August 7, 2023

Submitted electronically to: ***comments@pcaobus.org***

Ms. Phoebe W. Brown
Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket 051: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulation

Dear Ms. Brown,

SIFMA[1] appreciates the opportunity to provide feedback to the Public Company Accounting Oversight Board ("PCAOB" or "Board") regarding its proposal to revise auditing standards relating to companies' potential noncompliance with laws and regulations.

I. Executive Summary

In its proposal, the PCAOB states that its goals are to promote audit quality by enhancing the identification, evaluation, and communication of noncompliance with laws and regulations; to promote consistency in practice; and to improve investor protection on a real-time and ongoing basis.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation, and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

As described in more detail below, the proposed changes to auditing standards are not appropriate measures to achieve these purposes, for at least the following reasons:

- The proposal would dramatically expand the auditor's role to matters outside its area of competency, and thus would not be optimally effective while also being time-consuming, adding unnecessary expense (which ultimately will be borne by shareholders), and distracting from the important core function.

- The proposal would create significant ambiguity for auditors and companies, further increasing time and expense, and diminishing auditor effectiveness.

- The proposal is not sufficiently clear because the auditor is not permitted to perform management functions and is not in possession of all relevant information about the current and planned future operations of the business necessary to identify all laws and regulations that could potentially be applicable to the company and with which noncompliance could reasonably have a material effect on the financial statements.

- The proposal would undermine the attorney-client relationship, at the risk of depriving companies of expert guidance regarding their compliance with laws and regulations, and thereby materially increasing exposure to investors.

- The proposal would add an unnecessary and complicated oversight regime for industries that are already required by law to design, establish, and maintain a supervisory system and employ licensed supervisory personnel to achieve compliance with laws and regulations, including antifraud provisions of state and federal jurisdictions.

- As written, the proposed changes are not necessary and, in fact, may well undercut the very goals the PCAOB seeks to achieve.

The Board should not adopt the proposal because the existing audit standards appropriately address risks that are material to users of financial statements, while balancing the proper roles of auditors, companies, and companies' legal counsel.

SIFMA's primary concerns are discussed below.

II. <u>The proposal would dramatically expand the role of the independent auditor into areas well outside its role in the financial reporting process, compromising the auditor's competence and diverting attention from its core functions.</u>

Audit firms have neither the expertise nor the infrastructure to determine consistently and accurately when a company may be in violation of complex, varied, and numerous laws and regulations in a way that "could," even "indirectly" (as the PCAOB proposes), materially impact the company's financial statements. Proposed AS2405 would significantly expand requirements for existing audit procedures by requiring auditors to take new proactive steps to identify and consider noncompliance with laws and regulations which *could reasonably* have a material impact on the financial statements. In practice, this could lead to a thorough examination of nearly all laws and regulations to which a company may be subject. For companies that are global enterprises, auditors will be required to understand, consider, and analyze laws and regulations across multiple jurisdictions (including, potentially, internationally). Such a drastic expansion of the auditor's role is not only outside the auditor's qualifications, but also outside the PCAOB's authority itself, as the proposal goes far beyond establishing basic auditing standards.

The examples provided in the proposal illustrate this point. For example, the proposal suggests that an auditor would be responsible for investigating whether any waste disposal regulations exist that, if violated, might conceivably have a material impact on a chemical company's financial statements. Doing so would require auditors to research and interpret (often highly technical) laws and regulations, and make judgment calls on whether noncompliance with those laws and regulations could result in a material impact on the company's financial statements. Auditors, however, are not extensively trained in the law, and thus unqualified to perform these types of tasks, let alone make such judgments as to potentially immaterial items.

Auditors would likely need to engage specialists to assist with such surveys of the legal and regulatory landscape. However, this is not a viable process for a variety of reasons. First, lawyers engaged by auditors as specialists would have an attorney-client relationship with the auditors and not with the company subject to audit. Accordingly, any information provided by the company to such lawyers would not have the protection of attorney-client or work product privileges, thus creating great risks for the company whose financial statements are being audited, and potentially causing a chilling effect on a company's willingness to provide complete information and analyses. Second, any attempt to solve against these risks by having such lawyers analyze the laws and regulations applicable to the company without complete information could frustrate the auditors' efforts to identify potentially applicable laws and regulations and analyze their potential impact on the company's financial statements. Third, even if non-lawyer specialists could be identified with appropriate expertise to accomplish the PCAOB's objectives, it would quickly become cost-prohibitive to the company to pay for the auditor to engage these specialists to achieve the objectives stated in the proposal (especially when the company is already investing resources to secure advice from its own legal counsel and other experts retained to assist the company's legal counsel in complying with laws and regulations, which advice is subject to attorney-client privilege and work product protections).

