect on audit quality may change as the degree of intervention increases. Individuals may spend more time on a task than is necessary to accomplish it at the appropriate level of care. Similarly, individuals may excessively document the nature of their task performance to demonstrate compliance in a future proceeding. Time spent on unproductive, self-protective activities may detract from other important obligations and directly impact audit quality.

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[191] Annita Florou, Serena Morricone & Peter F. Pope, *Proactive Financial Reporting Enforcement: Audit Fees and Financial Reporting Quality Effects*, 95 ACCT. REV. 167, 167 (2020) ("We examine the costs and benefits of proactive financial reporting enforcement by the U.K. Financial Reporting Review Panel. Enforcement scrutiny is selective and varies by sector and over time, yet can be anticipated by auditors and companies. We find evidence that increased enforcement intensity leads to temporary increases in audit fees and more conservative accruals. However, cross-sectional analysis across market segments reveals that audit fees increase primarily in the less-regulated AIM segment, and especially those AIM companies with a higher likelihood of financial distress and less stringent governance. On the contrary, less reliable operating asset-related accruals are more conservative in the Main segment and, in particular, those Main companies with stronger incentives for higher financial reporting quality. Overall, our study indicates that financial reporting enforcement generates costs and benefits, but not always for the same companies.").

[192] *See, e.g.,* Timothy B. Bell, Wayne R. Landsman & Douglas A. Shackelford, *Auditors' Perceived Business Risk and Audit Fees: Analysis and Evidence*, 39 J. ACCT. RES. 35 (2001).

[193] *See* 2023 Proposing Release at 26.

Many commenters echoed this concern and emphasized the potential significance of this issue, including that its effects may discourage effective collaboration between and among accountants, especially in complex audits. Some of these commenters expressed concern that moving to a negligence standard for contributory liability would lead to sanctions of professionals who make judgments in good faith. A few commenters asserted that emphasizing every error an auditor makes will encourage auditors to focus on defensive auditing—which could result in a decrease in audit quality. These commenters' concerns center on the prospect that increased liability risk could lead auditors to prioritize self-protective measures (e.g., overemphasizing compliance documentation) and excessive monitoring over more important audit tasks, particularly in small- and mid-sized firms with limited resources. Another comment letter raised concerns about the impact of coercive enforcement strategies on audit practices, suggesting that such strategies could lead to defensive behaviors rather than genuine quality improvements.

The Board notes that the compliance and documentation requirements in applicable professional standards are designed to sufficiently demonstrate compliance, thus mitigating the need for excessive, unproductive documentation.[194] Furthermore, the possibility of such self-protective behavior is not new. As discussed above, the Commission currently can initiate enforcement proceedings against individuals for negligent contributory conduct.[195] And, as commenters have pointed out, the PCAOB currently possesses a robust enforcement regime covering negligent primary conduct. Therefore, the risk of litigation and sanctions is already a factor in the current regulatory environment, driving the existing need for individuals to act with reasonable care and to be able to demonstrate their compliance. Thus, while we acknowledge some inefficient behavior could result from the amendment, consistent with the incremental increase in deterrence that we posit above, we continue to believe that the likelihood that the amendment would drive significant increases in self-protective behavior is low.

ii. Lack of Available Personnel or Compensation Enhancements

As recognized in the Proposal, excessive risk of enforcement action could unintentionally discourage auditors from accepting important audit roles if they fear being held liable, leaving these roles to be accepted by less cautious or less qualified individuals.[196] Alternatively, auditors may seek to offset the increased risk by demanding higher compensation for taking certain roles or responsibilities, which could have downstream effects on audit fees.

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194 *See, e.g.,* AS 1215, *Audit Documentation*.

195 Also, as discussed in Section IV.D.2., the AICPA's Code of Professional Conduct makes certain negligent contributory acts by individuals an "act discreditable to the profession." *See* AICPA Code of Professional Conduct, ET § 501.05(a), *Negligence in the Preparation of Financial Statements or Records*, *recodified at* Section 1.400.040.01.

