

What PCOAB's Broadened Liability Rule Means For Auditors

By **John Carney, Teresa Goody Guillén, and Nikita Mistry** (September 25, 2024)

Last month, the U.S. Securities and Exchange Commission approved the Public Company Accounting Oversight Board's proposed ethics rule, which governs the standard of liability for associated persons who directly and substantially contribute to an audit firm's violations.

The amended rule expands liability for associated persons who directly and substantially contribute to a firm's violations by reducing the liability standard from knowing or reckless conduct to negligent conduct.

Rule 3502 provides that an individual who contributes to a registered firm's primary violation does not need to be an associated person of the firm that commits the primary violation; the individual need only be an associated person of any registered firm.

The rule clarifies that directly contributing to the firm's violation means that an associated person's conduct should either essentially constitute the firm's violation or be a reasonably proximate facilitating event of the violation. Substantially contributing to the firm's violation means that an associated person's conduct must contribute to a violation in a material or significant way.

Amendment

For nearly two decades since its enactment in 2005, PCAOB Rule 3502 prohibited any "person associated with a registered public accounting firm" from taking or omitting to take an action knowingly or recklessly in a way that would directly and substantially contribute to a violation of audit standards by that registered public accounting firm.[1] PCAOB Rule 3502 codified associated persons' ethical obligations to not contribute to a registered firm's violations of the laws, rules and standards that the PCAOB is charged with enforcing.

Prior to the amendment, the rule provided grounds for secondary liability when an associated person of a registered firm acted at least recklessly to directly and substantially contribute to such a violation.

On June 20, the PCAOB, an independent agency created by the Sarbanes-Oxley Act to oversee auditors for publicly traded companies, submitted a proposed amendment to Rule 3502 to the SEC.[2] Amended Rule 3502, "Responsibility Not to Knowingly or Recklessly Contribute to Violations," changed the liability standard from recklessness to negligence for actionable contributory conduct by associated persons. On Aug. 20, the SEC voted 3-2 to adopt the PCAOB's proposed rule.

Accordingly, the SEC approved the amendment and lowered the standard from recklessness to negligence for an associated person's contributory liability, while maintaining the requirement that to be held liable, an associated person must have contributed to the firm's



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violation "directly and substantially." [3]

Under the former recklessness standard, to be held liable, associated persons were required to have had 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." [4] Under the new negligence standard, associated persons will be liable if there is "failure to exercise reasonable care or competence" on their part. [5]

According to the PCAOB, the amended standard aligns with the same standard of reasonable care that auditors are required to exercise when executing their professional duties. The PCAOB explained that under the prior version of Rule 3502, an incongruity existed 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.

Specifically, a firm, which acts through its associated persons, could violate certain laws, rules or standards by acting negligently, but an associated person who directly and substantially contributed to that violation was held to a higher standard of recklessness to be secondarily liable. The PCAOB determined that this incongruity meant that associated persons may have weaker incentives to exercise the appropriate level of care.

The PCAOB also determined that the previous version of Rule 3502 prevented the board from fully executing its investor-protection mandate under the Sarbanes-Oxley Act. There had been instances in which the PCAOB had instituted proceedings against firms for negligence-based violations but was unable to charge individuals who negligently, directly and substantially contributed to the firms' violations.

The amendment allows the PCAOB to pursue charges against individuals whose conduct is now subject to the lower negligence standard. PCAOB Chair Erica Williams described the amendment as a "win for investors." [6]

PCAOB Rule 1001(p)(i) defines "person associated" with a registered or a public accounting firm to include

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.

The new standard applies broadly to professional employees of a public accounting firm. The definition of "associated person," however, does not include people engaged only in clerical or ministerial tasks. Rule 3502 further clarifies that an individual who contributes to a registered firm's primary violation does not need to be an associated person of the firm that commits the primary violation; the individual need only be an associated person of any registered firm.

Rule 3502 allows the PCAOB to hold associated persons accountable when they directly and substantially contribute to an accounting firm's violations. The associated persons contribute directly when their conduct either essentially constitutes the firm's violation or is a reasonably proximate facilitating event of the violation. For its part, the "substantially" element continues to require that the associated person's conduct contribute to the violation

in a material or significant way, though their conduct does not need to have been the sole cause of the violation.

The amendment to Rule 3502 will go into effect Oct. 19, 60 days after SEC approval. The amendment does not apply to conduct before the effective date.

Practical Takeaways

The amended Rule 3502 is expected to have major consequences for registered firms and other associated persons. Seasoned auditors could find themselves subject to enforcement action if they unknowingly — but negligently, directly and substantially — cause a primary audit firm's violation of PCAOB standards or rules. Component auditing firms, service centers and other associated persons responsible for overseeing a firm's quality controls or PCAOB-based disclosures could now be exposed to enforcement liability if they fail to exercise their oversight duties with reasonable care.

During the comment period on the amendment to Rule 3502, commenters questioned the need for the amendment and criticized the economic and investor-protection rationales put forth by the PCAOB. One commenter argued that the cost associated with enforcement actions could disproportionately affect small and midsize firms, which could result in some firms withdrawing from the issuer and broker-dealer audit market. In turn, this could cause a greater concentration of audit services.

The amendment could also adversely affect the talent pool and have anticompetitive outcomes.

The PCAOB's ability to take action against individuals for negligence would undermine the cooperative spirit of inspections. It could discourage potential auditors, who might opt for different career paths to avoid an adversarial atmosphere and the potential reputational harm from the publication of a mistake, difference of opinion with the PCAOB or minor violation. Auditor stress is increasing, and the heightened risk of PCAOB actions may escalate the attrition rates.

In conclusion, Rule 3502 enables the PCAOB to hold associated persons accountable when, regardless of their intent, they negligently, directly and substantially contribute to an accounting firm's violations.

This is a dramatic change to the legal standard that will likely be followed by increased enforcement activity against individual members of audit teams who the PCAOB believes contributed to an audit firm's violations. There will likely be continued legal challenges to this rule, as well as to the PCAOB itself, in light of recent U.S. Supreme Court opinions curtailing administrative adjudication.

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[1] See Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendment to PCAOB Rule 3502 Governing Contributory Liability, Release No. 34-100429 (June 26, 2024), <https://www.sec.gov/files/rules/pcaob/2024/34-100429.pdf>.

[2] 15 U.S.C. 78s(b).

[3] See Securities and Exchange Commission, Release No. 34-100772; File No. PCAOB-2024-04 (Aug. 20, 2024), <https://www.sec.gov/files/rules/pcaob/2024/34-100772.pdf>.

[4] In re S.W. Hatfield, C.P.A., SEC Release No. 34-69930, at 29 (July 3, 2013).

[5] Id. at 35 n.169 (citation and quotation marks omitted).

[6] See Public Company Accounting Oversight Board, Press Release (Aug. 20, 2024), <https://pcaobus.org/news-events/news-releases/news-release-detail/chair-williams-statement-on-sec-approval-of-three-pcaob-standard-setting-and-rulemaking-actions-that-will-protect-investors>.