



November 3, 2023

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

Re: Proposed Rule to Amend PCAOB Rule 3502, Responsibility Not to Knowingly or Recklessly Contribute to Violations; PCAOB Rulemaking Docket Matter No. 053; PCAOB Release No. 2023-007 (Sept. 19, 2023)

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board:

Better Markets<sup>1</sup> appreciates the opportunity to comment on the above-captioned Proposed Rule to Amend PCAOB Rule 3502 issued by the Public Company Accounting Oversight Board (“PCAOB” or “the Board”). Better Markets applauds the PCAOB for its proposed amendments to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, which is the Board’s rule governing the liability of associated persons who contribute to a registered public accounting firm’s violation of accounting standards.<sup>2</sup>

Better Markets strongly supports the Board’s Proposal to lower the threshold of liability for contributory actions by associated persons from recklessness to negligence. Better Markets also supports the Board’s Proposal to prohibit associated persons from negligently contributing to a violation by *any* registered public accounting firm, instead of solely the registered firm with which they are associated. In keeping with the Board’s statutory mission of investor protection set forth in the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”),<sup>3</sup> the proposed changes would advance the public interest by improving auditing quality, strengthening PCAOB enforcement, incentivizing compliance, and enhancing investors’ confidence in the reliability of companies’ financial statements.

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<sup>1</sup> Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies – including many in finance – to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

<sup>2</sup> PCAOB, *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability* (“the Proposal”), PCAOB Release No. 2023-007 (Sept. 19, 2023), [https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51\\_9](https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/053/pcaob-release-no.-2023-007-rule-3502-proposal.pdf?sfvrsn=7d49cc51_9).

<sup>3</sup> Pub. L. No. 107-204, 15 U.S.C. § 7201 *et seq.*

## I. Background

In the late 1990s and early 2000s, a series of high-profile corporate scandals rocked the financial markets and resulted in massive financial losses and significant harm to investors. Companies like Enron, WorldCom, Tyco, and others engaged in rampant accounting fraud, manipulated financial statements, and misled investors.<sup>4</sup> These scandals resulted in a severe erosion of investor confidence in the financial markets, as investors felt that they could no longer trust the accuracy and reliability of corporate financial statements, which are fundamental to investors' ability to make informed investment decisions. The PCAOB was created as a direct response to these accounting scandals and corporate failures. Its establishment was a key component of Sarbanes-Oxley, which aimed to restore public confidence in financial reporting and corporate governance. The Sarbanes-Oxley Act, at its core, "was designed to fix auditing problems of US public companies, which is consistent with the official name of the law: the Public Company Accounting Reform and Investor Protection Act of 2002."<sup>5</sup>

The establishment of the PCAOB was thus driven by a commitment to protect the public, investors, and markets by ensuring high auditing standards, transparency, and accountability in the financial reporting process. High auditing standards are vital for a well-functioning, robust, and trustworthy financial system that attracts investment and maintains market stability. As part of this mandate to protect investors and the public, Congress authorized the PCAOB to issue rules to regulate auditor conduct.<sup>6</sup>

In 2005, the Board codified auditors' longstanding obligation not to contribute to firms' violations in PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.<sup>7</sup> PCAOB Rule 3502 is a pivotal component of the regulatory framework that governs the auditing and financial reporting profession in the United States. It establishes the standard for liability for violations of PCAOB's rules and standards, aiming to enforce accountability, maintain professionalism, and protect the interests of investors and the public. The rule's significance lies in its contribution to audit quality, investor confidence, and the overall integrity of financial reporting.

As explained by the Proposal, "PCAOB Rule 3502 provides grounds for secondary liability when an associated person of a registered firm acts *at least recklessly* to directly and substantially contribute to a violation by that firm of a law, rule, or standard that the Board is charged with

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<sup>4</sup> See, e.g., C. William Thomas, *The Rise and Fall of Enron*, J. OF ACCOUNTANCY 1 (Apr. 2002).

<sup>5</sup> John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSPECTIVES 91 (2007), <https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.21.1.91>.