196 *See* 2023 Proposing Release at 26.

Many commenters remarked about the amendment's potential negative impact on the accounting and audit workforce. These commenters highlighted an existing "talent crisis," especially affecting small- and mid-sized firms. They noted that the amendment's threshold for sanctionable conduct and resulting increased liability risks could intensify the crisis. The commenters contended that the amendment might discourage talented individuals at various career stages from engaging in PCAOB-regulated work, potentially leading to lower audit quality, higher fees, and public company delisting. The commenters identified fear of punitive action and a culture of defensive auditing as factors that could deter newcomers from entering the profession and prompt experienced auditors to leave, further jeopardizing the talent pipeline. In addition, the commenters argued that the amendment would affect the on-the-job nature of auditors' learning. Many of the same commenters also raised concerns that a shift to a negligence standard might discourage experienced auditors from accepting essential roles due to the fear of increased liability for good faith judgments. According to these commenters, a negligence standard could dissuade risk-averse and diligent professionals integral to a firm's quality control system, thus affecting auditors' development, training, and monitoring. One commenter added that this amendment in combination with other recent proposed standards may exacerbate the talent crisis problem.

Some commenters cited literature to support their concerns that there has been a steady decline in the number of accounting graduates and that this is partly due to the regulatory environment making the profession unappealing.[197] While the cited studies indicate a decline in the number of accounting graduates and professionals or a waning interest in the accounting profession, they do not expressly point out regulatory oversight as a reason for the decline. Rather, according to one of these studies, the 150 CPA credit hour requirement as well as relatively low starting salaries are the two main reasons for not choosing accounting as a major among college students who considered accounting.[198]

The Board acknowledges the commenters' concerns about the amendment's potential impact on auditing personnel. However, the lack of available auditing personnel is likely the result of the interplay between numerous factors in the labor market. On the supply side, a notable decline in the number of entry-level auditors, as evidenced by a significant decrease in

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[197] *See* Association of International Certified Professional Accountants, *2023 Trends Report* (2023), *available at* https://www.aicpa-cima.com/professional-insights/download/2023-trends-report; *see also* Center for Audit Quality and Edge Research, *Increasing Diversity in the Accounting Profession Pipeline: Challenges and Opportunities* (2023) ("CAQ–Edge Report"), *available at* https://thecaqprod.wpengine powered.com/wp-content/uploads/2023/07/caq_increasing-diversity-in-the-accounting-profession-pipeline_2023-07.pdf.

[198] *See* CAQ–Edge Report at 7; *see also* Daniel Aobdia, Qin Li, Ke Na & Hong Wu, *The Influence of Labor Market Power in the Audit Profession,* Social Science Research Network (SSRN) (2024), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4732093 ("[W]e confirm that audit offices in more concentrated labor markets have greater labor market power and exercise it in the form of higher skill requirements and greater required effort from their auditors, at similar or slightly lower wages.").

the number of new CPA candidates, suggests a waning interest among entry-level professionals in auditing careers.[199] A study found that for graduates who have already completed the 150 CPA credit hour requirement, finding the time to study for the CPA exam and the overall rigor of the exam are the most significant challenges to licensure.[200] Other contributing factors may include the retirement of baby boomers and a lack of diversity in the profession.[201]

On the demand side, as the economy grows, businesses evolve, and more companies go public, the demand for auditors will increase.[202] Furthermore, technological advancements and the integration of digital tools into business processes have created a need for auditors with expertise in cybersecurity, blockchain, and data analytics.[203] Taking into account the current state of supply of and demand for auditors, attracting talent likely would depend primarily on factors under firms' control, such as auditor compensation, especially given that college students have cited low starting salary as one of the main hurdles to choosing accounting as a major.

Thus, while we acknowledge the potential for this amendment to affect the market for audit services, we disagree with commenters' assessment of the magnitude of these risks. First, we continue to believe that we are not establishing a novel burden on individuals to refrain from acting negligently and thereby contributing to a firm's violation; instead, we are

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199 According to the *2023 Trends Report*, the number of new CPA candidates decreased from 48,004 in 2016 to 30,251 in 2022.

