

Written comments are invited on: (a) whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; (b) the accuracy of the Commission's estimates of the burden of the proposed collection of information; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology. Consideration will be given to comments and suggestions submitted by August 30, 2024.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Please direct your written comments to: David Bottom, Director/Chief Information Officer, Securities and Exchange Commission, c/o John Pezzullo, 100 F Street NE, Washington, DC 20549, or send an email to: [PRA\\_Mailbox@sec.gov](mailto:PRA_Mailbox@sec.gov).

Dated: June 26, 2024.

**Sherry R. Haywood,**  
Assistant Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-100429; File No. PCAOB-2024-04]

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

June 26, 2024.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), notice is hereby given that on June 20, 2024, 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.<sup>1</sup> 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*.<sup>2</sup> 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

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

<sup>2</sup> *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](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.").

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 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.<sup>3</sup> As part of its

<sup>3</sup> Public Law 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

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<sup>4</sup> thereof for violations of the laws, rules, and standards that Congress charged the Board with enforcing.<sup>5</sup> 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.<sup>6</sup> 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*.<sup>7</sup> 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

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.").

<sup>4</sup> 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.*

<sup>5</sup> *See* Sections 105(b) & (c) of Sarbanes-Oxley.

<sup>6</sup> *See id.* 103(a)(1); *see also, e.g., id.* 101(c)(2), (c)(4), (c)(6) & (g)(1).

<sup>7</sup> *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](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.").

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<sup>8</sup> 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 can contribute to a primary violation of another registered firm).<sup>9</sup> The Board received 28 comment letters on the Proposal from commenters across a range of affiliations.<sup>10</sup> In general,

<sup>8</sup> 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."

<sup>9</sup> *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.?=7d49cc51\\_9](https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.?=7d49cc51_9).

<sup>10</sup> Comment letters on the Proposal, as well as a staff white paper regarding characteristics of

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.<sup>11</sup> Whereas negligence "is the failure to exercise reasonable care or competence,"<sup>12</sup> 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."<sup>13</sup> Indeed, Sarbanes-Oxley characterizes "reckless conduct" as a subset of "intentional or knowing conduct,"<sup>14</sup> whereas negligence is an "objective" standard that is not measured by "the intent of the accountant."<sup>15</sup>

The Board has adopted negligence as the liability standard for actionable contributory conduct under Rule 3502.

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/letters>. One of the comment letters was withdrawn.

<sup>11</sup> *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](https://pcaobus.org/Rulemaking/Docket017/2004-12-14_Release_2004-015.pdf).

<sup>12</sup> *In re SW Hatfield, C.P.A.*, SEC Release No. 34–69930, at 35 n.169 (July 3, 2013) (citation and quotation marks omitted).

<sup>13</sup> *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 'know, 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.").

<sup>14</sup> *See* Section 105(c)(5)(A) of Sarbanes-Oxley.

<sup>15</sup> *In re Melissa K. Koepfel, 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)).

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.<sup>16</sup> 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.”<sup>17</sup> Accordingly, through Rule 3502, the Board sought to “codify that obligation” and “make it clear that the obligation is enforceable by the Board.”<sup>18</sup> 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.<sup>19</sup>

Following a public comment period,<sup>20</sup> the Board adopted Rule 3502 with two

<sup>16</sup> 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-020.pdf?sfvrsn=69338fcd\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket017/2005-11-22_release-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.*

<sup>17</sup> 2004 Proposing Release at 18.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 18 n.40; see *id.* at A–4 (proposed rule text).

<sup>20</sup> “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

modifications from the proposal. First, while affirming its authority to promulgate a negligence-based ethics rule prohibiting contributory conduct,<sup>21</sup> 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.”<sup>22</sup> 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.<sup>23</sup> 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.”<sup>24</sup>

#### 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.”<sup>25</sup> The following subsections explain why the modification to Rule 3502 is appropriate in furtherance of the Board's mission to

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.

<sup>21</sup> See *id.* at 12 n.23.

<sup>22</sup> 2005 Adopting Release at 13; see *id.* at 12 & n.23.

<sup>23</sup> See *id.* at 9, 13.

<sup>24</sup> *Id.* at 13.

<sup>25</sup> 2005 Adopting Release at 10.

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.”<sup>26</sup> Accordingly, “a natural person's actions may render both the [firm] primarily liable and the natural person secondarily liable.”<sup>27</sup> 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).<sup>28</sup> 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

<sup>26</sup> 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.

