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BROKER-DEALERS

Broker-Dealers and Their Auditors Face Increased Regulatory Scrutiny



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I. Introduction

In the last two years, the Public Company Accounting Oversight Board (PCAOB or the “Board”) has sanctioned numerous auditors of broker-dealers for violating rules requiring auditor independence. These violations arose from new independence standards that be-

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gan to apply to broker-dealer audits in 2014.¹ These independence problems should concern audit firms, of course, particularly because the PCAOB has concluded, through its Interim Inspection Program, that a high fraction of auditors of broker-dealers were not independent.² But they should concern broker-dealers just as much; a broker-dealer has equal responsibility for ensuring its auditors are independent, and it faces equally serious exposure if it fails to do so.

In public remarks, Securities and Exchange Commission (SEC) officials have emphasized issuers’ responsibility for the quality of their audits, making it clear this will be a priority in future SEC enforcement actions, too.³ One senior SEC official explained that, for compa-

¹ PCAOB, STAFF GUIDANCE FOR AUDITORS OF SEC-REGISTERED BROKERS AND DEALERS ii (June 26, 2014), https://pcaobus.org/Standards/Documents/06262014_Staff_Guidance.pdf.

² PCAOB, ANNUAL REPORT ON THE INTERIM INSPECTION PROGRAM RELATED TO AUDITS OF BROKERS AND DEALERS, PCAOB Release No. 2015-006 (Aug. 18, 2015), at ii [hereinafter PCAOB 2014 INSPECTION REPORT], available at https://pcaobus.org/Inspections/Documents/BD_Interim_Inspection_Program_2015.pdf.

³ See Brian Croteau, Deputy Chief Accountant, SEC, Remarks Before the 2013 AICPA National Conference on Current SEC and PCAOB Developments – Audit Policy and Current Auditing and Internal Control Matters (Dec. 9, 2013), <https://www.sec.gov/News/Speech/Detail/Speech/1370540472057>. And in 2015, SEC Senior Associate Chief Accountant Michael

nies that file their financial statements with the SEC, “[e]nsuring auditor independence is as important as ensuring that revenues and expenses are properly reported and classified.”⁴ This official warned that an independence violation by the auditor means a legal violation by the company: “If the auditor’s independence is impaired, the company will not have satisfied its requirement to file financial statements audited by an independent accountant.”⁵ The official illustrated this risk by discussing an example where, because an auditor lacked independence, a company had not met the requirement that it file properly audited financial statements. In addition to thus violating the securities laws, the company was forced to engage a new auditor to re-audit the financial statements.⁶

When the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010⁷ (“the Dodd-Frank Act”) gave the PCAOB oversight authority over auditors of brokers and dealers registered with the SEC,⁸ broker-dealers’ compliance with the SEC’s reporting rules was also affected. While the PCAOB and others have provided extensive guidance to broker-dealer auditors about their obligations in the wake of the Dodd-Frank Act, there is not as much guidance available for the broker-dealers themselves.

Through its Interim Inspection Program, the PCAOB has inspected several hundred audits since 2011 to evaluate their compliance with existing standards and to educate the industry about common flaws the Board has observed. More recently, since the enactment of the PCAOB’s rules regarding auditors of broker-dealers, these inspection and educational efforts have given way to actual enforcement actions.⁹

W. Husich cited Croteau’s remarks and reiterated that “auditor independence is a shared responsibility between the auditor and the audit client.” See Michael W. Husich, Senior Associate Chief Accountant, SEC, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015), <https://www.sec.gov/news/speech/husich-remarks-2015-aicpa-conference-sec-pcaob-developments.html>.

⁴ Croteau, Remarks Before the 2013 AICPA National Conference, *supra* n.3.

