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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Statement of Legal Considerations Related to PCAOB Rulemaking Docket Matter No. 029, *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*

Dear Madame Secretary:

I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to joining the Duke faculty in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I am currently a member of the Standing Advisory Group of the Public Company Accounting Oversight Board. In the past, I was a member of the New York Stock Exchange Legal Advisory Committee, the National Association of Securities Dealers Legal Advisory Board, and the Committee of Corporate laws of the Business Law Section of the American Bar Association. Among my publications are Securities Regulations: Cases and Materials (7th ed. Aspen 2013)(with Langevoort and Hillman), which has been adopted in approximately two-thirds of American law schools, and a multi-volume award winning treatise, The Law of Corporations (3d ed. 2010)(with Hazen). The views I express here are my own and are not on behalf or to be attributed to any of the before-mentioned organizations.

Currently the audit opinion letter bears only the signature of the audit firm and not the signature of the particular professional in charge of that engagement (the engagement partner). In this submission I review a variety of legal issues related to the impact of expanding the opinion letter to include identification of the engagement partner. The focus of this analysis is on the federal securities laws and not state fraud laws. This reflects the premise that it is liability under the federal securities laws and not state law that is of most import. This premise reflects that materially misleading audited financial statements of public companies elicit class action proceedings that are most frequently guided solely by federal law. The dominance of federal law in such litigation is a consequence of the Securities Litigation Uniform Standard Act of 1998 (SLUSA) that enables defendants to remove class actions in "covered securities" to federal court; once the action is in federal court, federal, not state, principles shape the rights of plaintiffs and the defenses of defendants. Nonetheless, in the rare instance of a non-class action suit against the engagement partner, that partner's signing or not signing the opinion letter is of no consequence in determining the auditor's or his/her firm's liability to a relying plaintiff. That is, changing auditing procedures to require the engagement partner to sign or otherwise identify himself/herself will not change the contours of the auditor's liability under existing state law.

The predominant provisions of securities fraud suits for misleading audited financial statements are Section 11 of the Federal Securities Act, Section 10(b) and Rule 10b-5 under the Securities Exchange Act, Section 18 of the Securities Exchange Act, and the control person provision that private remedies in both the Securities Act and the Securities Exchange Act. Of these provisions, Section 11 is widely and correctly understood as the securities law provision that imposes the most demanding standard of conduct on auditors.

Audit Partner Liability under Section 11 of the Securities Act

Under Section 11(a)(4), audit firms presently are subject to liability for material omissions or misstatements in their audited statements when the registration statement becomes effective. Audit firms are liable as an "expert," which requires that among the exhibits to the registration statement there is a letter from the audit firm consenting to be identified as an expert with respect to the financial statements so audited. Section 11(b)(3)(B) provides that any expert is liable, unless the expert bears the burden of establishing that:

> (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy or extract from his report or valuation as an expert....

The above quote sets forth the so-called "due diligence" defense. Because the defense to liability demands a "reasonable investigation," it is akin to a negligence standard as it requires the auditor to undertake a searching inquiry of the type typically associated with auditing standards. So understood, there is no reason to believe that exposing the engagement partner to Section 11 liability changes the substantive or procedural requirements of generally accepted auditing standards. The due diligence standard of Section 11 complements the undertaking demanded by generally accepted auditing standards. The effect of the engagement auditor becoming an "expert" under Section 11 would be that the partner would be liable under Section 11 unless s/he established all the elements of the above-quoted due diligence defense - a standard that mirrors the common law and professional undertakings of being an auditor.

As a technical matter, engagement partners cannot be identified as or deemed an expert unless the SEC amends its rules to require the engagement partner to be identified as among the issuer's experts; the SEC would also have to act to provide that its rules require the engagement partner to consent to be identified as an expert. As with current practice for the auditing firm, the consent would be among its exhibits to the registrant's materials filed with the SEC. This conclusion would appear mandated by any fair reading of Section 7 of the Securities Act which requires that an expert must consent to be deemed an expert. This conclusion is based on the following from Section 7:

> If any accountant . . . is named as having prepared or certified any part of the registration statement . . . the written consent of such person shall be filed with the registration statement.

Therefore, if the PCAOB acts to require the engagement partner to sign or otherwise be identified with the audit opinion that is included in a '33 Act registration statement, such signature or identification alone would not render the engagement partner liable under Section 11; before liability can be extended to an engagement partner the SEC would have to complete the regulatory circle by amending its rules to complement Section 7 of the Securities Act.