<sup>27</sup> *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)).

<sup>28</sup> *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”).

actions. Indeed, “accountability frequently improves outcomes.”<sup>29</sup>

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.<sup>30</sup>

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.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup>

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.

<sup>32</sup> 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.

<sup>33</sup> 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*

Commenters also opined that amending Rule 3502 is unnecessary because the Board’s then-proposed (now-adopted<sup>34</sup>) QC 1000 standard provides clearer expectations with regard to individuals in quality control (QC) roles.<sup>35</sup> 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.<sup>36</sup>

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 *inadequately* incentivizes associated persons to exercise the appropriate level of care in their audit work. This commenter also noted that, beyond incentivizing individuals’ compliance, a negligence standard also would incentivize *firms* to ensure, through training and other measures, that their

*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.

<sup>34</sup> 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.

<sup>35</sup> 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”).

<sup>36</sup> 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)).

<sup>29</sup> Honigsberg, *supra*, at 1902.

<sup>30</sup> Comment Letter from Better Markets at 3 (Nov. 3, 2023).

<sup>31</sup> 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

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.<sup>37</sup> 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.<sup>38</sup>

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 "striking 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.<sup>39</sup>

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.<sup>40</sup> 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.<sup>41</sup>

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.<sup>42</sup> 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

<sup>40</sup> 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.

<sup>41</sup> 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).

<sup>42</sup> 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").

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

<sup>38</sup> 2023 Proposing Release at 14 n.51.

<sup>39</sup> 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.

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.<sup>43</sup>

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.<sup>44</sup> 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 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<sup>45</sup> or fail to file (or file timely) required PCAOB forms.<sup>46</sup> In each scenario, the respective primary violations can be committed only by a firm because the obligations are imposed solely on the firm,<sup>47</sup> 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.<sup>48</sup> 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.<sup>49</sup>

### 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."<sup>50</sup> 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."<sup>51</sup> 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.<sup>52</sup> 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).<sup>53</sup> 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 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

<sup>51</sup> *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.").

<sup>52</sup> *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](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.

<sup>53</sup> *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, *Detering 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.").

<sup>45</sup> *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).

<sup>46</sup> *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).

<sup>47</sup> *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).

<sup>48</sup> 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.

<sup>49</sup> The resource is available at [https://wp.nyu.edu/compliance\\_enforcement/category/artificial-intelligence](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.

<sup>50</sup> 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/](https://assets.pcaobus.org/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/strategic-plan-2022-2026.pdf?sfvrsn=b2ec4b6a_4/).

<sup>43</sup> *See* 2023 Proposing Release at 9.

<sup>44</sup> Comment Letter from PricewaterhouseCoopers LLP at A4 (Nov. 2, 2023).

effective enforcement tool, and in so doing, better aligns the rule with Sarbanes-Oxley.<sup>54</sup>

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,<sup>55</sup> 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.<sup>56</sup> 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.<sup>57</sup>

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.<sup>58</sup>

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

<sup>54</sup> 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.").

<sup>55</sup> Comment Letter from Council of Institutional Investors at 5 (Oct. 26, 2023).

<sup>56</sup> Comment Letter from Better Markets at 8.

<sup>57</sup> Comment Letter from Center for American Progress at 2 (Nov. 3, 2023).

<sup>58</sup> Comment Letter from Better Markets at 5.

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,<sup>59</sup> whereas the incoming phrase sets a negligence standard using "classic negligence language."<sup>60</sup> Consequently,

<sup>59</sup> See 2005 Adopting Release at 12 n.23.

<sup>60</sup> *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*

the Board is changing the standard for contributory liability from an "extreme departure from the standard of ordinary care" <sup>61</sup> (recklessness) to "the failure to exercise reasonable care or competence" (negligence).<sup>62</sup>

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.<sup>63</sup> 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.<sup>64</sup> 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."<sup>65</sup> Indeed, one commenter remarked that such language is "familiar in the American legal system."<sup>66</sup> 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

*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").

<sup>61</sup> *Marrie*, 374 F.3d at 1204 (citation and quotation marks omitted).

<sup>62</sup> *SW Hatfield*, SEC Release No. 34–69930, at 35 n.169 (citation and quotation marks omitted).

<sup>63</sup> 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.

<sup>64</sup> Comment Letter from RSM US LLP at 1 (Nov. 3, 2023).

<sup>65</sup> 2023 Proposing Release at 13 & n.45.

<sup>66</sup> Comment Letter from Center for Audit Quality at 11 (Nov. 2, 2023).