Moreover, auditors' involvement of experts will consume significant time of, and distract, company management, including by responding to information and document requests as well as discussing complex analyses. This is particularly true given that, as discussed above, many companies subject to these audit procedures operate across multiple jurisdictions and thus are subject to legal regimes across the United States and across the world. As a result, auditors would likely need to retain, and company management would need to engage with, multiple experts across such jurisdictions in order to conduct the type of analyses contemplated by the PCAOB's proposal. This, along with the cost involved, would have a negative impact on companies (and their shareholders) that already have robust procedures intended to ensure their compliance with laws.

To summarize, because the proposal would require ongoing and continuous policing by auditors, it, by definition, would add significant burdens on the auditors and add substantial time to the audit process, potentially lessening the effectiveness of the overall audits (while further increasing cost to the companies). Auditors would almost certainly need to hire additional personnel to address this expanded role, which would be challenging given that there is a recognized shortage of qualified auditors and fewer candidates taking the CPA exam each year.[2]

III. The proposal would create significant ambiguity for auditors and companies.

The proposed change to AS 2405, which would require auditors to design audit procedures to detect illegal acts that could reasonably result in an indirect material effect on financial statements, would introduce significant ambiguity into the audit process and would almost certainly result in inconsistent applications of that standard by auditors.

The universe of potential compliance issues that "could" result in indirect effects on financial statements is broad, undefined, and would be virtually impossible to administer with any level of consistency, including within the audit team for the same company.

The proposed change would also put pressure on companies to establish systems designed to detect any and every potential compliance issue that could conceivably result in even an "indirect" impact on their financial statements. Such systems are impractical and would ultimately distract management from proactively detecting and addressing compliance issues that have substantial and direct impacts on the company's finances and, thus, its investors.

[2] *See, e.g.,* Society for Human Resource Management, The CPA Shortage (May 6, 2023) (stating "[t]he declining number of people entering and staying in the accounting field is posing a significant challenge for public and private organizations. More than 300,000 U.S. accountants and auditors left their jobs in the past two years— a 17 percent decline in employed accountants and auditors from a 2019 peak, according to The Wall Street Journal in a December 2022 article."), available at https://www.shrm.org/hr-today/news/all-things-work/pages/the-cpa-shortage.aspx.

IV. The proposal would undermine the attorney-client relationship.

Under the new proposal, auditors would be required to make inquiries about potential noncompliance with numerous third parties. Inevitably, auditors (or specialists retained by auditors) will require additional information protected by the attorney work product doctrine from the companies they audit in order to analyze potential legal issues adequately and in line with the proposal.

Requiring auditors to demand that companies and their legal counsel share substantive privileged and confidential materials regarding compliance with laws and regulations would create significant tension between and among companies, their counsel, and their auditors. The proposed new rules would put those companies and counsel in the difficult position of deciding whether it is acceptable to share attorney work product with third parties that are outside privilege protections, at the risk of appearing uncooperative with the company's own auditors.

The proposal may also ultimately erode the attorney-client and work product privileges by introducing potential waiver issues and cause companies to lose trust in the confidential nature of its communications with outside (and even internal) counsel, leading those companies to be much more cautious in the advice they seek from counsel regarding compliance issues.

If that occurs, the very goal the PCAOB seeks to achieve—that is, identifying and addressing legal and regulatory issues in a timely manner—would be undermined by this proposal, as frequent and frank assistance from experienced counsel is the appropriate way for companies proactively to ensure compliance with laws and regulations.

V. In heavily regulated industries, such as the financial services industry, the proposal would add an unnecessary and complicated new oversight regime.

There are already rules and regulations in place requiring that companies establish and maintain a system to supervise their activities, and those of their associated persons, reasonably designed to achieve compliance with applicable laws and regulations, and to employ duly licensed and registered persons with authority to carry out those supervisory responsibilities.

Securities laws and banking regulations require that a company's senior management be duly licensed and take proactive steps to identify potential noncompliance with laws and regulations, implement a program to detect and prevent violations of the law, and timely remedy and report any instances of noncompliance. *See, e.g.*, Section 15(b) of the Securities Exchange Act of 1934 (the "Exchange Act"); FINRA Rule 3110; and 12 C.F.R. § 21.21.