Audit Partner Liability under Section 10(b) and Rule 10b-5

Much of the private litigation against auditors has been under Section 10(b) and Rule 10b-5. Unlike Section 11's "due diligence" standard, liability under Rule 10b-5 requires conduct that is at least recklessness. This standard not only means an extreme departure from the standard of reasonable care but requires as well deliberateness on the defendant's part in the form of a conscious embrace of a substantial risk that a statement s/he makes is materially misleading. The standard, therefore, has an element of consciousness of a disclosure violation; for this reason this element is customarily referred to as the scienter requirement for Rule 10b-5. After the Private Securities Litigation Reform Act of 1995, the complaint instituting a Rule 10b-5 suit must not only allege with particularity facts supporting the allegation that the defendant acted with scienter but those facts must also support a "strong inference" the defendant acted with scienter. Courts have consistently held that an auditor's failure to act consistent with generally accepted accounting principles and/or to employ generally accepted auditing standards alone does not constitute scienter.

Liability under Rule 10b-5 does not extend to "aiders and abettors" but only to primary participants. The definition of a primary participant is currently subject to some uncertainty, discussed below. In holding there is no aiding and abetting liability in Rule 10b-5 actions, the Supreme Court in *Central Bank of Denver v. First Interstate Bank,* 511 U.S. 164 (1994), reasoned Rule 10b-5 proscribed only the "*making* of a material misstatement (or omission)." The court nonetheless observed:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in securities markets are always free from liability under the securities acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or *makes* a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all the requirements of primary liability Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators. . . .

Id. at 191 (emphasis added).

As can be seen, "make" is the operative verb in *Central Bank of Denver*; a primary violator is the individual who *made* the misrepresentation that is the heart of the claim of fraud. The most authoritative guidance on the meaning of "make" is *Janus Capital Group Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011):.

> For the purpose of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. . . . One who prepares or publishes a statement on behalf of another is not its maker. *And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by . . . the party to whom it is attributed.*

Id. at 2302 (emphasis added). There have been no case holdings on auditors as primary participants under *Janus Capital.* If the engagement partner did sign the audit opinion, it would thereby allow third party users of the financial statements to attribute the financial statements covered by that signed opinion letter to the signing engagement partner.

It is not clear what the result will be reached under Rule 10b-5 for an engagement partner who is not identified in the audit opinion. The uncertainty to this question arises on several levels. First, in applying *Janus Capital,* it is not clear how the question of who has the ultimate authority for the release/publication of the audited financial statements. When there is no way to attribute the statement directly to the individual auditor, i.e., the engagement partner is not identified, we then must rely on the "ultimate authority" standard. Under this standard, it would appear that the ultimate authority would rest elsewhere than the engagement partner. For example, the filing of Form 10-K requires a series of signatures, including the majority of the directors, to be filed. Do we conclude that ultimate authority rests with the signatories of the audit client? Thus, were only the "ultimate authority" standard tobe applied, it is uncertain whether *Janus Capital* would insulate the audit firm and its engagement partner. However, if both the firm and the engagement partner sign the audit opinion letter, a more persuasive argument is that *Janus Capital* would treat the signing audit firm and its engagement partner as primary participants consistent with the "attribution" reference in the italicized portion of the quote from *Janus Capital*.

A second level of uncertainty is whether the focus on "make" is narrower than all possible claims that can be asserted under Rule 10b-5. That is, there are three broad proscriptions in Rule 10b-5 and only one of those clauses uses the verb "make." Rule 10b-5 provides:

> It shall be unlawful for any person . . .
>
> (a) to employ any device, scheme, or artiface to defraud,
> (b) to *make* any untrue statement of material fact or to omit to state a material fact necessary in order to *make* the statements *made*, in light of the circumstances under which they were *made*, not misleading, or
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceipt upon any person,
>
> in connection with the purchase or sale of any security. (emphasis added)