200 *See* CAQ–Edge Report at 15.

201 *See* Drew Niehaus, *Fixing the Crisis in Accounting: Five Steps to Attracting Tomorrow's CPAs*, CPA JOURNAL (Nov. 2022), and Mark Maurer, *Job Security Isn't Enough to Keep Many Accountants from Quitting*, WALL ST. J. (Sept. 22, 2023), *available at* https://www.wsj.com/articles/accounting-quit-job-security-675fc28f.

202 *See* Bureau of Labor Statistics, *Occupational Outlook Handbook: Accountants and Auditors, available at* https://www.bls.gov/ooh/business-and-financial/accountants-and-auditors.htm#tab-6 ("In general, employment growth of accountants and auditors is expected to be closely tied to the health of the overall economy. As the economy grows, these workers will continue being needed to prepare and examine financial records. In addition, as more companies go public, there will be greater need for public accountants to handle the legally required financial documentation. The continued globalization of business may lead to increased demand for accounting expertise and services related to international trade and international mergers and acquisitions.").

203 *See, e.g.,* Najoura Elommal & Riadh Manita, *How Blockchain Innovation Could Affect the Audit Profession: A Qualitative Study,* 37 J. INNOVATION ECON. & MGMT. 37, 38 (2022) ("According to Alles (2015), the use of advanced technologies and blockchain by audit clients would be the catalyst for the adoption of these technologies by auditors. Blockchain, associated with other digital technologies, could change the audit process by modifying the way in which the auditor accesses data, collects evidence, and analyzes data (Rozario, Thomas, 2019). Auditors have the choice only to integrate these technologies and to change their organization and their process at the risk of losing their legitimacy in the audit market.").

merely providing a mechanism for the PCAOB to discipline individuals who fail to meet that standard. The effect is, therefore, the incremental probability of PCAOB enforcement. However, this increased probability is not so novel and significant that it would be expected to impact noticeably the market for associated persons' services. Second, firms have a tool at their disposal—adjusting compensation—that could tend to increase the supply of these services as needed, although there may be short-term displacements. The increased cost of labor may be absorbed by firms or passed to issuers and investors through increased audit fees.

iii. Reduced Competition in the Audit Market

The amendment to Rule 3502 could disproportionately impact small- and medium-sized firms if they are less able to bear the cost of defending their personnel. As discussed in Section VI.C.2, these costs include attorney fees to defend associated persons against charges and distracting personnel from generating income from the performance of client services. In an extreme case, a firm might not be able to sustain its practice considering the negative impact; more broadly, less profitable firms may perceive that the risk of such costs is too significant compared to their existing net profit from issuer and broker-dealer audit work and, therefore, decide to exit those markets. This result could further consolidate the market for issuer and broker-dealer audit services.

Several commenters asserted that the amendment could reduce competition in the audit market. They noted that the increase in liability could discourage firms, especially non-U.S. firms, from participating in U.S. issuer and broker-dealer audits. One commenter argued that the amendment "may inadvertently create barriers" for smaller firms and those servicing emerging industries by elevating the risk profile of conducting audits.[204] Another commenter asserted that there has been a decline in PCAOB-registered firms auditing issuers and broker-dealers due to regulatory burdens.