⁵ *Id.*

⁶ *Id.*

⁷ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁸ PCAOB, Fact Sheet: PCAOB Standards for Broker-Dealer Auditors, https://pcaobus.org/News/Releases/Pages/10102013_BD_FactSheet.aspx (last visited Aug. 12, 2016). The Board recently issued a Staff Inspection Brief in which it describes the scope and objectives of its 2016 inspections of auditors of broker-dealers. PCAOB, Staff Inspection Brief (July 2016), <https://pcaobus.org/Inspections/Documents/Inspection-Brief-2016-3-Issuers.pdf>. For example, and as discussed further below, the PCAOB intends to review audit areas and attestation procedures where its inspectors previously found deficiencies, and it will also look at audit work for related party transactions and review auditor independence.

⁹ In another indication of the importance to the PCAOB of this new area of regulation, and the need for additional education of those affected by it, on March 15, 2016, the PCAOB announced that it would hold five forums in 2016 for auditors of broker-dealers, “to share important information about Board activities with PCAOB-registered public accounting firms that audit smaller broker-dealers registered with the Securities and Exchange Commission.” Press Release, PCAOB, PCAOB Announces 2016 Forums for Auditors of Broker-Dealers (Mar. 15, 2016), <http://pcaobus.org/News/Releases/Pages/2016-broker-dealer-forums-dates-and-locations.aspx>.

II. Application of the Regulatory Regime to Broker-Dealer Auditors

Congress included oversight of broker-dealer auditors in the Dodd-Frank Act in response to the perceived loss of confidence in the safekeeping of customer securities and funds by securities broker-dealers, exemplified by the Bernard Madoff and Bayou hedge fund frauds. In 2009, Madoff pleaded guilty to defrauding his firm’s advisory clients in a long-running multi-billion dollar Ponzi scheme. Madoff’s scheme eventually unraveled when there was no evidence of options trading with any counterparties. Madoff’s scheme was made possible by his reliance on a fly-by-night auditing firm with only one active accountant who had neither registered with the PCAOB nor even participated in New York State’s peer review program for auditors.¹⁰ In the Bayou hedge fund fraud, the promoters went a step further and invented a fictitious auditing firm and forged certifications in its name. This fraudulent device likely would have been thwarted if the firm’s auditor had been required to register with PCAOB, enabling investors to confirm its legitimacy or existence.¹¹

A. The PCAOB’s Expanded Jurisdiction over Broker-Dealer Auditors

The PCAOB was established under the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) to increase the protection of public investors by regulating and overseeing the audits of U.S. public companies. To accomplish its mission, the PCAOB engages in standard-setting, inspections, and enforcement with respect to auditors registered with the Board. Beginning in 2010 with the passage of the Dodd-Frank Act, the PCAOB’s jurisdiction was expanded to apply its registration, reporting and auditing standards to auditors of broker-dealers.¹²

Auditors of broker-dealers that are also public companies – for example, the broker-dealer subsidiaries of the largest banks – already were subject to PCAOB regulation prior to the Dodd-Frank Act. Therefore, the new requirements principally affect auditors of broker-dealer auditors who are not public companies. As a practical matter, the new requirements brought auditors of medium-sized and smaller broker-dealers under the Board’s regulatory regime for the first time.

Under the PCAOB’s expanded authority, financial statements of broker-dealers for fiscal years ending after December 31, 2008, must be certified by a registered public accounting firm. Accounting firms that prepare or issue an audit report for a broker or dealer must register with the Board.¹³ The registered auditor also must

¹⁰ *The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform*, Hearing on S. 3217 Before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. 111-176 (Jan. 27, 2009) (statement of John Coffee, Columbia University Law School).

¹¹ *In Re Bayou Group, LLC*, 396 B.R. 810, 822-23 (Bankr. S.D.N.Y. 2008).

¹² *See Custody of Funds or Securities of Clients by Investment Advisers*, 75 Fed. Reg. 1,456 (Jan. 11, 2010) (codified at 17 C.F.R. pts. 275-279).

