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2022 DEVELOPMENTS FOR AUDITOR REGULATION UNDER THE U.S. SECURITIES LAWS

In this article the authors begin by discussing “stunning ethical lapses” by Ernst & Young addressed by the SEC in enforcement proceedings against the firm. They then discuss the SEC’s announced “firm commitment” to target auditor independence cases. They close discussing potential progress on addressing audit quality for China-based audits.

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Access to the United States capital markets turns on numerous third-party “gatekeepers,” including perhaps most prominently public accounting firms, who provide independent audits of the financial statements for publicly traded companies.¹ As courts have noted, the integral role of the independent audits in particular effectively transforms the firms into a “public watchdog” for investors.² Yet, over the past years, commentators have raised increasing concerns about the state of auditing, with Oxford professor Karthik Ramanna writing in 2019 that there was a “crisis of

trust” in auditing — “an especially perverse situation given the audit’s central role in fostering trust in markets.”³ An alarming series of high-profile audit failures and revelations of auditor misconduct since then has only worsened this crisis of trust.

Indeed, later that same year, one of the so-called Big Four accounting firms — KPMG — admitted to stealing confidential information concerning KPMG’s regulatory inspections. That scheme led to prison sentences for KPMG personnel, and KPMG agreed to pay a \$50 million penalty and retain an independent consultant to assess the firm’s ethics and integrity to settle charges of its own admitted wrongdoing.⁴ More recently, during the

¹ See, e.g., *SEC v. Worldcom, Inc.*, No. 02 CIV. 4963 (JSR), 2003 WL 22004827, at *17 (S.D.N.Y. Aug. 26, 2003) (“[B]oards of directors, outside auditors and outside counsel are the gatekeepers of behavior standards who are able to prevent damage before it occurs if they are alert, and above all if they are willing to act when necessary.”).

² *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984) [104 S.Ct. 1495, 1503, 79 L.Ed.2d 826]; see also, *In re Parmalat Sec. Litig.*, 375 F.Supp.2d 278, 289 (S.D.N.Y. 2005) (“Independent auditors serve a crucial role in the functioning of world capital markets because they are reputational intermediaries.”).

³ K. Ramana, Building a culture of challenge in audit firms, Sept. 2019, available at <https://www.pwc.co.uk/who-we-are/future-of-audit/building-a-culture-of-challenge-in-audit-firms.pdf>.

⁴ SEC Press Release, *KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams* (June 17, 2019); J. Godoy, *Ex-KPMG Partner Gets Year In Prison For Regulatory Fraud*, LAW360, Sept. 11, 2019, available at <https://www.law360.com/articles/1197762/ex-kpmg-partner-gets-year-in-prison-for-regulatory-fraud>.

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criminal trial of former Theranos CEO Elizabeth Holmes — in which Holmes was found guilty of multiple charges related to defrauding investors — the public learned that at least three of the “Big Four” accounting firms had been engaged to provide services to Theranos, including audits.⁵ These accounting firms made millions of dollars in fees and never raised their hands to signal that something may be amiss.

Over the last year, the Securities and Exchange Commission — the U.S. regulator most directly charged with overseeing and enforcing the U.S. securities regime, including as to audit quality — has indicated it may be attempting to address this worsening level of public confidence. Signaling this potential escalation were December 2021 comments by SEC Enforcement Director Gurbir Grewal that candidly acknowledged the agency’s prior enforcement efforts had not had the “desired deterrent effect” on auditors, and that the agency’s fines had simply become a “cost of doing business.”⁶ In the months since, Grewal and other SEC officials have repeatedly continued to emphasize an increased focus on auditors and other gatekeepers. For example, on July 21, 2022, during testimony on “Oversight of the SEC’s Division of Enforcement” before the U.S. House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Grewal stated that part of the SEC’s enforcement priorities included a focus on “gatekeeper accountability.” In another instance, Grewal publicly stated that the SEC would “continue to take a hard look at gatekeepers to ensure that they are fulfilling their own professional responsibilities and not giving cover to corporations or executives engaged in possible misconduct.”⁷ Nearly a

year after Grewal’s December 2021 remarks during November 15, 2022 comments at the Securities Enforcement Forum, Grewal again emphasized increased enforcement against auditors “[b]ecause that’s what’s required for accountability and deterrence.”⁸

We summarize below three developments in the SEC’s auditor enforcement over the last year that suggest these and other comments were not just tough talk concerning: (1) stunning lapses in ethics by audit professionals at the highest levels; (2) continuing concerns about audit independence; and (3) ongoing emphasis on the need for supervision of foreign audit firms. As discussed below, these developments are promising, but also make clear that for the SEC to fulfill its duties to protect investors, this renewed rigor needs to continue.