The likelihood that defense costs cause substantial changes in the relevant markets is lowered by three factors. First, a firm may already defend against an allegation of negligent primary conduct (brought using the PCAOB's current authority) such that, in any additional cases brought under the amended rule, defending individuals facing a charge of negligent contributory conduct would likely involve common sets of facts and legal theories and could be done more efficiently (i.e., at lower additional cost) as compared to a wholly novel proceeding. Second, a firm may already defend an individual against an allegation of primary violations, involving common sets of facts and legal theories related to an allegation against a firm. Third, the Commission's existing authority to sanction associated persons for negligent contributory conduct means that firms' profitability calculations should already factor in the risk of defending personnel against charges of this nature, albeit with a modestly greater frequency in

[204] Comment Letter from Chamber of Digital Commerce at 1 (Nov. 2, 2023).

light of the amended rule. Thus, in addition to the firm's defense, the incremental cost of defending an individual may not be as significant as it appears at first glance. [205]

While we agree that there has been a decline in the number of firms performing audits of public companies, we note that firms may decide to cease providing audits for any number of reasons, mostly strategic in nature.[206] While the amendment could lead some firms to exit the issuer audit market because of increased risk of higher expected litigation expenses (thus reducing competition), this exit might involve low-quality auditors and lead to better matching between auditors and clients.[207] While the amendment may induce market shifts, the resulting landscape could be characterized by a higher concentration of more capable and compliant audit firms, mitigating the negative impacts on the competitive landscape.

iv. Other Distortions/Inefficiencies

One commenter expressed concern that the amendment could change the dynamics of the settlement negotiation process during enforcement cases and "tip the scale" in the PCAOB's favor.[208] The commenter further contended that the PCAOB may pursue weaker cases, which would divert its resources to less meritorious cases, while another commenter asserted its belief that the PCAOB will appropriately exercise its prosecutorial discretion. Some commenters asserted that the amendment could have negative effects on the PCAOB's inspections program. One commenter noted that the amendment could cause firms to be particularly reluctant to provide services to novel industries.

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[205] One commenter stated that the assertions in the Proposal that defense costs would be lowered by an increase in the volume of cases to defend is not based in fact. It appears that the nature of our assertion was misinterpreted; as discussed in Section VI.C.2 above, we believe that individuals and firms will incur additional litigation costs to defend against charges brought under the amended rule. However, we have considered the nature of those costs and how they would relate to the way that staff might investigate and make recommendations regarding these cases, and the frequency of those charges, and we believe that those factors diminish the size of the expected increase—i.e., while costs will go up, they will go up less than if firms needed to defend a wholly new class of charges.

[206] Michael Ettredge, Juan Mao & Mary S. Stone, *Small Audit Firm De-registrations from the PCAOB-Regulated Audit Market: Strategic Considerations and Consequences*, Social Science Research Network (SSRN) (2022), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3572291.

[207] One study suggests that PCAOB inspections incentivize low-quality auditors to exit the market, resulting in an overall improvement in audit quality. *See* Mark L. DeFond & Clive S. Lennox, *The Effect of SOX on Small Auditor Exits and Audit Quality*, 52 J. ACCT. & ECON. 21, 39 (2011) ("We conclude that while the PCAOB inspections are intended to improve audit quality primarily through the remediation of poor audit practices, they also improve audit quality by incentivizing the lower quality auditors to exit the market.").

[208] Comment Letter from U.S. Chamber of Commerce at 12.

We emphasize that the amendment is designed to enhance regulatory oversight and accountability, not to unfairly "tip the scale" against firms and their associated persons. The PCAOB is committed to using its enforcement resources efficiently, and the Board emphasizes that enforcement proceedings are based on substantive evidence and legal principles, thereby helping to maintain the integrity and effectiveness of the PCAOB's overall enforcement process to protect investors' interests. Moreover, we believe that enhancements to the PCAOB's enforcement program will serve as a natural complement to the inspections program; even today, with a primary liability regime based on negligence, the vast majority of inspection deficiencies do not result in enforcement proceedings. We do not anticipate that the incremental effects of the amendment to Rule 3502 will prompt significant changes in the nature of the inspections process that has developed over time.

The amendment is intended to strengthen the PCAOB's ability to address instances of negligence that may harm investors or undermine the integrity of the audit process, ensuring a more effective and transparent regulatory framework. On balance we believe that the amendment will enhance audit quality, not diminish it. Enhancements in audit quality will also benefit emerging industries: while the amendment does not specifically target these industries, it is precisely because these industries operate in evolving regulatory and legal frameworks that they may benefit from more thorough and diligent auditing practices. Therefore, we believe that, rather than deterring firms from engaging with innovative sectors, the amendment can serve to enhance the quality and effectiveness of audits in these industries, ultimately benefiting both participants in the emerging industries and investors.