¹³ The certification requirement also applies to auditors that play a “substantial role” in the preparation or furnishing of an audit report, meaning that its engagement hours or fees constitute 20% or more of the total engagement hours or fees

cooperate with the PCAOB inspection or enforcement processes, and must comply with the PCAOB's annual and special reporting rules.

Registered public accounting firms are required to follow auditing and related attestation, quality control, ethics, and independence standards with respect to the preparation and issuance of audit reports for public companies.¹⁴ The Dodd-Frank Act imported these standards to audits of filings by brokers and dealers.

B. Broker-Dealer Obligations under the New Regime

While the PCAOB directly regulates only accounting firms, new regulations regarding auditors of broker-dealers significantly impact the firms that are subject to these audits. If the auditor does not comply with PCAOB standards, the broker-dealer violates its own obligations under SEC rules, beginning with the requirement that it file properly audited financial statements. The new standards also place greater responsibility on broker-dealer management to understand the applicable financial reporting requirements and audit standards and to ensure that their auditors are complying with the standards. In the case of many broker-dealers, management takes on this role because non-public broker-dealers will not necessarily have an audit committee that has that responsibility.

Broker-dealers have long been required to file annual reports with the SEC.¹⁵ Beginning in 2014, audits of brokers-dealers' annual reports became subject to PCAOB regulation; that is, the audits now must be performed in accordance with the standards of the PCAOB by an independent public accountant.¹⁶

1. Annual Reports: Financial, Compliance or Exemption

Broker-dealers must now file annual reports with the SEC that consist of a financial report¹⁷ and either a compliance report or an exemption report. The compliance report is required if the broker-dealer must comply with the SEC's financial responsibility rule, Rule 15c3-3¹⁸, and the exemption report is required if the broker-dealer claims that it was exempt from the financial responsibility rule. The financial responsibility rule requires broker-dealers to maintain physical possession

on the audit, or it has performed a majority of the audit work of a subsidiary of the broker or dealer. PCAOB Rule 1001(p)(ii).

¹⁴ Such filings are required by Rule 17a-5 under the Securities Exchange Act of 1934, 15 U.S.C. § 78 (the "Exchange Act").

¹⁵ PCAOB, Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission, PCAOB Release No. 2013-007 (Oct. 10, 2013) at 3, available at https://pcaobus.org/Rulemaking/Docket035/PCAOB_Release_2013_007.pdf; 17 C.F.R. § 240.17a-5(d)(1) (Rule 17a-5(d)(1) under the Exchange Act).

¹⁶ See Broker-Dealer Reports, Exchange Act Release No. 70073 (July 30, 2013), <https://www.sec.gov/rules/final/2013/34-70073.pdf>; 78 Fed. Reg. 51,910 (Aug. 21, 2013).

¹⁷ The financial report must include, among other things, a statement of financial condition, a statement of income, and a statement of cash flows, all of which SEC rules already required broker-dealers to file. Rule 17a-5(d)(2)(i).

¹⁸ Customer Protection – Reserves and Custody of Securities, Rule 15c3-3 of the Exchange Act.

or control of all fully-paid securities and excess margin securities carried for the account of customers,¹⁹ and to maintain a reserve balance for the exclusive benefit of customers computed in accordance with a formula set forth in the rule.²⁰ Generally, firms that carry customer assets are covered by the rule and are required to file a compliance report. Firms that do not hold customer securities and/or funds or do not do business with the public are exempt from the provisions of the customer protection rule and may file an exemption report.²¹

The compliance report must, among other things, (i) state whether the broker or dealer established and maintained effective "Internal Control Over Compliance" as defined in the rule, (ii) affirm that the firm complied with the SEC's financial responsibility rules, and (iii) provide certain reports and disclosures about the firm's internal controls and compliance with the financial responsibility rules. The exemption report must, among other things, identify the basis of the broker-dealer's claim of an exemption and state that the exemption was met.²²

The annual reports required by these rule amendments – the financial report and compliance or exemption report – must be examined by an independent public accountant registered with the PCAOB. The accountant is required to prepare a report based on that examination. Thus, the amendments indirectly require auditors of broker-dealers to conduct their audits and related work in accordance with PCAOB professional standards.