<sup>6</sup> Sarbanes-Oxley, § 103(a)(1); § 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), [https://pcaobus.org/Rulemaking/Docket017/2005-07-26\\_Release\\_2005-014.pdf](https://pcaobus.org/Rulemaking/Docket017/2005-07-26_Release_2005-014.pdf).

enforcing.”<sup>8</sup> For nearly two decades since its issuance in 2005, Rule 3502 has served as the PCAOB’s basis for bringing enforcement actions against associated persons who contribute to violations, and it has played a critical role in ensuring the integrity and accountability of auditors, audit firms, and other professionals engaged in the audit and review of financial statements.

## **II. The Current Rule Is Inappropriately Limited, and the Board’s Proposed Changes Harmonize the Liability Provisions in Accordance with Logic and Policy.**

Despite the importance of Rule 3502, the rule’s “current formulation contains an incongruity that places *negligent* contributors to firms’ violations beyond the rule’s reach.”<sup>9</sup> This incongruity stems from the fact that although a firm can commit a primary violation of an accounting rule by acting *negligently*, an “an associated person who directly and substantially contributed to that violation must have acted at least *recklessly* to be secondarily liable.”<sup>10</sup> In other words, Rule 3502 currently requires “a level of culpability higher than negligence—at least recklessness—before the Board can impose sanctions against associated persons who contribute to firms’ negligence-based violations.”<sup>11</sup>

The difference between these two standards of liability is substantial and consequential, directly impacting the Board’s ability to fulfill its statutory mission. As the Board describes it, whereas negligence is “the failure to exercise reasonable care or competence,”<sup>12</sup> recklessness requires “an extreme departure from the standard of ordinary care for auditors” that “is either known to the actor or is so obvious that the actor must have been aware of it.”<sup>13</sup> Thus, the current Rule 3502 can produce anomalous results where “associated persons who do not exercise reasonable care and contribute to firms’ violations may escape liability and accountability—even while the firms committing the violations do not.”<sup>14</sup>

The illogic of applying two separate standards to firms and individuals is apparent on its face. First, as the Proposal notes, registered firms can only act through natural persons, and “[i]t logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person’s negligence.”<sup>15</sup> It makes little sense, then, that

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<sup>8</sup> Proposal, at 4 (emphasis added).

<sup>9</sup> Proposal, at 7 (emphasis added) (“A firm can commit a primary violation of certain laws, rules, or standards by acting negligently, but an associated person who directly and substantially contributed to that violation must have acted at least recklessly to be secondarily liable.”)

<sup>10</sup> Proposal, at 7 (emphasis added).

<sup>11</sup> Proposal, at 3.

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

<sup>13</sup> *Marrie v. SEC*, 374 F.3d 1196, 1203 (D.C. Cir. 2004) (citation and quotation marks omitted); *see also* 2005 Adopting Release, *supra* note 7 at 13 (“[T]he phrase ‘knew, or was reckless in not knowing’ is a well-understood legal concept, and the Board intends for the phrase to be given its normal meaning.”).

<sup>14</sup> Proposal, at 3.

<sup>15</sup> Proposal, at 3.

the individuals whose negligence directly contributed to a firm’s violation can escape liability while the firm is nonetheless found liable.<sup>16</sup>

The Board has therefore rightly proposed to change the standard for secondary liability from an “extreme departure from the standard of ordinary care” (recklessness) to “the failure to exercise reasonable care or competence” (negligence).<sup>17</sup> Under the new negligence standard, an associated person can be held liable for an act or omission the person “knew or should have known” would contribute to a violation. This is in keeping with the ordinary negligence standard found elsewhere in the law, which is subject to the traditional “reasonable person” test.<sup>18</sup>

Moreover, as a second component of the rule, the Board proposes to amend the rule to remove the longstanding requirement that the individual who causes a violation by the registered firm be an associated person of that very same firm. Under the new rule, “an individual contributing to a registered firm’s primary violation need not be an associated person of the firm that commits the violation so long as the individual is an associated person of some registered firm.”<sup>19</sup> This too is an important reform that will appropriately expand the universe of persons who can be held accountable for contributing to violations of the accounting standards. Our comments here focus primarily on the first enhancement to the rule, which lowers the standard of liability for associated persons from recklessness to negligence.