D. Alternatives Considered

The Board considered two alternatives to the amendment, as discussed below.[209]

1. Alternative Articulations of the Standard of Liability

Rather than amending Rule 3502 as done today, the Board considered rewriting Rule 3502 to mirror the language in the cease-and-desist provisions of the Exchange Act, 15 U.S.C. § 78u-3(a).

The primary benefit of such an approach would be to facilitate interpretive alignment with the scope of the Commission's causing-liability regime, which may provide associated persons with more clarity on the nature of the legal risk. However, for more than a dozen years, the Board has developed a distinguishable body of practice under Rule 3502 through its enforcement program—including via the rule-based requirement that any contribution to a

[209] As discussed in Section V, the Proposal considered amending Rule 3502 to provide that an associated person that negligently contributes to a firm's violation need not be an associated person of the firm that commits the primary violation. The Board decided not to adopt this aspect of the Proposal.

primary violation be "direct[ ] and substantial[ ]"—and the amended rule will maintain that familiar practice while narrowly adjusting only the standard of liability.

In response to comments, the Board also considered other potential liability standards, including whether to adopt a framework that would require a showing of multiple acts of negligence to hold an individual liable for contributory conduct at the negligence level. Commenters noted that because Section 21C proceedings are usually brought in conjunction with Rule 102(e) proceedings, the Commission often pursues a multiple acts of negligence or a heightened form of negligence theory. Commenters also discussed their belief that it would be inequitable or inappropriate for the Board to hold individuals liable for one-time errors.

However, as discussed in Section IV.C, while the Commission often chooses to bring Section 21C and Rule 102(e) matters together, nothing requires it to do so. Similarly, under the amendment, the Board may choose to bring a case that has repeated acts of negligence, so that an appropriate remedial sanction can be imposed.[210] Or, in appropriate facts and circumstances, it may choose to bring a case that involves a single act of negligence. This optionality thus mirrors that available to the Commission under Section 21C. Requiring multiple instances of negligence, moreover, would not fully close the regulatory gap noted above, would not give the Board authority that is co-extensive with the Commission, and would not fully achieve the efficiency benefits that the amendment seeks to achieve.

2. Removing Additional Barriers to Contributory Liability

The Board also considered an alternative that would expand the Board's ability to hold persons liable for contributing to firm violations by changing the "directly and substantially" modifier that describes the relationship of an associated person's contribution to a firm's primary violation, including removing it altogether. This is currently an element of proof required for the Board to find a violation of Rule 3502.

Removing "directly and substantially" would enable the Board to use Rule 3502 to hold accountable any individual who took part in any way in the chain of events leading to a firm's violation, even if only remotely. The relationship between contributory conduct and the primary violation could be a discretionary factor to consider in bringing a proceeding in the first instance and when determining the appropriate sanction.

This alternative could improve audit quality by ensuring that all individuals with relevant professional responsibilities are appropriately motivated to perform their responsibilities with reasonable care. However, this could exacerbate the costs and unintended consequences discussed above in conjunction with the amendment. Therefore, this alternative might lead to

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[210] *See supra* page 30 & footnote 123 (discussing the Board's ability to impose heightened sanctions in only certain circumstances, including repeated acts of negligence).

excessive motivation for auditors to increase defensive efforts that do not contribute to audit quality (e.g., excessive self-protective measures in anticipation of future litigation).

The amended rule maintains the criteria of nexus and magnitude ("directly and substantially") for an associated person's contribution to a firm's violation, although it does not require proof that the individual knew or was negligent in not knowing that their conduct would be a direct and substantial contributor. These requirements appropriately specify the conduct the Board considers actionable for "contributing" to a primary violation, as outlined above. This approach tailors the incentives to individuals with the most direct responsibility for firm compliance. In other words, the amendment continues to focus on individuals most likely influenced by increased litigation risk leading to improved firm compliance and audit quality. Conversely, individuals who are less involved would experience lower benefits in relation to costs and unintended consequences.

