

2023 developments in SEC Rule 102(e) enforcement against auditors

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In 2023, the Securities and Exchange Commission (SEC) continued its trend of bringing fewer enforcement actions against auditors than in recent years. The SEC brought 17 enforcement actions against auditors in 2023. As a point of comparison, the SEC brought 44 such actions in 2015, but only 11 in 2020, 12 in 2021, and 13 in 2023.

However, 2023 was significant in that we saw the SEC bring what appears to be the first enforcement actions against auditors in connection with SPACs (special purpose acquisition companies) as well as an auditor independence violation claim in a federal district court, rather than in an administrative proceeding.

Background to Rule 102(e)

SEC Rule of Practice 102(e), which was codified in Section 602 of Sarbanes-Oxley, allows the SEC to seek relief against an individual auditor or audit firm that has intentionally, willfully, or negligently violated professional auditing or accounting standards. For these violations, the SEC typically seeks relief such as censures, cease and desist orders, fines, and prophylactic relief to protect the integrity of the SEC's processes, through measures including suspensions from appearing or practicing before the SEC for a specific number of years, after which the auditor or firm may apply for reinstatement from the SEC's Office of Chief Accountant if the suspension imposed is not permanent.

For an auditor, the implications of a suspension 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. This can significantly limit the scope of non-audit work an individual can undertake during a bar period and could encompass activity such as contributing to a draft SEC filing.

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

2023 enforcement activity

The number of 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.

In 2023, the SEC charged or settled with 17 individual auditors, as compared with 13 in 2022, 10 in 2021, 9 in 2020, 13 in 2019, 9 in 2018, 18 in 2017, 29 in 2016, and 28 in 2015. Similarly, the total number of enforcement actions against individual auditors and audit firms was 17 in 2023, as compared to 13 in 2022, 12 in 2021, 11 in 2020, 23 in 2019, 17 in 2018, 22 in 2017, 42 in 2016, and 44 in 2015.

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The 2023 fact patterns for charges against auditors are generally consistent with actions over the past few years. This year's activity stemmed from 12 investigations, which related to improper revenue recognition, poor engagement quality review, inadequate documentation of audit procedures, auditor independence violations, and other audit failures.

The settlements with individuals resulted in censures, cease and desist orders, civil monetary penalties, and 102(e) suspensions that ranged up to [five] years. The settlements with audit firms involved censures, cease and desist orders, undertakings, and civil monetary penalties. Also, like in recent years, the SEC has focused on large civil monetary penalties, shown this year by a \$10 million civil monetary penalty against an audit firm. However, there are two notable developments distinguishing this year's activity from enforcement activity in prior years.

First, in a case captioned as *SEC v. Prager Metis CPAs, LLC*, filed in the United States District Court for the Southern District of Florida,

the SEC sued an audit firm for independence violations. This is significant because the SEC has historically brought such actions in its administrative courts under Rule 102(e). This departure is likely due to the pendency of the *Jarkesy* case before the Supreme Court, which involves a constitutional challenge to the SEC's use of administrative courts. A decision in *Jarkesy* is expected in mid-2024.

Significantly, the SEC's claims in *Prager* are based only on violations of the Securities Exchange Act of 1934 and Investment Advisers Act of 1940 and rules promulgated thereunder, as well as Regulation S-X. The SEC does not allege a violation of Rule 102(e) because that rule authorizes only the SEC to take action — “[the] Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission.”

We believe *Prager* demonstrates that, no matter what the outcome in *Jarkesy*, the Commission is not likely to step back from its efforts to protect investors from misconduct by auditors and audit firms.

Second, the SEC reached settlements with auditors in two separate investigations related to failures in audits of SPAC clients. SPACs — special purpose acquisition companies — saw a resurgence in the last few years as a method to take companies public involving raising capital through an IPO for the purpose of acquiring an existing operating company.

In one case, the SEC settled with audit firm Marcum LLP, which was responsible for over 400 SPAC clients out of the 860 that IPOed in 2020 and 2021. The SEC found that this volume exceeded the capacity of the audit firm's resources, leading to “difficulty in staffing engagements, difficulty and delays in completing work within required deadlines and non-compliance with numerous PCAOB audit standards.” In addition, the SEC found that “[s]taffing of engagement quality reviews became extremely difficult.”

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In settling with the audit firm for these violations of Rule 102(e), among other things, the SEC required the firm to retain an independent consultant to evaluate the audit firm's audit, review, and quality controls, policies, and procedures, limited the acceptance of new audit clients, and imposed a \$10 million civil penalty. Over the past few years, we have seen an increase in undertakings in audit-related settlements, and believe this trend is likely to continue.

In a second settlement, the SEC found that an audit by Crowe U.K. LLP of a SPAC acquisition target was deficient because it did not detect that the target materially and intentionally overstated its revenue. In settling with the firm under Rule 102(e), among other rules and regulations, the SEC ordered disgorgement that was satisfied by the firm's \$11.5 million payment to investors in the SPAC, limitations on the acceptance of new audit clients, an undertaking to retain an independent consultant to review the firm's audit policies and procedures, and a \$750,000 civil monetary penalty. The Commission settled with two individual auditors by imposing two-year practice bars and \$25,000 and \$10,000 civil monetary penalties.

Outlook

Heading into 2024, we expect enforcement actions against auditors to remain at roughly the same level. In addition, the *Jarkesy* decision could cause a sea change in how the SEC takes enforcement action against auditors and their firms, should the Supreme Court rule that administrative courts are unconstitutional. If that comes to pass, perhaps as previewed in the *Prager* case, the SEC could exclusively file actions in the district court and no longer rely on Rule 102(e). We do not believe, however, that a decision on the SEC's process would be likely to cause the Commission to step back from enforcing its statutes, rules, and regulations and against audit firms or additional auditors. The playing field may shift, but the game will likely look the same.

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