2. Attestation Standards

The auditor's review of the compliance or exemption report are governed by two attestation standards, and another auditing standard, adopted by the PCAOB to address the SEC's 2013 rule amendments.

Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, applies to registered audit firms conducting attestation engagements related to broker-dealer compliance reports. Attestation Standard No. 1 requires auditors to, among other things, obtain sufficient evidence to opine on a broker-dealer's assertions in its compliance report that it has established and maintained effective internal controls, and that it was in compliance with the SEC's net capital and customer protection/reserve requirements.²³ Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, applies to an audit firm's review of statements by a broker-dealer in an exemption report. It requires the auditor to obtain assurance about the broker-dealer's claims about its exemption from the customer protection rules.²⁴ The PCAOB also adopted a new Auditing Standard, AS No. 17, Auditing Supplemental Information Accompanying Audited Financial

¹⁹ Rule 15c3-3(b)(1) of the Exchange Act.

²⁰ Rule 15c3-3(e)(1) of the Exchange Act.

²¹ Examples of exempt firms are specialists, market makers and floor brokers, all of which have no contact with the public and are subject to close daily supervision by an exchange.

²² Rule 17a-5(d)(4) of the Exchange Act.

²³ PCAOB, Attestation Standard No. 1, PCAOB Release No. 2013-007 (Oct. 10, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB_Release_2013_007.pdf.

²⁴ PCAOB, Attestation Standard No. 2, PCAOB Release No. 2013-007 (Oct. 10, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB_Release_2013_007.pdf.

Statements, which requires auditors to determine that the supplemental information accompanying audited financial statements can be reconciled to the underlying accounting records or to the financial statements.

3. Independence

Like all auditors subject to PCAOB rules, auditors of broker-dealers must be independent. A violation of independence rules by the auditor presents a significant problem for the broker-dealer, since if the auditor is not independent, then the broker-dealer has failed to comply with its own reporting obligations under SEC Rule 17a-5.

Under the Dodd-Frank Act, the PCAOB's independence rules (which conform to the SEC's stricter standards) apply to non-issuer broker-dealers and their auditor.²⁵ Before the PCAOB acquired jurisdiction over broker-dealer auditors, audits of public issuers were governed by SEC independence rules, while audits of non-issuer broker-dealers were governed only by the independence rules issued by the American Institute of Certified Public Accountants ("AICPA"). Broker-dealer auditors often prepared the firm's financial statements from the firm's books and records, then audited the same financial statements.

The SEC rules are stricter than those of the AICPA in defining independence. SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client (unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant). Thus, the effect of the Dodd-Frank Act was to make it a violation of independence standards for the auditor to prepare the firm's financial statements before auditing them.

III. PCAOB In terim Inspection Program

The Dodd-Frank Act granted the PCAOB explicit oversight authority with respect to audits of registered brokers and dealers. Pursuant to the Dodd-Frank Act, on June 14, 2011, the Board adopted Rule 4020T to establish the Interim Inspection Program. The purpose of the Interim Inspection Program is to assess the compliance of accounting firms with the Dodd-Frank Act, and to inform the eventual implementation of a permanent inspection program.²⁶ This section presents the key findings from the Interim Inspection Program so far.

A. Interim Inspections from 2011 to 2014 Found Deficiencies in Almost All Audits Inspected

Before the new PCAOB standards became applicable to brokers and dealers beginning June 1, 2014, the

²⁵ Rule 17a-5(f)(1) requires that an accountant must be independent in accordance with Section 210.2-01 under the Exchange Act, and must be registered with the PCAOB, if required to by Sarbanes-Oxley.