3. Nonenforcement Alternatives Suggested by Commenters

Several commenters asserted that an alternative to the amendment is for the Board to provide auditors with additional guidance, training, and tools illustrating successful and problematic practices. Commenters indicated that this could be achieved through enhanced communication, such as issuing interpretive guidance and publishing observations from enforcement activities, to educate auditors and to help them better understand accountability expectations for associated persons, or through implementing a real-time consultation process similar to the Commission's. One commenter also expressed appreciation of the PCAOB's Spotlight series that is published to help users of financial statements better understand the PCAOB's activities and observations.

Although we agree that these alternative approaches are beneficial, devoting additional resources to activities buttressing these approaches, without addressing the existing regulatory gap, would not yield the benefits discussed in Section VI.C.1 that are associated with providing the PCAOB with the appropriate tool to hold individuals accountable for failing to act reasonably and contributing directly and substantially to a firm's violation. An increase in the number of regulators that can pursue negligent contributory conduct increases the likelihood of the conduct being detected and deterred through a range of sanctions that can be imposed by the PCAOB, including training.

One commenter suggested an alternative to the amendment could be to adopt standards addressing the roles of individuals involved in designing and monitoring firms' systems of quality control. The commenter believes this approach would provide predictability in enforcement of PCAOB standards and would more effectively accomplish the PCAOB's goals. While addressing the conduct of individuals involved in designing and monitoring a firm's system of quality control is important, the scope of the amendment, and Rule 3502 generally,

are broader than quality control.[211] As discussed previously, the amendment aims to address a specific gap in the PCAOB's regulatory framework related to liability standards for firms and associated persons, ensuring a more consistent and effective regulatory framework.

VII. SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES

The amendment does not impose additional requirements on emerging growth company (EGC) audits. Accordingly, the Board believes that Section 103(a)(3)(C) of Sarbanes-Oxley does not apply. Nevertheless, the discussion of benefits, costs, and potential unintended consequences in Section VI.C generally applies to the audits of EGCs, and we include this analysis for completeness.

Under Section 104 of the Jumpstart Our Business Startups Act (JOBS Act), rules adopted by the Board after April 5, 2012, generally do not apply to the audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act, unless the Commission "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[212] As a result of the JOBS Act, the rules and related amendments to PCAOB standards adopted by the Board are generally subject to a separate determination by the Commission regarding their applicability to audits of EGCs.

To inform consideration of the application of auditing standards to audits of EGCs, Board staff prepares a white paper annually that provides general information about the characteristics of EGCs.[213] As of November 15, 2022, PCAOB staff identified 3,031 companies that self-identified with the Commission as EGCs and filed audited financial statements in the 18 months preceding that date.[214]

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[211] QC 1000, if approved by the Commission, would provide clear expectations for certain individuals serving in quality control roles. QC 1000 and Rule 3502 may overlap in some but not all circumstances because Rule 3502 applies to individuals more broadly than just quality control roles.

[212] *See* Pub. L. No. 112-106 (Apr. 5, 2012). Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act, also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the issuer's financial statements (auditor discussion and analysis) do not apply to an audit of an EGC. The amended Rule 3502 falls outside these two categories.

[213] For the most recent EGC report, see *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2022* (February 20, 2024), *available at* https://pcaobus.org/resources/other-research-projects ("EGC White Paper").