The distinction in operative verbs among the three parts of Rule 10b-5 was recently invoked by three of the five SEC Commissioners, as well as two intermediate courts, to extend Rule 10b-5 beyond *Janus Capital*. *In the Matter of John P. Flannery & James D. Hopkins,* Sec. Act. Rel. No. 9869 (Dec. 15, 2014). *See also* SEC v. Monterosso, 756 F.3d 1326 (11th Cir. 2014)(reading *Janus* as interpreting only that clause in Rule 10b-5 that references "make" with the consequence that SEC was successful in establishing defendants in enforcement action were primary participants even though they lacked ultimate control over release of misleading information); Prousalis v. Moore, 751 F.3d 272 (4th Cir. 2014)(*Janus* ultimate authority test does not define primary participant in a criminal proceeding). If *Janus'* ultimate responsibility standard is cabined to only Rule 10b-5(b) that refers to the "making" of an untrue statement, it could result in a fraudulent engagement partner being deemed a primary participant, even though the engagement partner is not identified in the audit opinion. This outcome, however, depends on whether courts employ an attribution standard whereby a primary participant must be sufficiently identified with the false statement so that a third party can attribute that statement to that defendant. *See e.g., Wright v. Ernst & Young LLP*, 152 F.3d 169 (2nd Cir. 1998). This was the approach across most circuits before *Janus* was decided. Under such an attribution standard, an engagement partner who is not identified with the misleading financial statements would not be a primary participant. Before *Janus* was decided, a minority of the circuit courts applied the broader "substantial participant" standard to impose liability on individuals who drafted misleading statements even if the statements could not be attributed to the auditor. *See e.g., Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (3d Cir. 1994). On the whole, it would appear that a requirement that the engagement partner sign or otherwise be identified would likely increase the risk of personal liability under Rule 10b-5 for the signing engagement partner this conclusion is qualified by the uncertainty whether both the *Janus* and attribution standards will ultimately prevail as the boundaries of Rule 10b-5 continue to evolve.

Audit Partner Liability under Section 18

Section 18 of the Securities Exchange Act imposes liability on "any person who shall make or cause to be made any statement in" a filing with the SEC. Courts have not held that *Janus'* ultimate authority approach to "make" or "made" applies to actions under Section 18. An engagement partner could well be deemed a person who makes such a statement and this determination would appear unrelated to whether the engagement partner signed or is otherwise identified with the false audit opinion. This result would follow by distinguishing the making of the misleading statement itself from the making of the filing. The literal reading of Section 18 refers to the former but not the latter. In contrast, under *Janus'* construction of Rule 10b-5, the Court's focus was on the publication or circulation of the misleading statement, not who prepared or wrote the particular misleading statement. If focus is on making the statement rather than making the filing, the absence of the auditor's signature on the opinion letter is of no consequence.

Because Section 18 requires the plaintiff to make an affirmative allegation of reliance, it is not possible for claims raised under Section 18 to be aggregated in a class action. Nonetheless, Section 18 is frequently resorted to by so-called "opt outs," who are invariably institutional investors who have suffered large losses as a result of the misrepresentation. The institution's loss is large enough so that as a practical matter the claim can be pursued independently, i.e., aggregation with the claims of others is not necessary to justify the expected costs of pursuing the claim. Among the advantages of Section 18, despite burdening the plaintiff with an affirmative requirement of reliance, is the plaintiff's complaint does not have to allege a "strong inference" of fraud as applies in Rule 10b-5 suits; the element of the defendant's knowledge enters the case as part of the defendant establishing "he acted in good faith and had no knowledge that such statement was false or misleading." In sum, there is a very good likelihood of individual liability under Section 18 of a non-signing engagement partner; thus, a new requirement that the engagement partner sign the opinion letter, or otherwise be identified, would have not alter the auditor's liability exposure.

Control Person Liability

Each provision of the securities laws provides that a person who controls another who commits a violation is liable as a control person. The control person liability provision for the Securities Act is set forth in Section 15. Securities Exchange Act Section 20(a) also imposes liability on control persons. There does not appear to be much chance that an engagement partner would be deemed a control person of the partner's audit firm and certainly would not be a control person of the audit client. In any case, signing the audit opinion has no impact on whether the auditor would be a control person.

To begin the analysis, Section 15 of the Securities Act imposes liability on anyone who controls a person liable under Section 11. Thus, if an audit firm is liable under Section 11 then a person who controls the audit firm can be also liable. However, at least in the case of Big 4 or second-tier public accounting firms, the engagement partner is unlikely to be deemed to "control" the employing audit firm. Control has been defined in the courts to require that a person to be a control person have actually exercised control over the operations of the wrongdoer (e.g., primary violator) generally and have had the potential or power to have controlled the specific wrongful transaction itself. *See e.g.*, Metge v. Baehler, 762 F.2d 621, 630-631 (8th Cir. 1985). The engagement partner likely meets the latter but not the former. However, if the accounting firm is quite small, it could be possible that the engagement partner would have both exercised control over the accounting firm and have at least had the potential to control the audit that was fraudulent. To my knowledge, the control person provision has never been successfully invoked against an engagement partner. In both events - when the engagement partner does not control or does control the audit firm – the signing the audit letter has no consequential effect on the auditor's liability as a control person.

I am hopeful that the above overview of the liability standards that surround the audit opinion letter, and more particularly the additional risk to the engagement partner, if any, of the PCAOB requiring the engagement partner to sign the audit opinion or otherwise be identified as the engagement partner, will be helpful to the PCAOB as it considers this matter of great importance to the users of audited financial statements.

Sincerely,

James D. Cox