Further, the current auditing and accounting guidance that applies to consideration of noncompliance with laws and regulations ensures that auditors play an important role at the appropriate point in providing assurance that financial statements appropriately account for and disclose the impact of noncompliance with applicable laws and regulations.

However, under the PCAOB's proposal, auditors would need to reach judgment regarding potential noncompliance and communicate those conclusions to the company's audit committee *before* the auditors have evaluated the company's own analysis, resulting in a significant increase in the amount of information an audit committee receives and processes in the course of its duties. Meanwhile, the company will typically have already established a risk or compliance committee to which certain similar responsibilities have previously been delegated. Thus, requiring company management and audit committees to dedicate time and resources to analyze these reports from auditors would often be needlessly duplicative. It also would be inappropriate and inefficient to put a new system in place that gives authority to the auditor to reach conclusions in a host of areas in which companies already have affirmative duties and obligations that are covered under an existing regulatory examination regime.

Broker-dealers in particular are subject to regular supervisory inspections and exams by the SEC and FINRA; having the audit process duplicate current internal and supervisory processes risks wasting time and resources, adds conflicting lines of responsibility, as well as creating unmanageable compliance processes. For instance, existing FINRA rules already require broker-dealers to maintain a system of supervision designed to achieve compliance with applicable laws and regulations (FINRA Rule 3110); submit annual reports to the board of directors and audit committee concerning the effectiveness of such systems (FINRA Rule 3130); and report to FINRA any instances that management knows (or reasonably should have concluded) resulted in violations of applicable laws and regulations, certain customer complaints, judicial proceedings, and external or internal disciplinary actions (FINRA Rule 4530). Moreover, under existing audit processes, broker-dealers must file annual audit reports to the SEC, FINRA, and the Securities Investor Protection Corporation ("SIPC") (*see, e.g.,* Exchange Act Rule 17a-5(d)(6)).

Broker-dealers would be particularly affected, given that the proposal would extend an auditor's Section 10A[3] obligations to them, as well as give auditors broad new obligations and authority that would supersede Section 10A, which was carefully considered and works in practice. Section 10A already requires that "[e]ach audit required pursuant to this chapter of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards… (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts…" (15 U.S.C. § 78j–1(a)(1).) Section 10A requires auditors to take

[3] Section 10A of the Exchange Act generally requires reporting to the SEC when, during the course of a financial audit, an auditor detects likely illegal acts that have a material impact on the financial statements and appropriate remedial action is not being taken by management or the board of directors. *See* 15 U.S.C. § 78j–1.

certain steps "[i]f, in the course of conducting an audit… the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred…" (15 U.S.C. § 78j–1(b)(1)). These steps include notifying the appropriate issuer management and the audit committee or board of the matter, and if the issuer fails to take appropriate action, then potentially resigning from the audit and reporting the matter to the SEC. (15 U.S.C. § 78j–1(b)(2)-(4)).

VI. **Compliance with the proposal might conflict with other regulatory requirements that could make it impossible to comply with both the PCAOB's proposal and these other regulatory limitations.**

The proposal also raises concerns where broker-dealers are subsidiaries of financial holding companies and affiliates of prudentially regulated banks. The proposal should make clear that it is not the role of auditors of a broker-dealer to review compliance with consolidated prudential regulations and supervisory guidance applicable to the broker-dealer's parent holding company or bank affiliate. If auditors viewed their obligations under the proposal to review consolidated compliance with such prudential regulations and supervisory guidance, the resulting audit would be onerous, open-ended, and duplicate internal compliance processes and supervisory oversight. Moreover, supervisory communications of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation (the "U.S. Bank Regulators") and the supervised institutions' responses to the U.S. Bank Regulators are considered "confidential supervisory information" ("CSI"). Supervised institutions may only share CSI with auditors "when necessary or appropriate" in connection with auditing services. *See* 12 CFR § 261.21(b)(3). Currently, it is not always necessary for auditors to have access to CSI because noncompliance with such prudential regulations or supervisory guidance does not directly affect the accuracy of a supervised institution's or broker-dealer's financial statements. However, the PCAOB's proposal could conceivably require an auditor to demand access to such information whenever it exists on the basis that a broker-dealer may not be compliant with regulatory requirements. It is not clear whether disclosure in these circumstances is "necessary or appropriate" in connection with the audit of a supervised institution's or broker-dealer's financial statements. Likewise, given the confidentiality of supervisory communications, the broker-dealer, its parent, or affiliate that concludes such access is not "necessary or appropriate" may not be able to disclose evidence of regulatory compliance to satisfy auditor requests or to challenge an auditor's assessment of noncompliance.