### **III. The Proposal on the Liability Threshold Is Well-Justified on Multiple Grounds, and It Will Serve the Objectives of the PCAOB and the Broader Public Interest.**

Better Markets strongly agrees with the PCAOB that reducing Rule 3502’s liability threshold from recklessness to negligence will better protect investors and strengthen financial markets. It will do so by (1) better deterring misconduct and enhancing audit quality; (2) strengthening PCAOB enforcement efforts; (3) increasing investor confidence in corporate financial statements; (4) imposing fair and appropriate ethical standards in keeping with industry practices elsewhere; and (5) clearly and unambiguously advancing the Board’s statutory mission.

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<sup>16</sup> See Anthony C. Thompson, Board Member, *PCAOB Open Board Meeting, Board Member Thompson’s Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (Sept. 19, 2023) (“The PCAOB can hold a firm accountable for negligently violating PCAOB rules and standards; however, an associated person who directly and substantially contributes to such violations is held to a recklessness standard, which is a higher threshold [and] [t]his discrepancy is inconsistent with our investor protection mission.”), <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson>.

<sup>17</sup> Proposal, at 13.

<sup>18</sup> Proposal, at 22.

<sup>19</sup> Proposal, at 3.

**1. *The Proposed Rule Would Deter Auditor Misconduct and Thereby Enhance Audit Quality.***

Rule 3502’s current recklessness standard inadequately incentivizes associated persons to exercise the appropriate level of due care in their audit work. If an associated person knows that they cannot be held individually liable by the PCAOB for a firm’s primary violation unless an act or omission by them amounts to an “an extreme departure from the standard of ordinary care for auditors,” they may be less inclined to exercise reasonable care in all aspects of their auditing work.<sup>20</sup>

Conversely, the threat of liability for negligence under the revised Rule 3502 will encourage auditors and audit firms to maintain a high level of quality in their audit work, benefiting investors and financial markets alike.<sup>21</sup> A negligence standard sends a strong message to auditors that they must exercise a higher level of care and diligence in their auditing.<sup>22</sup> This heightened level of deterrence will reduce the risk of substandard audits by encouraging auditors to be more diligent in adhering to professional standards and regulations to avoid potential liability.<sup>23</sup> The rule will not only incentivize individual compliance but also induce firms to ensure, through training and other measures, that their employees are more scrupulously compliant with auditing standards. This, in turn, will contribute to the reliability and accuracy of financial statements, which are essential for investors and other stakeholders.

**2. *The Proposed Rule Would Strengthen PCAOB Enforcement Efforts.***

By reducing the relevant burden of proof for the liability of associated persons to a more appropriate level, the proposed rule will strengthen the Board’s enforcement of important accounting rules. As the Proposal rightly notes, demonstrating recklessness entails meeting a higher burden of proof than a showing of negligence and can thus be challenging and resource-intensive to establish in legal proceedings. A negligence standard, which, contrary to recklessness, does not require a showing of knowledge or intent, will make it easier for regulators to establish liability against individuals who bear responsibility for violations, freeing up time and resources

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<sup>20</sup> See Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 VAND. L. REV. 1871, 1885 (2019) (observing that “existing deterrence mechanisms have failed to produce optimal audit quality”).

<sup>21</sup> See Alan Reinstein, Carl Pacini, & Brian Patrick Green, *Examining the Current Legal Environment Facing the Public Accounting Profession: Recommendations for a Consistent U.S. Policy*, 35 J. ACCOUNT. AUD. & FIN. 3, 21 (2020) (“[S]uccessful malpractice lawsuits and PCAOB sanctions help improve the target’s and other CPA firms’ audit procedures.”), <https://tinyurl.com/yufo3k9s>.

<sup>22</sup> 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.”).