I. STUNNING ETHICAL LAPSES

The most spectacular development this year in auditor regulation occurred on June 28, 2022, when the SEC announced a record \$100 million settlement with Ernst & Young (“EY”) concerning conduct that almost defied credulity: EY admitted widespread cheating by audit professionals on required ethics examinations, including those designed to ensure that its audit professionals could “properly evaluate whether clients’ financial statements are presented fairly in all material respects and comply with Generally Accepted Accounting Principles.”⁹ Remarkably, the SEC outlined *two* different cheating schemes in place at, and admitted by, EY. First, during 2012 and 2015, over 200 EY audit professionals

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Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, July 21, 2022, available at https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922#_ftn7.

⁸ G. Grewal, *Remarks at Securities Enforcement Forum*, Nov. 15, 2022, available at <https://www.sec.gov/news/speech/grewal-speech-securities-enforcement-forum-111522>.

⁹ SEC Press Release, *Ernst & Young to Pay \$100 Million Penalty for Employees Cheating on CPA Ethics Exams and Misleading Investigation* (June 28, 2022).

⁵ F. McKenna, *Elizabeth Holmes and her Big 4 audit firm buddies at Theranos*, Jan. 6, 2022, available at <https://thedig.substack.com/p/elizabeth-holmes-and-her-big-4-audit?s=r>.

⁶ A. Barbarino, *After EY Cheating Scandal, Will the ‘Big Four’ Finally Get It?*, LAW360, July 1, 2022, available at <https://www.law360.com/articles/1507293/after-ey-cheating-scandal-will-the-big-four-finally-get-it-?>.

⁷ G. Grewal, *Testimony on “Oversight of the SEC’s Division of Enforcement” Before the United States House of*

exploited software flaws to cheat and pass CPE exams. In response to both incidences of cheating, EY implemented a warning system. However, when the firm learned that professionals continued to cheat, it did nothing. Second, between 2017 and 2021, audit professionals cheated on Ethics examinations for Certified Public Accountants (“CPAs”) and Continuing Professional Education courses by sharing answer keys with colleagues. Further, even the professionals who did not cheat, but knew cheating was happening, improperly failed to report it (therefore violating the firm’s code of conduct).

Finally, the SEC also charged EY with improperly withholding from the SEC evidence regarding its investigation of the misconduct in question, to which EY did *not* admit. The allegations here concern in part the SEC’s view that EY acted improperly in failing to inform the SEC of its internal findings uncovering the cheating conduct. According to the SEC’s allegations, EY omitted from its response to SEC requests for information that EY had, *that same day*, received a tip about cheating within the firm.

In addition to the record \$100 million settlement amount, the SEC required EY to implement extensive remedial measures, including the unusual step of retaining *two* independent compliance consultants, instead of one.¹⁰ The \$100 million settlement amount was twice the size of the largest prior settlement to date, which concerned KPMG’s \$50 million settlement in 2019 for its admitted criminal efforts to deceive the Public Company Accounting Oversight Board (“PCAOB”) — the quasi-independent agency overseen by the SEC that is charged with oversight of audit quality. In other words, within three years, *half* of the Big Four firms — who audit the largest and most important public companies and have significant responsibility for protecting the integrity of the public markets — had collectively paid tens of millions of dollars to settle fundamental failures in understanding right and wrong. As the SEC described:

“This action involves breaches of trust by gatekeepers within the gatekeeper entrusted to audit many of our Nation’s public companies. It’s simply outrageous that the very professionals responsible for catching cheating by clients cheated on ethics exams of all things

. . . And it’s equally shocking that Ernst & Young hindered our investigation of this misconduct. This action should serve as a clear message that the SEC will not tolerate integrity failures by independent auditors who choose the easier wrong over the harder right.”¹¹

II. AUDITOR INDEPENDENCE

In his December 2021 comments, SEC Enforcement Director Grewal specifically flagged that the SEC would have a “firm commitment moving forward to continue to target . . . auditor independence cases.”¹² The importance of the auditor as “independent” has been enshrined as part of U.S. securities laws since the 1930s, as the Supreme Court recognized in its 1984 decision in *U.S. v. Arthur Young & Co.* There, the Court wrote that the regulations requiring public companies to have annual financial statements audited by independent auditors serves to “obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation’s industries.”¹³

The rationale for stressing the independence of the auditor is to protect investors from conflicts of interest that could impair or compromise the firms’ ability to conduct objective and unbiased independent reviews of public companies’ financials. The requirement for independence includes conducting non-audit work for clients — such as consulting; indeed, the Act “prohibits firms from providing certain services to their audit clients including bookkeeping and valuations, among others.”¹⁴

¹¹ SEC Press Release, *Ernst & Young to Pay \$100 Million Penalty for Employees Cheating on CPA Ethics Exams and Misleading Investigation* (June 28, 2022).