²⁶ PCAOB, REPORT ON THE PROGRESS OF THE INTERIM INSPECTION PROGRAM RELATED TO AUDITS OF BROKERS AND DEALERS, PCAOB Release No. 2012-005 (Aug. 20, 2012) [hereinafter PCAOB 2011 INSPECTION REPORT] at 1-2, available at <https://pcaobus.org/Inspections/Documents/BD-Interim-Inspection-Program-2016.pdf>.

PCAOB's interim inspections from October 2011 through December 31, 2014 determined whether the audits complied with generally accepted auditing standards (GAAS). These reports under GAAS, the last of which was issued in August 2015, found significant shortfalls in the satisfaction of the relevant standards since the inception of the program. The PCAOB reported all of its cumulative deficiency findings under the GAAS standards between 2011 and 2014. The Board inspected 155 firms, covering portions of 279 audit engagements.²⁷ Of these 279 engagements, the PCAOB identified audit deficiencies or defects in independence in 243 cases (87 percent).²⁸ The most numerous deficiencies in audit procedures related to: revenue recognition (67 percent), report on material inadequacies (56 percent), reliance on records and reports (51 percent), financial statement presentation and disclosures (39 percent), and failure to properly compute net capital consistent with the Net Capital Rule, Exchange Act Rule 15c3-1 (37 percent).²⁹ The Board summarized the extent of these deficiencies as "unacceptably high", despite its best efforts since 2011 to admonish the industry through previous progress reports, PCAOB staff guidance, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff.³⁰

Though the audit deficiencies were most numerous in the above-mentioned categories, the Board emphasized its particular concerns about defects in independence, calling out the settled disciplinary orders against 14 audit firms for independence violations (as of August 2015), and that this represented an area where firms needed to take corrective action.³¹ Thus, although comparatively fewer (25 percent) audits uncovered independence findings than other areas of deficiency, e.g., revenue recognition,³² the Board made it explicit that independence violations have been and will be an emphasis of future enforcement actions. The PCAOB's first three waves of enforcement actions for independence violations are discussed *infra* at IV.

B. Inspections Since Adoption of New Rules on June 1, 2014

Since PCAOB standards became mandatory in broker-dealer audits with fiscal years ending on or after June 1, 2014, the Board has conducted two reviews under the Interim Inspection Program: a mid-year review of five audit firms issued on January 28, 2015,³³ and the 2015 Annual Report issued on August 18, 2016.³⁴ In the mid-year review, the Board found that all five audit firms reviewed were deficient in complying with

²⁷ PCAOB 2014 INSPECTION REPORT at iii.

²⁸ *Id.*

²⁹ *Id.* at 35.

³⁰ *Id.* at ii.

³¹ *Id.* at v.

³² *Id.* at 33-34.

³³ PCAOB, Observations from PCAOB Inspections Covering Five Audits of Brokers and Dealers Required to be Conducted in Accordance with PCAOB Standards, PCAOB Release No. 2015-001 (Jan. 28, 2015), https://pcaobus.org/Inspections/Documents/BD_Interim_Inspections_2015.pdf.

³⁴ PCAOB, ANNUAL REPORT ON THE INTERIM INSPECTION PROGRAM RELATED TO AUDITS OF BROKERS AND DEALERS, PCAOB Release No. 2016-004 (Aug. 18, 2016) [hereinafter PCAOB 2015 INSPECTION REPORT] at ii, available at <https://pcaobus.org/Inspections/Documents/BD-Interim-Inspection-Program-2016.pdf>.