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, 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*.<sup>67</sup> To be sure, due professional care and reasonable care and competence are largely overlapping concepts.<sup>68</sup> 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;<sup>69</sup> 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 that violate professional standards.<sup>70</sup> 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<sup>71</sup>—including with respect to less senior engagement team members.<sup>72</sup> The amendment focuses on unreasonable conduct; it does not impose strict liability.<sup>73</sup>

One commenter opined that a Rule 3502 charge could cause associated persons to "lose their livelihood" due to "career-ending penalties" under the Proposal.<sup>74</sup> 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.<sup>75</sup> 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.'" <sup>76</sup> Nor do the Board's standards require that auditors exercise "perfect judgment at all times," as one commenter put it,<sup>77</sup> to avoid an enforcement proceeding (under Rule 3502 or otherwise).<sup>78</sup>

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,"<sup>79</sup> 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

<sup>75</sup> 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.

<sup>76</sup> Comment Letter from U.S. Chamber of Commerce at 9, 10.

<sup>77</sup> Comment Letter from RSM US LLP at 3.

<sup>78</sup> 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.").

<sup>79</sup> Comment Letter from U.S. Chamber of Commerce at 2.

<sup>67</sup> 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*.

<sup>68</sup> 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.").

<sup>69</sup> 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).

<sup>70</sup> 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).

<sup>71</sup> Comment Letter from U.S. Chamber of Commerce at 2 (Nov. 7, 2023).

<sup>72</sup> 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.

<sup>73</sup> "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.

<sup>74</sup> Comment Letter from RSM US LLP at 1, 2.



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.”<sup>80</sup> 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<sup>81</sup> and has proposed amendments to other standards<sup>82</sup> and to

certain PCAOB rules.<sup>83</sup> 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.”<sup>84</sup> 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.<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup> 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.<sup>88</sup>

### 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.<sup>89</sup> 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<sup>90</sup>—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.”<sup>91</sup> 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

<sup>87</sup> Comment Letter from RSM US LLP at 3.

<sup>88</sup> 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.”).

<sup>89</sup> 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.

<sup>90</sup> 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.”).

<sup>91</sup> See 2005 Adopting Release at 13.

<sup>80</sup> 2005 Adopting Release at 14.

<sup>81</sup> 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).

<sup>82</sup> 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).

<sup>83</sup> 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).

<sup>84</sup> PCAOB, Strategic Plan 2022–2026, at 10.  
<sup>85</sup> 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).

<sup>86</sup> Comment Letter from U.S. Chamber of Commerce at 10.

not.”<sup>92</sup> 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.<sup>93</sup>

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.”<sup>94</sup> 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.”<sup>95</sup>

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.”<sup>96</sup> 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 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,<sup>97</sup> and another asked whether the terms “will be applied differently moving forward.”<sup>98</sup>

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 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.<sup>99</sup> 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.”<sup>100</sup> Such a standard, however, more aptly describes conduct that is reckless (as opposed to negligent),<sup>101</sup> 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.<sup>102</sup> 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

<sup>99</sup> 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).

<sup>100</sup> Comment Letter from Accounting & Auditing Steering Committee of the Pennsylvania Institute of Certified Public Accountants at 5.

<sup>101</sup> 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)).

<sup>102</sup> Comment Letter from RSM US LLP at 7.

<sup>92</sup> *Id.*

<sup>93</sup> 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].”).

<sup>94</sup> 2005 Adopting Release at 13.

<sup>95</sup> *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.

<sup>96</sup> Comment Letter from Ernst & Young LLP at 4 (Nov. 3, 2023).

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

<sup>98</sup> Comment Letter from Audit and Assurance Services Committee of the Illinois CPA Society at 3 (Nov. 2, 2023).

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 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,"<sup>103</sup> 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."<sup>104</sup> 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.<sup>105</sup>

<sup>103</sup> 15 U.S.C. 78u-3(a); see also 15 U.S.C. 77h-1(a), 80a-9(f)(1), 80b-3(k)(1).

<sup>104</sup> 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 Public Law 111-203.

<sup>105</sup> 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.).

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."<sup>106</sup> Sanctions are not available under Rule 102(e) when an auditor engages in a single instance of unreasonable (but not highly unreasonable) conduct.<sup>107</sup> Thus, certain commenters said that the cases were not "on par" with what the Board intends through the amendment to Rule 3502.<sup>108</sup>

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)*.<sup>109</sup> Rather, commenters instead

<sup>106</sup> 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).