[214] The EGC White Paper uses a lagging 18-month window to identify companies as EGCs. Please refer to the "Current Methodology" section of the EGC White Paper for details. Using an 18-month

EGCs are likely to be newer public companies, which may increase the importance to investors of the external audit to enhance the credibility of management disclosures. All else equal, the benefits of the higher audit quality resulting from the amendment may be more significant for EGCs than for non-EGCs, including improved efficiency of capital allocation, lower cost of capital, and enhanced capital formation. By increasing the likelihood that associated persons are held accountable for their negligent contributory roles in firm violations, the amendment to Rule 3502 aims to bolster investor confidence in the audit process. Because investors who lack confidence in a company's financial statements may require a larger risk premium that increases the cost of capital to companies, the improved audit quality resulting from applying the amendment to EGC audits could reduce the cost of capital to those EGCs.[215]

The amendment could impact competition in an EGC product market if the costs disproportionately affect the EGCs relative to their competitors. However, as discussed in Section VI.C.2, the costs associated with the amendment are expected to be small, particularly given the Commission's existing authority to sanction associated persons for single acts of contributory negligence. Therefore, the amendment's impact on competition, if any, is expected to be limited. Overall, the amendment is expected to enhance audit quality and increase the credibility of financial reporting by EGCs, thereby fostering efficiency.

Some commenters agreed that the amendment should apply to audits of EGCs and that doing so would benefit such audits. One commenter remarked that there was no reason not to apply the amendment to audits of EGCs and that the principles, standards, and scope of enforcement against violations involving contributory negligence should be the same regardless of the scale and size of the entity and of the firm. Another commenter posited that excluding EGCs from the application of the amendment would be inconsistent with protecting the public interest.

As previously discussed, one commenter suggested that the amendment would have a greater impact on smaller firms with fewer resources to defend personnel and navigate an uncertain liability environment, and consequently, these firms are more likely to cease auditing entities that require PCAOB-registered auditors. The Board agrees that the amendment may

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window enables staff to analyze the characteristics of a fuller population in the EGC White Paper, but may tend to result in a larger number of EGCs being included for purposes of the present EGC analysis than would alternative methodologies. For example, an estimate using a lagging 12-month window would exclude some EGCs that are delinquent in making periodic filings. An estimate as of the measurement date would exclude EGCs that have terminated their registration or exceeded the eligibility or time limits. *See id*.

[215] For a discussion of how increasing reliable public information about a company can reduce risk premiums, see David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1573 (2004) ("These findings suggest an important role for the accuracy of accounting information in asset pricing. Here, greater precision directly lowers a company's cost of capital because it reduces the riskiness of the asset to the uninformed.").

have a greater impact on smaller firms to the extent that their individual auditors are investigated under the amended rule, and the firms are unable to absorb the direct costs and distractions. This would, in turn, impact EGCs because they are more likely than non-EGCs to engage small firms.[216] The Board believes that the amendment should apply uniformly to audits of EGCs to maintain high standards of audit quality and uphold investor protection across all entities.

Considering these comments and the reasons explained above, the Board will request that the Commission determine, to the extent that Section 103(a)(3)(C) of the Sarbanes-Oxley applies, that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the amendment will promote efficiency, competition, and capital formation, to apply the amendment to audits of EGCs.

VIII. EFFECTIVE DATE

If the amendment to PCAOB Rule 3502 is approved by the Commission, then (as proposed) the Board intends that it would become effective 60 days from the date of Commission approval.[217] In that regard, the Board anticipates that conduct occurring more than 60 days after Commission approval would be subject to Rule 3502, as amended, but that conduct occurring prior to, or within 60 days after, Commission approval would not be subject to the amendment to Rule 3502.

Commenters expressed mixed views regarding the effective date. One commenter agreed that 60 days after Commission approval is appropriate, and another stated that it did not disagree with the Board's basis for an effective date 60 days after Commission approval. Another commenter stated that it could not comment on an appropriate effective date because the Board should redeliberate and repropose amendments to Rule 3502. Other commenters encouraged the Board to delay the effectiveness until the Board more fulsomely assesses the costs of the amendment and considers the amendment's impact on the profession and audit quality.