PCAOB standards in conducting audit and attestation engagements of brokers and dealers.³⁵

The 2015 Annual Report was the first annual cycle in which all 115 audits and 114 related attestation engagements reviewed were performed in accordance with PCAOB standards.³⁶ The most commonly identified audit deficiencies in 2015 were consistent with those found in the previous annual reports, comprising: revenue recognition; engagement quality review; financial statement presentation and disclosures; and failure to properly compute net capital consistent with the Net Capital Rule.³⁷ Independence findings were again noted in a relatively lower percentage, 7 percent.³⁸

IV. Enforcement Actions Stress Independence Violations

Despite the relatively lower percentage of independence defects, enforcement actions by the SEC and PCAOB have demonstrated that the regulators find independence violations the most troubling. In several groups of enforcement actions brought since the new regulatory regime became effective, regulators have found that auditors of broker-dealers violated their independence obligations. On December 8, 2014, the SEC and PCAOB brought 15 settled actions between them (the “2014 Orders”), finding that the auditors violated independence rules.³⁹ On July 9, 2015, the PCAOB settled disciplinary orders sanctioning seven more firms for violating independence requirements in connection with audits of brokers and dealers (“the 2015 Orders”).⁴⁰ And on March 15, 2016, the PCAOB sanctioned another five audit firms for independence violations (the “2016 Orders”).⁴¹

The 2014 Orders, 2015 Orders, and 2016 Orders all stressed the sanctity of auditor independence as, in effect, fundamental to broker-dealer audit quality. In the 2014 and 2015 Orders, the sanctioned accounting firms prepared financial statements, or portions of the financial statements, it later audited. In the 2016 Orders, the PCAOB approached the independence defects as disclo-

sure violations. The PCAOB found that by conducting broker-dealer audits when they lacked independence, the auditors violated the SEC rule that requires that the report filed by the independent public accountant state whether the audit was made in accordance with GAAS.⁴² In stating that that the audits were conducted in accordance with GAAS when the auditor was not independent, the auditors made a false statement, according to the PCAOB. Independence criteria require, among other things, that the accountant not provide non-audit services to an audit client, such as bookkeeping or other services related to the accounting records or financial statements of the audit client or preparing the audit client’s financial statements that are filed with the Commission.⁴³

In addition, the 2016 Orders found that the respondent accountants ran afoul of independence requirements in preparing specified documents required by Rule 17a-5(d)(2), including: a Statement of Financial Condition, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders’ or Partners’ or Sole Proprietor’s Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. The PCAOB found in each of the 2016 Orders that the respondent accountants used information obtained from the firm, such as trial balance, balance sheets and cash flow schedules, to prepare these statements. The PCAOB also noted that each accountant billed the broker-dealer for preparation of those statements.

Just as important as the Board’s decisions to sanction auditors for independence violations are the Board’s decisions to not sanction auditors who have self-identified violations and provided “extraordinary cooperation.” The PCAOB defines “extraordinary cooperation” as voluntary and timely: (i) self-reporting upon learning of violations; (ii) remedial or corrective actions designed to reduce the likelihood and risk that similar violations will recur, as well as actions to correct violative conduct; or (iii) substantial assistance to the Board’s investigative processes or to other law enforcement authorities, including the provision of information or documentation that might not have been available to the Board absent cooperation.⁴⁴ Although the Board’s stated policy is to give “credit” for extraordinary cooperation by reducing charges and sanctions imposed,⁴⁵ in practice, the Board declined entirely to sanction one firm in 2015 and another in 2016 for extraordinary cooperation.⁴⁶

³⁵ Observations from PCAOB Inspections Covering Five Audits of Brokers and Dealers Required to be Conducted in Accordance with PCAOB Standards, at 2.

³⁶ PCAOB 2015 INSPECTION REPORT, at i.

³⁷ *Id.* at 6.

³⁸ *Id.* at 5.

³⁹ Press Release, SEC Sanctions Eight Audit Firms for Violating Auditor Independence Rules (Dec. 8, 2014), <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588>; Press Release, PCAOB Announces Settled Disciplinary Orders Against Seven Audit Firms for Independence Violations When Auditing Broker-Dealers (Dec. 8, 2014), https://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx.

