

Expect 2021 SEC To Turn Hawkish On Auditor Enforcement

By **Charles Smith and Andrew Fuchs**

In 2020, the U.S. Securities and Exchange Commission continued its trend of bringing fewer enforcement actions against auditors than it had under the prior administration.

The SEC brought just 11 enforcement actions against auditors in 2020.

For a point of reference, the SEC brought 44 such actions in 2015.

As to our outlook for 2021, we think it is likely that the Biden administration will prioritize enforcement actions against auditors as gatekeepers and thus we will see a reversion to higher activity levels for such enforcement actions.

However, given that changes in enforcement priorities take time to implement, and given the lag from the time of those changes to the public seeing their fruits in disclosed settlements and resolutions, we do not expect to see evidence of increased enforcement actions until late 2021 or early 2022.

The SEC Rule of Practice 102(e), which was codified in Section 602 of the Sarbanes-Oxley Act, allows the SEC to seek sanctions against an individual auditor or audit firm that has intentionally or negligently violated professional auditing or accounting standards.

For such violations, the SEC typically seeks sanctions such as censures, cease-and-desist orders, fines, remedial actions and bars from practicing before the SEC for a specific number of years, after which the auditor or firm may apply for reinstatement.

For an auditor, the implications of a practice bar go beyond the ability to audit for the duration of the bar.

Under the SEC's broad view, a bar generally prohibits any work relating to the preparation of financial statements of a public company or its affiliates, which can significantly limit the scope of nonaudit work an individual can undertake during a bar period.

In 2013, the SEC launched Operation Broken Gate to prioritize enforcement actions against auditors by holding accountable those auditors who intentionally or negligently violate professional auditing or accounting standards.

This announcement marked the beginning of a period of increased use of Rule 102(e) to charge auditors that failed to adhere to professional standards.

Under Operation Broken Gate, the SEC charged or settled a wide range of Rule 102(e) cases, including against auditors from prominent national firms and the firms themselves.



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However, the number of Rule 102(e) charges and settlements against auditors for violations of professional auditing or accounting standards has declined in recent years as compared to the period following the announcement of Operation Broken Gate.

The statistics show that in 2020, the SEC charged or settled with nine individual auditors under Rule 102(e), as compared with 13 in 2019, nine in 2018, 18 in 2017, 29 in 2016, and 28 in 2015.

Similarly, the total number of such actions, including both individual auditors and audit firms, is 11 to-date in 2020, as compared to 23 in 2019, 17 in 2018, 22 in 2017, 42 in 2016, and 44 in 2015.

It is also noteworthy that the SEC Division of Enforcement 2020 annual report contained only a minimal discussion of enforcement actions against auditors.

In 2019, the annual report prominently featured a section touting the SEC's success against auditors and audit firms.

This section emphasized the importance of auditors as gatekeepers and highlighted actions "to address auditor independence violations, failed audits, and other serious auditor misconduct."

The 2020 report did not contain a section devoted to auditors and audit firms, although auditors were mentioned among other actors in a section titled "Holding Individuals Accountable."

We expect the trend of diminished actions against auditors to continue for the beginning of and perhaps all of 2021, with the total number of Rule 102(e) actions against auditors on par with the 2017-20 levels, but then to increase in late 2021 and 2022 under the new administration.

These actions take some time to work their way through the system, and thus the actions brought in any given year are a function of investigations the staff have commenced and pursued in the preceding few years.

As the sample size for 2020 is small, it is difficult to draw from it any qualitative conclusions about enforcement activity against auditors.

However, looking at these actions over the past few years, we have seen that in settlements with individuals and firms the SEC has regularly imposed sanctions such as censures, cease-and-desist orders, fines and practice bars, including lengthy and permanent bars.

But in contrast to the prior administration and work under Operation Broken Gate, in the last few years the SEC has agreed to one-year practice bars for auditing violations or even to cease-and-desist or censures with no practice bars.

This is significant because for a number of years the SEC generally maintained a two-year floor for practice bars and typically would insist on a practice bar.

Practitioners understood the rationale for this policy to be that, if a violation was significant enough for the SEC to charge an auditor, a bar of at least two-years was warranted. 2020 is in line with these recent trends.

For example, of the three most recent settled actions against individual auditors, two imposed a two-year bar and one imposed a one-year bar along with a cease-and-desist.

Further, Rule 102(e) actions against audit firms over the last few years reflect the SEC's continued focus on undertakings designed to prevent future independence violations.

In such settlements, the SEC may require the firm to employ an independent consultant to complete a review of the firm's systems for ensuring compliance with the requirements at issue, including, for example, auditor independence requirements.

The SEC has expressed its belief that it is effectively using "undertakings that are tailored to remedial objectives and specific to the wrongful conduct at issue."

In 2021 and beyond, we expect to see the SEC continue to use undertakings that require firms to engage independent consultants to assure the remediation of violations that the SEC considers to have been caused by systemic issues.

Our takeaway for SEC enforcement actions against auditors going forward is that the decreased enforcement actions against auditors in 2020 may not be representative of enforcement activity for the next few years.

On the other hand, while there have been some changes in the penalties and remedies the SEC has required in settlements with auditors, we expect that for the most part the SEC will continue to seek these types of sanctions against individual auditors and audit firms that may have violated professional auditing or accounting standards.

The SEC also apparently believes that undertakings, including independent monitors, are effective measures to remedy violations at audit firms and we expect to continue to see these tools used going forward.

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