<sup>107</sup> 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.").

<sup>108</sup> 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.

<sup>109</sup> 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 CFR 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.

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

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,<sup>112</sup> 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.<sup>113</sup>

<sup>110</sup> 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.'").

<sup>111</sup> *Id.* at n.47.

<sup>112</sup> 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.")

<sup>113</sup> 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

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.<sup>114</sup> 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.”<sup>115</sup>

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<sup>116</sup>—

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)).

<sup>114</sup> 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]henver 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).

<sup>115</sup> 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.

<sup>116</sup> 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

Sarbanes-Oxley *does* place express limits on what sanctions the Board can impose.<sup>117</sup> 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.”<sup>118</sup>

#### 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,”<sup>119</sup> 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

U.S.C. 78u–3(a); see also *id.* 78c(a)(9) (defining “person”).

<sup>117</sup> 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.

<sup>118</sup> 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.”).

<sup>119</sup> Comment Letter from U.S. Chamber of Commerce at 2.

for reasons the Board has previously explained,<sup>120</sup> 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).

The Board has long recognized this grant of authority,<sup>121</sup> 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,”<sup>122</sup> and another posited that Congress “clearly” intended for the Board to sanction associated persons for negligent conduct.<sup>123</sup> Still another asserted that Sarbanes-Oxley “empowers” the Board

<sup>120</sup> See 2004 Proposing Release at 18; 2005 Adopting Release at 10–12; see also 2023 Proposing Release at 12 n.43.

<sup>121</sup> 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.

<sup>122</sup> Comment Letter from North American Securities Administrators Association, Inc. at 1 (Nov. 13, 2023).

<sup>123</sup> Comment Letter from Center for American Progress at 3.

to sanction associated persons in instances “when their conduct was not intentional or reckless.”<sup>124</sup> Indeed, this latter commenter opined that the Proposal created a “misimpression” that associated persons currently can *only* be sanctioned for intentional or reckless misconduct.<sup>125</sup> 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.”<sup>126</sup> 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.<sup>127</sup>

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

Congress intended to grant to the Board “plenary authority” to establish or adopt ethics standards.<sup>128</sup> 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.<sup>129</sup>

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.<sup>130</sup>

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.<sup>131</sup>

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.”<sup>132</sup> 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<sup>133</sup>—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.*”<sup>134</sup> 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.*”<sup>135</sup>

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,<sup>136</sup> 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 whole or in part, any portion of any [such] statement.”<sup>137</sup> 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

is the only authoritative source of AICPA ethics rules and interpretations.” (italics omitted)).

<sup>134</sup> 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.

<sup>135</sup> *Id.* § 501.05(c) (emphases added).

<sup>136</sup> 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).

<sup>137</sup> 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).

<sup>130</sup> 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.

<sup>131</sup> 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.”).

<sup>132</sup> 2005 Adopting Release at 9.

<sup>133</sup> 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

<sup>124</sup> Comment Letter from Ernst & Young LLP at 2.

<sup>125</sup> *Id.*

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

<sup>127</sup> See, e.g., *FCC v. NextWave Personal Cmmc’s 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)).

<sup>128</sup> S. Rep. 107–205, at 8.

<sup>129</sup> See also Section 101(c)(2) of Sarbanes-Oxley.

“[n]ot knowingly or recklessly misrepresenting facts,” without reference to negligence.<sup>138</sup> 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<sup>139</sup> 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.”<sup>140</sup> 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.<sup>141</sup> 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,<sup>142</sup> and with

that distinct mandate comes distinct authority.<sup>143</sup> 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.”<sup>144</sup> 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.<sup>145</sup>

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.”<sup>146</sup> 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.”<sup>147</sup> The amendment, and Rule 3502 generally, do precisely that.

### Statement Regarding the Proposed Amendment to Clarify the Relationship Between Contributory Actor and Primary Violator

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).<sup>148</sup> 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.<sup>149</sup> 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

<sup>138</sup> 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.”).

<sup>144</sup> 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).

<sup>145</sup> 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 Telecomm’ns, Inc. v. Global Crossing Telecomm’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.).

<sup>146</sup> Sections 101(c)(4) and (6) of Sarbanes-Oxley.

<sup>147</sup> 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)).

<sup>148</sup> See 2023 Proposing Release at 16–17.

<sup>149</sup> See *id.* at 10 n.36.

<sup>138</sup> QC 1000 Release at A4–1.