⁴⁰ Press Release, PCAOB Announced Settled Disciplinary Orders and Extraordinary Cooperation Credit in Audits of Broker-Dealers (July 9, 2015), https://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx (declining to commence disciplinary action against an eight audit firm based on credit given for extraordinary cooperation).

⁴¹ Press Release, PCAOB Sanctions Five Broker-Dealer Audit Firms for Independence Violations and Grants Sixth Firm Extraordinary Cooperation Credit to Avoid Discipline (Mar. 15, 2016), <https://pcaobus.org/News/Releases/Pages/Five-BD-independence-orders-one-cooperation-3-15-16.aspx> (also announcing its decision not to bring action against a sixth audit firm based on the firm’s extraordinary cooperation).

⁴² *Id.*; see, e.g., Order Instituting Disciplinary Proceedings In the Matter of Carnaghi & Schwark PLLC, PCAOB Release No. 105-2016-009 (Mar. 15, 2016); Order Instituting Disciplinary Proceedings In the Matter of Holt & Patterson, LLC, PCAOB Release No. 105-2016-010 (Mar. 15, 2016); see also Rule 17a-5(i) of the Exchange Act.

⁴³ Exchange Act Rule 2-01(c)(4).

⁴⁴ PCAOB, Policy Statement Regarding Credit for Extraordinary Cooperation In Connection With Board Investigations, PCAOB Release No. 2013-003 (Apr. 24, 2013) at 3-4, available at https://pcaobus.org/Enforcement/Documents/Release_2013_003.pdf.

⁴⁵ *Id.* at 5.

⁴⁶ See *supra* n. 40, 41.

V. Potential Consequences and Lessons for Broker-Dealers

Until recently, most broker-dealers and their auditors had been operating without significant regulatory oversight over the audit process. They developed practices that, while previously permitted, are now sanctionable by the SEC and PCAOB under the new regulatory regime. While the regulators appear to have permitted a period of adjustment to the new regime, they are now actively looking to bring enforcement actions against auditors, as seen in the spate of orders since 2014 censuring and fining accounting firms, and requiring them to establish policies and procedures to ensure independence going forward.⁴⁷

These sanctions serve the dual purpose of punishing deficient behavior in discrete cases, while also educating the industry about how to meet the new standards. The simplest lesson to convey, and apparently the low-hanging fruit for regulators under the new regime, relates to violations of the independence standards. While the enforcement actions to date for violations of these standards have been against auditors, such violations also significantly impact broker-dealers. Enforcement actions against a broker-dealer's auditor might impair a

broker-dealer's ability to issue required reports, and create the possibility of disciplinary action against the broker-dealer itself. Accordingly, broker-dealers should be cognizant of the new PCAOB standards, and that they are threatened by potential findings that their auditors were not independent.⁴⁸ As the authorities have stressed repeatedly, it is the broker-dealers' responsibility to ensure that their auditors are compliant.

The second lesson for broker-dealers is that in the event they discover an auditor independence violation, they should urge their auditor to self-report to the PCAOB Tip Line and provide extraordinary cooperation, in the form of self-reporting, remedial or corrective action, and substantial assistance.

⁴⁸ An additional potential consequence of a defect in auditor independence is a violation of the Custody Rule, Rule 206(4)-2, which requires investment advisers who have "custody" of client funds to undergo an annual examination by an independent public accountant registered with the PCAOB. *See, e.g.,* Order Making Findings and Remedial Sanctions and a Cease-and-Desist Order in the Matter of Total Wealth Management et. al., Exchange Act Release No. 76643 (Dec. 14, 2015), at 9-10 (finding a violation of the Custody Rule where accountant prepared financial statements and then audited the same statements). The Custody Rule was implemented in large part because of the harms caused by investment advisers such as Madoff and the Bayou hedge fund, discussed earlier.

⁴⁷ *See e.g., Carnaghi & Schwark; Holt & Patterson.*