Several commenters suggested that the Board delay the effectiveness of any amendment to Rule 3502 to provide for time to gauge the impact of other then-pending proposals, including QC 1000 and AS 1000 (both of which have since been adopted). In general, these commenters opined that the impact of the amendment to Rule 3502 could depend on how the amendment interacts with, and the potential unintended consequences of, changes to other professional standards. Another commenter encouraged the Board to delay the

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[216] Staff analysis indicates that, compared to exchange-listed non-EGCs, exchange-listed EGCs are approximately 2.6 times as likely to be audited by a firm that is not affiliated with the largest global networks, and approximately 1.3 times as likely to be audited by a triennially inspected firm. Source: EGC White Paper and S&P.

[217] *See* 2023 Proposing Release at 31.

effectiveness of the amendment for medium-sized and smaller firms, including those in non-U.S. jurisdictions, to appropriately understand the amendment's ramifications and to respond accordingly.

The Board recognizes that it is in various stages of the process of modernizing several of its standards and rules to protect the interests of investors and further the public interest. Those updates (both adopted and proposed) reflect that, over the years, audits and the audit industry have evolved, and the Board's standards and rules should as well.[218] The Board also appreciates that its revised standards and rules may require adjustment by individuals and firms, which is why each of those standards also includes (or proposes to include, in the case of proposals) a delay in its respective effective date following the date of Commission approval.[219] The notion that multiple standards are being modernized in parallel, however, is not a basis for permitting individuals—regardless of the size of the firm(s) with which they are associated—to negligently, directly, and substantially contribute to firms' primary violations. And as noted above, as firms make efforts to comply with new standards, it necessarily follows that individuals who could be subject to Rule 3502 also would be making such efforts (because firms can act only through their natural persons).

Accordingly, having considered the comments and for the reasons above, the Board continues to believe that 60 days after Commission approval is an appropriate effective date for the amendment to Rule 3502. That period provides sufficient time for associated persons to familiarize themselves with the applicable legal standards and to increase their diligence as necessary and appropriate, which enhances audit quality and therefore serves the interests of the public and better protects investors.

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[218] *See* PCAOB, Strategic Plan 2022-2026, at 10 ("[A]s important as [auditing, attestation, quality control, ethics, and Independence] standards are, some of them were written by the audit profession prior to the PCAOB's establishment and have not been updated since we adopted them in 2003 on what was intended to be an interim basis. The world has changed since 2003, and our standards must adapt to keep up with developments in auditing and the capital markets. We intend to modernize and streamline our existing standards and to issue new standards where necessary to meet today's needs.").

[219] *See supra* footnote 87 (effective dates for adopted standards); *see also* PCAOB Release No. 2024-006, at 61 (contemplating effectiveness for audits of fiscal years beginning on or after December 15 in the year of approval by the Commission); PCAOB Release No. 2024-003, at 89 (proposing effective dates of 90 days after Commission approval for certain aspects and no earlier than March 31, 2026, or one year after Commission approval, whichever is later, for other aspects); PCAOB Release No. 2024-002, at 186 (proposing phased effective dates beginning no earlier than October 1 in the year after Commission approval); PCAOB Release No. 2024-001, at 63 (proposing an effective date of six months after Commission approval to comply with certain aspects); PCAOB Release No. 2023-003, at 94 (contemplating effectiveness for audits of fiscal years beginning in the year after approval by the Commission, or if Commission approval occurs in the fourth quarter of a calendar year, effectiveness for audits of fiscal years beginning two years after the year of Commission approval).

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On the 12th day of June, in the year 2024, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

June 12, 2024

Appendix—Amendment to Board Rules

PCAOB Rule 3502 is amended as set forth below. Language deleted by the amendment is struck through; language added by the amendment is underlined.

RULES OF THE BOARD

SECTION 3. Auditing and Related Professional Practice Standards

* * * *

Rule 3502. Responsibility Not to ~~Knowingly or Recklessly~~ Contribute to Violations

A person associated with a registered public accounting firm shall not ~~take or omit to take an action knowing, or recklessly not knowing, that the act or omission would~~ directly and substantially contribute to a violation by that registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, by an act or omission that the person knew or should have known would contribute to such violation.

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