<sup>23</sup> See Dharmasiri P, Phang SY, Prasad A, Webster J., *Consequences of Ethical and Audit Violations: Evidence from the PCAOB Settled Disciplinary Orders*, 179 J. BUS. ETHICS 179 (2022) (“Prior research indicates that legislation and regulations formulated by the PCAOB create pressure for auditors to adopt or pursue certain practices.”), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7975239/>.

for other enforcement efforts. The proposed changes are thus in keeping with the Board’s stated goal to “strengthen enforcement,” as set forth in its Draft Strategic Plan for 2022–2026.<sup>24</sup>

**3. *The Proposed Rule Would Increase Investor Confidence in Corporate Financial Statements, Bolstering Financial Markets and Capital Formation.***

Ensuring the integrity of financial reporting is critical to maintaining confidence in the capital markets. This protection is especially important because consumers and investors rely on financial statements and audit reports for making informed financial decisions. By establishing a clear framework of liability for negligent auditors, the proposed rule will likely boost investor confidence in the financial reporting process, thereby strengthening our financial markets as a whole. As Board member Anthony C. Thompson put it, “[t]his rulemaking seeks to ensure that persons who orchestrate or facilitate firm violations cannot continue to perpetuate such conduct uncharged and unsanctioned. As we know, such conduct can erode investors’ perception of the quality of audits and their confidence in the capital markets.”<sup>25</sup> Under the new standard, investors would be able to more safely rely on audited financial statements as a credible source of information for their investment decisions, an outcome that not only better protects investors but also strengthens and attracts capital to our financial markets.

**4. *The Proposed Rule Is Fair, Limited in Scope, and Consistent with the Law Elsewhere.***

To the extent associated persons impacted by this rule change may be concerned about an ostensibly overbroad rule ensnaring them in liability for relatively minor accounting mistakes, these concerns should be allayed by the rule’s limitation to solely individuals who “*directly and substantially contributed* to a firm’s violations of the laws, rules, and standards that the Board enforces.”<sup>26</sup> As Chair Erica Williams rightly put it, the scope of the rule’s language is narrow and is not intended to trap unsuspecting accountants with minor mistakes:

[T]hese updates are not intended to ensnare junior professionals or other auditors who are responsibly executing their duties. Again, to be held liable under the proposal, not only do associated persons have to act negligently, this proposal also maintains the current requirement that their negligence must have contributed to the firm’s violation both “directly and substantially.” That does not include auditors whose conduct is remote from, or tangential to, the firm’s violation.<sup>27</sup>

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<sup>24</sup> Draft 2022-2026 PCAOB Strategic Plan, PCAOB Release No. 2022-003 (Aug. 16, 2022), <https://tinyurl.com/ys9h8ucp>.

<sup>25</sup> Anthony C. Thompson, Board Member, PCAOB Open Board Meeting, *Board Member Thompson’s Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations*, (Sept. 19, 2023), <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability-thompson>.

<sup>26</sup> Proposal, at 12 (emphasis added).

<sup>27</sup> Erica Y. Williams, Chair, PCAOB Open Board Meeting, *Chair Williams’ Statement on Proposed Changes to Board Rule on Contributory Liability for Firm Violations* (Sept. 19, 2023), <https://pcaobus.org/news-events/speeches/speech-detail/chair-williams-statement-on-proposed-changes-to-board-rule-on-contributory-liability-for-firm-violations>.

The proposed negligence standard would also better align with the approach in the majority of states, which overwhelmingly do not limit auditors' liability for negligent violations of auditing standards.<sup>28</sup> Indeed, in private suits brought against auditors for negligent misrepresentation, courts have long applied the *Restatement (Second) of Torts* to hold that auditors owe a duty not only to their clients but also to any foreseeable third-party who reasonably relies on the auditor's work to their detriment:

A 1968 Rhode Island federal district court first expanded auditor liability for negligent misrepresentation to foreseen or known users in *Rusch Factors v. Levin* (284 F. Supp. 85 [D.R.I. 1968]). The court applied §552 of the *Restatement (Second) of Torts*. Thus, an auditor who audits or prepares client financial information owes a duty to the client and to any other person or one of a class of persons whom the accountant or client intends the information to influence if that person justifiably relies on the information in a transaction that the accountant or client intends the information to influence, and such reliance results in a pecuniary loss for the person. The . . . *Restatement* standard . . . does not require the auditor to know the specific persons' identity; it instead requires only that the third parties be members of a limited class of persons known to the auditor.<sup>29</sup>

As summarized by Reinstein *et al.*, thirty-three states now follow some version of this *Restatement* standard when determining liability for negligent auditors.<sup>30</sup> The Board's proposal to expand the scope of liability for associated persons to include negligence is thus far from a radical departure from common industry practice.