<sup>139</sup> 15 U.S.C. 78j.

<sup>140</sup> *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

<sup>141</sup> 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.

<sup>142</sup> 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.

“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.<sup>150</sup> 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.<sup>151</sup> 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.<sup>152</sup> 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,

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

<sup>151</sup> 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.

<sup>152</sup> See 2023 Proposing Release at 31.

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 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.<sup>153</sup> 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

<sup>153</sup> 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.”).

following the date of Commission approval.<sup>154</sup> 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

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

<sup>154</sup> 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).

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.<sup>155</sup> 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 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.<sup>156</sup> 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.<sup>157</sup>

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,

<sup>155</sup> 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.

<sup>156</sup> 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.

<sup>157</sup> 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.



inclusion of the 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.<sup>158</sup>

### 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 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.<sup>159</sup> 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 hold individuals accountable under that rule when they act unreasonably but not recklessly. The amendment thus is not "duplicative," as some commenters suggested,<sup>160</sup> 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

<sup>158</sup> 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.

<sup>159</sup> 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.").

<sup>160</sup> Comment Letter from U.S. Chamber of Commerce at 7; Comment Letter from Center for Audit Quality at 6.

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.

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.<sup>161</sup> 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.<sup>162</sup>

<sup>161</sup> 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.

<sup>162</sup> 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://pcaob.us/news-events/news-releases/news->

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.<sup>163</sup> 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.<sup>164</sup> The Board

*release-detail/pcaob-report-audits-with-deficiencies-rose-for-second-year-in-a-row-to-40-in-2022.*

<sup>163</sup> 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.

<sup>164</sup> 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 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.

continues to note 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 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.<sup>165</sup>

<sup>165</sup> 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

Moreover, the PCAOB has existing authorities to bring charges against individuals—both for primary violations and for at least reckless contributory conduct;<sup>166</sup> 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 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.<sup>167</sup>

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.

- 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,<sup>168</sup> 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 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

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.

<sup>166</sup> Here, the Board agrees with commenters who pointed out that the PCAOB has alternative means of bringing charges against individuals.

<sup>167</sup> 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.

<sup>168</sup> See Section 107(c) of Sarbanes-Oxley; *see also*, *e.g.*, *SW Hatfield, C.P.A.*, SEC Release No. 34-69930, at 2-3.

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.<sup>169</sup> Finally, a firm cannot suspend an individual's CPA license, but a PCAOB sanction can lead to collateral consequences with relevant state accountancy authorities.<sup>170</sup>

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 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.<sup>171</sup>

<sup>169</sup> See Section 105(c)(7) of Sarbanes-Oxley.

<sup>170</sup> 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.

<sup>171</sup> 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

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 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.<sup>172</sup> Furthermore, in

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.").

<sup>172</sup> 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.").

general, academic research provides evidence that enforcement proceedings have a deterrent effect<sup>173</sup> and can potentially improve audit quality of non-sanctioned entities that are aware of sanctions imposed on others.<sup>174</sup> Other related literature also discusses the role of regulation in providing auditors with incentives for improving audit quality.<sup>175</sup>

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. The Board considered these commenters' perspectives as well as academic research noted above that suggests enforcement proceedings have a deterrent effect.<sup>176</sup> The Board believes that there is sufficient support for the Board's belief that the amendment would enhance deterrence (albeit

<sup>173</sup> 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.").

<sup>174</sup> 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.").

<sup>175</sup> 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.").

<sup>176</sup> 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?*

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.<sup>177</sup> Unlike internal disciplinary measures, public sanctions are visible to everyone, including potential clients and employers.<sup>178</sup> This public visibility may result in all 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.<sup>179</sup>

#### b. Effects on Firms

Some firms choose to invest in staffing and resources voluntarily to comply better with regulatory requirements. Yet, competitive

<sup>177</sup> 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.

<sup>178</sup> 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.

<sup>179</sup> See, e.g., Scholz, Enforcement Policy and Corporate Misconduct 265.

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 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.<sup>180</sup> 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

<sup>180</sup> 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.

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.<sup>181</sup> 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 in capital markets generally, leading to an increase in the supply of capital.<sup>182</sup> An increase in the supply of capital could increase capital formation while also reducing the cost of capital to companies.<sup>183</sup> 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

<sup>181</sup> 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>.

<sup>182</sup> 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).