¹² D. Michaels, *Big Four Accounting Firms Come Under Regulator’s Scrutiny*, WALL ST. J., Mar. 15, 2022, available at https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574?mod=hp_lead_pos3.

¹³ J. Jensen & J. Rizio-Hamilton, *SEC Investigation Of Accounting Firms Is A Good First Step*, LAW360, Apr. 6, 2022, available at <https://www.law360.com/articles/1480219>; see also *Auditor Independence*, SEC.gov, available at <https://www.sec.gov/news/extra/audback.htm> (last modified 6/27/2000).

¹⁴ A. Iacone, *SEC Questions Auditor Independence as Firm’s Advisory Work Booms*, Bloomberg, Nov. 3, 2021, available at <https://news.bloombergtax.com/financial-accounting/sec->

¹⁰ M. Solomon, et al., *Lessons from The SEC’s Largest-Ever Audit Firm Penalty*, LAW360, July 13, 2022, available at <https://www.law360.com/articles/1511015/lessons-from-the-sec-s-largest-ever-audit-firm-penalty->

History has repeatedly shown that these sorts of concerns about independence — that an auditor’s objectivity and impartiality may be impaired by non-audit work — are not just abstract. Among the more notorious examples is the criminal accounting fraud perpetrated at Enron Corp. Enron’s auditor, Arthur Andersen LLP, gave its seal of approval to Enron’s fraudulent financials while also making millions of dollars from consulting work for Enron — with consulting fees even exceeding audit fees in the year preceding Enron’s collapse.¹⁵ Yet even as Enron and other scandals heightened focus on the importance of auditor independence, independence violations continued by the Big Four. Over the last decade, each of the Big Four have paid fines collectively totaling millions of dollars.¹⁶ During that same time, the significance of consulting and other non-audit business for the Big Four and other accounting firms has continued to grow, with consulting revenue outpacing auditing for the Big Four since 2010.¹⁷

Breaking news early in 2022 suggested that the SEC was finally taking bold new steps to address this worrying issue and following through on Grewal’s tough talk about independence. On March 15, 2022, the *Wall Street Journal* broke that the SEC was reportedly conducting a sweeping investigation of conflicts of interest at accounting firms, including the Big Four.¹⁸

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¹⁵ R. Abelson & J. Glater, *Enron’s Collapse: The Auditors; Who’s Keeping the Accountants Accountable?*, N.Y. Times, Jan. 15, 2002, available at <https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants-accountable.html>.

¹⁶ See, e.g., D. Michaels, *Big Four Accounting Firms Come Under Regulator’s Scrutiny*, WALL ST. J., Mar. 15, 2022, available at <https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574?mod=djemalert&NEWS&fbclid=IwAR1dSQaVhFCwNe4mGMrhUkezhX5qEFTF4NyAvWIr-AqC5Q9FUSLLadJb8bQ> (noting payments for independence violations by PwC (\$8 million), E&Y (\$4 million), KPMG (\$8.2 million) and Deloitte (\$1.1 million)).

¹⁷ See, e.g., supra note 17 (see graph); M. Maurer, *Big Four Firms EY, Deloitte Report Higher Revenue*, WALL ST. J., Sept. 9, 2021, available at <https://www.wsj.com/articles/big-four-firms-ey-deloitte-report-higher-revenue-11631222772>.

¹⁸ D. Michaels, *Big Four Accounting Firms Come Under Regulator’s Scrutiny*, WALL ST. J., Mar. 15, 2022, available at <https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574?mod=djemalert>

The *Journal* reported that the SEC’s Miami office had sent letters to accounting firms, including the Big Four, requesting information about “client work that could cause auditors to violate rules requiring they be independent of clients whose finances they inspect” such as “consulting, tax advice, and lobbying to audit clients.” The SEC further requested information regarding “cases in which audit firms obtained contracts that reimburse them for losses caused by lawsuits over their work or made fees contingent on a particular result or outcome.”