##### ***5. The Proposed Rule Clearly and Unambiguously Advances the Board's Statutory Mission.***

While any profit-driven firm — such as the accounting firms and professionals regulated by this rule — will predictably and understandably always be concerned by the prospect of an expansion in the scope of their potential liability, the PCAOB's mission is not to protect accountants' bottom line. Under Sarbanes-Oxley, the main function of the PCAOB is “to oversee the auditors of public companies, protect the interests of investors, further the public interest in the preparation of informative, accurate, and independent audit reports,” and generally, to administer

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<sup>28</sup> Reinstein *et al.*, at 13 (“[O]nly 15 states limit auditors' liability for negligence to third parties. Much variation exists among the other 35 states.”).

<sup>29</sup> Reinstein *et al.*, at 6–7.

<sup>30</sup> Reinstein *et al.*, at 7; *see also* Tim Bush, Stella Fearnley, & Shyam Sunder, *Auditor Liability Reforms in the UK and the US: A Comparative Review*, pp. 1-47 (2007), <https://depot.som.yale.edu/icf/papers/fileuploads/2575/original/07-33.pdf>.

the accounting provisions of the Sarbanes-Oxley Act.<sup>31</sup> The proposed changes to Rule 3502 fall squarely within the scope of this mission and clearly and unambiguously advance its cause.

We also urge the Board to look skeptically upon the claims of undue burden, cost, and expense coming from industry voices subject to the proposed rule. Time and again, those seeking to derail any attempt at stronger regulation will levy unjustified predictions of industries being wholly upended or stifled by agencies' rules and regulations. Virtually never do these predictions come to pass, and nor will they here. The Proposal clearly and unambiguously puts the interests of the public and investors front and center, which is precisely what the Board is tasked to do under Sarbanes-Oxley.

#### **IV. The Second Component of the Proposal Will Advance the PCAOB's Mission by Expanding the Rule's Scope to Better Account for Contemporary Auditing Realities.**

To be subject to potential liability under the current Rule 3502, “an associated person of a registered public accounting firm must at least recklessly, directly, and substantially ‘contribute to a violation by that registered public accounting firm,’ meaning the firm of which the individual is an associated person—and *only* that firm.”<sup>32</sup> In other words, “Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated.”<sup>33</sup>

The second component of the proposed rule amends Rule 3502 to provide that “an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation (i.e., that an associated person of one firm can contribute to a primary violation of another firm).”<sup>34</sup> In other words, the proposed amendment would remove the current requirement that “the registered firm of which the contributory actor is an associated person must be the same firm that commits the primary violation.”<sup>35</sup>

This is a welcome revision to Rule 3502 that better takes into account “the complexity of many contemporary audits and the multiple firms involved in them.”<sup>36</sup> As the Proposal rightly notes, “contributory liability for an associated person who directly and substantially contributes to a firm’s primary violation shouldn’t be contingent upon the individual’s formal role or relationship with that firm, so long as the individual is an associated person of *any* registered firm.”<sup>37</sup> This

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<sup>31</sup> See Sarbanes-Oxley Act, Section 101 *et seq*; see also John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, *supra* note 5; Thomas C. Pearson, *Potential Litigation Against Auditors for Negligence*, 5 BROOK. J. CORP. FIN. & COM. L. 405, 406 (2011), <https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1100&context=bjcfcl>.

<sup>32</sup> Proposal, at 8 (emphasis added).

<sup>33</sup> Proposal, at 16.

<sup>34</sup> Proposal, at 1.

<sup>35</sup> Proposal, at 16.

<sup>36</sup> Proposal, at 3.

<sup>37</sup> Proposal, at 9.



change would clarify the scope and application Rule 3502, “mindful of registered firms’ contemporary organizational structures, operational practices, and varied roles and assignments for certain personnel.”<sup>38</sup> Better Markets therefore agrees with the Board that the proposed amendments would better enhance investor protection and advance the statutory mission of the PCAOB.

## **CONCLUSION**

We hope these comments are helpful as the Board finalizes this meritorious Proposal.

Sincerely,



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<sup>38</sup> Proposal, at 16–17.