<sup>183</sup> 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. Stud.* 1, 16–18 (2012); David Easley & Maureen O’Hara, *Information and the Cost of Capital*, 59 *J. Fin. Stud.* 1553, 1571 (2005); and William Robert Scott & Patricia C. O’Brien, *Financial Accounting Theory* 412 (Prentice Hall 3d ed. 2003).

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.

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.<sup>184</sup> 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.

<sup>184</sup> 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.

- 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.<sup>185</sup> 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,<sup>186</sup> 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.<sup>187</sup>

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.<sup>188</sup>

<sup>185</sup> 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).

<sup>186</sup> 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).

<sup>187</sup> 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.

<sup>188</sup> If not foreclosed from doing so, individuals might seek to have their firm bear these financial

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 these costs could exist in any proceeding brought under the amendment.<sup>189</sup> 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

costs pursuant to indemnification agreements, insurance agreements, or otherwise. However, such agreements or arrangements might not cover civil money penalties.

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

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.

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.<sup>190</sup> They also may be less impacted by the concern raised by other commenters that responsibility for

<sup>190</sup> 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.

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 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.<sup>191</sup>

#### 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.<sup>192</sup> 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.<sup>193</sup> 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.

#### i. Self-Protective Behavior

The Board recognized in the Proposal that auditors might engage in self-

<sup>191</sup> 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.

<sup>192</sup> Annita Florou, Serena Morricono & 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.").

<sup>193</sup> 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).

protective behavior.<sup>194</sup> 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, 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.<sup>195</sup> 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.<sup>196</sup> 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.<sup>197</sup> 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.

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'

<sup>196</sup> 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.*

<sup>197</sup> See 2023 Proposing Release at 26.

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.<sup>198</sup> 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.<sup>199</sup>

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

<sup>198</sup> 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.wpenginepowered.com/wp-content/uploads/2023/07/caq\\_increasing\\_diversity-in-the-accounting-profession-pipeline\\_2023-07.pdf](https://thecaqprod.wpenginepowered.com/wp-content/uploads/2023/07/caq_increasing_diversity-in-the-accounting-profession-pipeline_2023-07.pdf).

<sup>199</sup> 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](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.").

<sup>194</sup> See 2023 Proposing Release at 26.

<sup>195</sup> See, e.g., AS 1215, Audit Documentation.



careers.<sup>200</sup> 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.<sup>201</sup> Other contributing factors may include the retirement of baby boomers and a lack of diversity in the profession.<sup>202</sup>

On the demand side, as the economy grows, businesses evolve, and more companies go public, the demand for auditors will increase.<sup>203</sup> 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.<sup>204</sup> 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 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.<sup>205</sup> 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 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.<sup>206</sup>

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.<sup>207</sup> 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.<sup>208</sup> While the

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

<sup>201</sup> See CAQ—Edge Report at 15.

<sup>202</sup> 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>.

<sup>203</sup> 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.”).

<sup>204</sup> 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.”).

<sup>205</sup> Comment Letter from Chamber of Digital Commerce at 1 (Nov. 2, 2023).

<sup>206</sup> 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.

<sup>207</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3572291).

<sup>208</sup> 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

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.<sup>209</sup> 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 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

through the remediation of poor audit practices, they also improve audit quality by incentivizing the lower quality auditors to exit the market.”).

<sup>209</sup> Comment Letter from U.S. Chamber of Commerce at 12.

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.<sup>210</sup>

##### 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 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.

<sup>210</sup> 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.

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.<sup>211</sup> 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.”<sup>212</sup> 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

<sup>211</sup> 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.

<sup>212</sup> See Public Law 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.

audits of EGCs, Board staff prepares a white paper annually that provides general information about the characteristics of EGCs.<sup>213</sup> 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.<sup>214</sup>

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.<sup>215</sup>

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

<sup>213</sup> 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”).

<sup>214</sup> 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.*

<sup>215</sup> 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.”).

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.<sup>216</sup> 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.

<sup>216</sup> 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.

### 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
- Send an email to [rule-comments@sec.gov](mailto: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 email 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 July 23, 2024.

For the Commission by the Office of the Chief Accountant.

**Sherry R. Haywood,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-100430; File No. PCAOB-2024-03]

### Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendments Related to Aspects of Designing and Performing Audit Procedures That Involve Technology-Assisted Analysis of Information in Electronic Form

June 26, 2024.

Pursuant to section 107(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley," or the "Act"), notice is hereby given that on June 20, 2024, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or the "SEC") 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 *Amendments Related to Aspects of Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form* ("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-052> and at the Commission's Public Reference Room.