There have been no further reported developments on the probe since the story broke, even as additional enforcement actions continue to reinforce concerns around independence. For example, in October 2022, the SEC instituted a public administrative proceeding against a former Big Four audit partner at PwC, Joshua Abrahams, concerning his violations of auditor independence rules and other professional misconduct.¹⁹ In addition to failing to correct a \$109 million error on Mattel Inc.’s 2017 financial statement for which Abrams oversaw the audit, the SEC also alleged that Abraham had “failed to maintain independence by providing prohibited human resource advice to Mattel, including suggesting to Mattel’s then-CFO which candidate would be the best fit for a senior position at the company, as well as who should not be hired.”²⁰ These actions contradicted SEC and PCAOB independence standards, including rules that prohibit auditors from “Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that the accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate’s competence for financial accounting, administrative, or control positions).”²¹

As the rules explain, allowing an auditor to have a say in hiring by a client creates an independence conflict because the auditor would have to evaluate a candidate that the auditor helped hire. This disincentivizes objectivity and “places the auditor in the position of having an interest in the success of the employees that the auditor has selected, tested, or evaluated.” Mr. Abraham’s proceedings are continuing. The disregard

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¹⁹ SEC Press Release, *SEC Charges Mattel with Financial Misstatements and Former PwC Audit Partner with Improper Professional Conduct*, (Oct. 21, 2022).

²⁰ *Id.*

²¹ Release No. 34-96127 (2022).

for these independence standards by a Big Four partner working on the audit for such a prominent public company reaffirms the need for bold SEC enforcement, such as the probe described by the *Wall Street Journal*.

III. POTENTIAL PROGRESS ON ADDRESSING AUDIT QUALITY FOR CHINA-BASED AUDITS

This year also saw further developments relating to the SEC's long-running concerns with the use of foreign audit firms not subject to SEC or PCAOB inspection. The primary concern in this respect has been China, in which the operations of numerous companies looking to access the U.S. capital markets have been based. Among other things, numerous Chinese companies have sought to obtain access to the U.S. capital markets by registering for listing in the United States, which requires annual independent audited financial statements to be prepared — and subject to the oversight and inspections of the PCAOB. However, the quality oversight and enforcement provided by the PCAOB has been completely compromised for the influx of China-based companies, as Chinese officials have blocked U.S. regulators from conducting required inspections for audits conducted by PCAOB-registered firms in China.

As the year began, there were signs for optimism. In December 2021, the SEC finalized a disclosure rule to track and potentially delist foreign issuers that were “subject” to the “influence” of foreign governments, including those that used auditors who improperly avoided PCAOB inspections. In response, the U.S. and China began negotiating whether to allow PCAOB inspectors into the latter country to assess Chinese companies listed on U.S. exchanges.

As negotiations continued, in public remarks in July 2022, SEC Chair Gary Gensler reinforced that the Commission was not backing down on its enforcement efforts concerning foreign companies listed on U.S. exchanges, including specifically as to Chinese audits. The following month, August 2022, China had agreed to finally grant the PCAOB access to Chinese companies' records as part of an effort to avoid delisting Chinese companies from U.S. exchanges. In September 2022, Chair of the PCAOB, Erica Williams, stated that investors will know by the end of the year whether China is upholding its transparency promises or if it has continued to “obstruct” U.S. auditors.²² Indeed, just

before the year ended, on December 16, 2022, the PCAOB announced that it investigated and inspected the audit work of public accounting firms in mainland China and Hong Kong, finding deficiencies “consistent with the types and number of findings the PCAOB has encountered in other first-time inspections around the world.” According to Chair Williams, the inspections mark the beginning, not the end, of the organization's work in China.²³

An SEC enforcement action, announced the same month China agreed to grant PCAOB access, reinforced the continuing threat to investors posed by this issue and the urgent need for the SEC to address it. On September 29, 2022, the SEC issued an order charging Deloitte's China affiliate (“Deloitte China”) with failing to adhere to fundamental U.S. auditing requirements.²⁴ Specifically, the SEC alleged that Deloitte-China had allowed clients to “select their own samples for testing and to prepare audit documentation purporting to show that Deloitte-China had obtained and assessed the supporting evidence for certain clients' accounting entries.²⁵

In this connection, the SEC announced that Deloitte-China had agreed to settle the charges by paying a \$20 million penalty and implementing extensive remedial measures, including retaining an independent consultant to review and assess its policies and procedures. In its press release, SEC Director of Enforcement Grewal described the audit failures as occurring “at the most

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Audit Committee Summit (Oct. 7, 2022), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-chair-williams-delivers-remarks-at-uci-audit-committee-summit>.