VII. SIFMA's response to specific questions raised in the PCAOB proposal.

SIFMA provides the following responses to certain questions posed by the PCAOB in its proposal:

- **Is the proposed definition of "noncompliance with laws and regulations" sufficiently clear? If not, why not? *[PCAOB's Question No. 1]***
  - In the context of the proposed rule, this definition is not sufficiently clear because it would require auditors to make judgments about immaterial items that have an indirect impact on the issuer's financial statements and would also require auditors to go beyond their expertise to perform legal analysis and reach legal conclusions.

- **Is the rationale for including fraud, as described in AS 2401, within the proposed definition of noncompliance with laws and regulations sufficiently clear? If not, why not? *[PCAOB's Question No. 2*]**
  - In the context of the proposed rule, the inclusion of fraud is not sufficiently clear because it would require auditors to make judgments about what constitutes "fraud," make judgments about immaterial items that have an indirect impact on the company's financial statements and would also require auditors to go beyond their expertise to perform legal analyses and reach legal conclusions. More specifically, we note that the legal definition of "fraud" generally includes an element of intent. Auditors are not well positioned to make findings and conclusions about intent. We note that even the Association of Certified Fraud Examiners does not permit its members to form an ultimate conclusion about whether any person or entity has committed fraud, noting in its CFE Code of Professional Standards under Section V. Standards of Reporting that "No opinion shall be expressed regarding the legal guilt or innocence of any person or party."

- **Is the proposed requirement for auditors to identify laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements sufficiently clear? If not, why not? *[PCAOB's Question No. 7]***
  - The proposed requirement is not sufficiently clear because the auditor is not permitted to perform management functions and is not in possession of all relevant information about the current and planned future operations of the business necessary to identify all laws and regulations that could potentially be applicable to the company and

with which noncompliance could reasonably have a material effect on the financial statements. SEC Rule 2-01, Section (c)(4)(vi) provides that it is a violation of an accountant's independence to perform: "Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client." The proposal would place the auditor in the role of conducting supervisory and ongoing monitoring functions regarding potentially applicable laws and regulations, which is a management function that auditors are prohibited from performing.

- **Will auditors be able to identify those laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements? If not, why not? *[PCAOB's Question No. 8]***

  - Auditors lack the training, knowledge, and experience to identify all laws and regulations potentially applicable to the company with which noncompliance could reasonably have a material effect on the financial statements. Further, auditors are not in possession of all relevant information about the current and planned future operations of the business necessary to conduct this analysis. This analysis is a function of management, as advised by legal counsel under attorney-client privilege and attorney work product protection. Requiring auditors to conduct such a legal analysis for which they are not qualified would likely lead to inaccurate audit results.

- **The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what are the potential unintended consequences and what responses should be considered? *[PCAOB's Question No. 64]***

  - The proposal risks significant unintended consequences that are summarized in the body of our letter. The Board should not adopt the proposal because the existing audit standards appropriately address risks that are material to users of financial statements, while balancing the proper roles of auditors, companies, and companies' legal counsel.

- **Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits? If so, what are those factors and how should they be considered?** ***[PCAOB's Question No. 66]***

    - There are specific factors related to audits of brokers and dealers that may affect the application of the proposal to those audits. The factors are described in the body of our letter. The Board should not adopt the proposal because the existing audit standards appropriately address risks that are material to users of the financial statements of these firms, while balancing the proper roles of auditors, companies, and companies' legal counsel.

- **How much time following SEC approval would audit firms need to implement the proposed requirements?** ***[PCAOB's Question No. 70]***

    - Given the significant steps that will be required for audit firms to perform the expanded role contemplated by the PCAOB's proposal—including hiring additional staff and external experts, identifying all laws and regulations to which its constituent companies are subject, and understanding companies' existing compliance frameworks—audit firms will need at least several years to implement the proposed requirements.

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VIII. <u>Conclusion</u>

Thank you for the opportunity to comment. Should you have any questions or require further information concerning any of the matters discussed in this letter, please do not hesitate to contact Michael Formichelli, Chair of the SIFMA PCAOB Non-Compliance with Law Proposal Task Force, or the undersigned Timothy Bridges.

Regards,

Timothy J. Bridges

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