²³ K. Perera, *PCAOB Wraps First-Ever Exams Of China-Based Co. Audits*, LAW360, December 15, 2022, available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history>; PCAOB News Release, *PCAOB Secures Complete Access to Inspect, Investigate Chinese Firms for First Time in History* (Dec. 15, 2022), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history>.

²⁴ S. Ho, *SEC Fines Deloitte-China for Audit Failures*, THOMSON REUTERS, Sept. 30, 2022, available at <https://tax.thomsonreuters.com/news/sec-fines-deloitte-china-for-audit-failures/>.

²⁵ SEC Press Release, *Deloitte's Chinese Affiliate to Pay \$20 Million Penalty for Asking Audit Clients to Conduct Their Own Audit Work* (Sept. 29, 2022); Release No. 95938 (2022).

²² J. Corso, *PCAOB Chair Puts Year-End Deadline On Chinese Audits*, LAW360, Sept. 22, 2017, available at <https://www.law360.com/articles/1533173/pcaob-chair-puts-year-end-deadline-on-chinese-audits?copied=1>; PCAOB News Release, *PCAOB Chair Williams Delivers Remarks at UCI*

basic level” and stated that “Deloitte-China failed to meet professional standards, exercise independence, and fulfill their essential role as gatekeepers.” SEC Chair Gensler also stated that the action underscored the need for the PCAOB “to inspect Chinese audit firms,” adding that “A fundamental goal of the PCAOB’s inspection regime is to identify weaknesses in the firms’ quality control processes — the very weaknesses at issue in this case.”

IV. WHAT’S NEXT?

While developments in 2022 suggested a commendable vigor by the SEC in holding auditors accountable for the important role they play as watchdogs for the public markets, the shortfalls and stunning failures at the highest levels of the profession also further confirm that such enforcement was overdue and that there is much more to be done to protect investors. Indeed, developments on the horizon indicate that even greater efforts will be required: in May 2022, the *Wall Street Journal* reported that “amid regulatory scrutiny of conflicts of interest in the profession,”²⁶ EY is considering restructuring efforts that would split the firms into standalone entities focused on auditing on the one hand, and tax and consulting businesses on the other.²⁷

As the SEC has acknowledged, these sorts of restructurings raise additional concerns for investors. For example, in an August 29, 2022 SEC press release, the SEC’s Acting Chief Accountant Paul Munter explained that these sorts of “complex transactions with investors that are not traditional accounting firms and have not previously been subject to the same independence and ethical responsibilities” elevates the risk to the auditor’s “independence with respect to its audit clients,” and “[f]or any such transaction to avoid potential auditor independence violations, all parties to the transaction should . . . implement monitoring processes and controls in order to comply with, among other requirements, the commission’s auditor independence rule.”²⁸

It is crucial that the SEC continue to work to address investors’ loss of trust — and repeated harms — from the systemic shortcomings and attempts to evade accountability by the auditing gatekeepers. The investigations and enforcement actions described above need to be just the first of many steps. To protect investors and our capital markets, the SEC must follow through with increased enforcement activity and, when appropriate, large fines that disincentivize any economic incentive for the watchdogs to stay quiet. ■

²⁶ M. Armental, *Ernst & Young Taps Bridget Walsh to Lead Private-Equity Expansion*, WALL ST. J., June 7, 2022, available at <https://www.wsj.com/articles/ernst-young-taps-bridget-walsh-to-lead-private-equity-expansion-11654642861>; M. Maurer & J. Eaglesham, *Accounting Firm EY Considers Split of Audit, Advisory Businesses*, WALL ST. J., May 26, 2022, available at https://www.wsj.com/articles/accounting-firm-ey-considers-splitting-audit-and-advisory-businesses-11653592588?mod=article_inline.

²⁷ A. Barbarino, *SEC Signals Audit Crackdown as Firms Seek PE Partners*, LAW360, Sept. 1, 2022, available at <https://www.law360.com/articles/1525846/sec-signals-audit-crackdown-as-firms-seek-pe-partners>.

²⁸ P. Munter, *Statement on Auditor Independence and Ethical Responsibilities: Critical Points to Consider When Contemplating an Audit Firm Restructuring*, August 29, 2022, available at <https://www.sec.gov/news/statement/munter-statement-auditor-independence-and-ethical-responsibilities-082922>.