GIBSON DUNN

Accounting Firm Quarterly Update

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PCAOB Continues Aggressive Standard-Setting Activity

The PCAOB continued in the third quarter of 2023 to push forward with updates to its rules and standards on multiple fronts.

On September 19, 2023, the PCAOB unanimously voted to issue for comment a proposed rulemaking to amend PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* ("Proposal"). The Proposal would update the nearly 20-year-old rule to: (1) change the *mens rea* element of contributory liability from recklessness to negligence; (2) remove the requirement that a contributory violator have any awareness that their contribution to a violation is direct and substantial (while maintaining the requirement that the contribution actually be direct and substantial); and (3) provide that an associated person violates Rule 3502 by contributing to a rule or standard violation by any registered firm, not just the firm with which the associated person is associated.

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On September 28, 2023, the Board unanimously adopted a new standard to modernize the auditor's confirmation process. PCAOB Chair Erica Williams touted the new standard—now called AS 2310, *The Auditor's Use of Confirmation*—as furthering the PCAOB's efforts to "modernize standards to make sure they are effective at protecting investors in today's world." Among other things, the new standard reflects the prevailing use of electronic communications in the confirmation process, reduces the auditor's ability to rely on negative confirmations, and emphasizes the need for the auditor to "maintain control" over the confirmation process.

Although both votes were unanimous, Board members Duane DesParte and Christina Ho both voiced reservations about the proposed amendment to Rule 3502, expressing concerns that it could have negative unintended consequences for the profession.

Meanwhile, the PCAOB's earlier proposal regarding noncompliance with laws and regulations continued to generate significant attention and comments, with over 100 comment letters and members of Congress weighing in.

Public comments on the Rule 3502 proposal must be submitted by November 3, 2023. The confirmation standard will be effective for audits of financial statements for fiscal years ending on or after June 15, 2025.

PCAOB Staff Report Finds 40 Percent of Audits Have Part I.A Deficiencies

In July 2023, the PCAOB released a staff report indicating that 40 percent of audits inspected in 2022 will have one or more Part I.A deficiencies. This represents a 6 percentage point increase over 2021.

In a statement on the report, Chair Williams called the deficiency rate "completely unacceptable" and pledged that the PCAOB would hold auditors accountable through inspections and enforcement actions. Chair Williams also encouraged audit committees and investors to do more in response to inspection findings.

SEC Chief Accountant Issues Statements on Crypto Assurance Work and Risk Assessment

SEC Chief Accountant Paul Munter issued statements in the third quarter on two issues that have generated significant recent attention: crypto assurance work and risk assessment.

On July 27, 2023, Munter issued "The Potential Pitfalls of Purported Crypto 'Assurance' Work," in which he advised accounting firms to take certain precautions when performing work in the crypto space—particularly, when retained by crypto asset trading platforms. Munter urged accounting firms to remain mindful of independence requirements and to "carefully consider" how to describe the nature and scope of assurance work to avoid leading investors to believe that the firm had conducted a full financial statement audit, and to avoid using terms such as "audit," "GAAS," "PCAOB standards," and "PCAOB inspections" in engagement letters with clients in the crypto-asset space.

On August 25, 2023, Munter issued a statement entitled, "The Importance of a Comprehensive Risk Assessment by Auditors and Management," expressing concern regarding instances in

which auditors appeared "too narrowly focused on information and risks that directly impact financial reporting, while disregarding broader, entity-level issues that may also impact financial reporting and internal controls." Munter opined that an effective risk management process requires management to (1) "take a holistic approach" to risk assessment, including by implementing entity-level controls; (2) establish processes and controls to be "responsive" to identified risks; and (3) "effectively identify information" to disclose to investors.

Second Circuit Decertifies Investor Class in Long-Running Dispute

In a long-running securities class action, the U.S. Court of Appeals for the Second Circuit decertified a plaintiff class where plaintiffs had relied on the "inflation maintenance" theory to show that the challenged statements had a price impact and the presumption of reliance was appropriate. In A*rkansas Teacher Retirement System v. Goldman Sachs Group, Inc.*, plaintiffs argued that reliance could be presumed because Goldman Sachs's stock traded in an efficient market and the drop in stock price following the alleged corrective disclosures illustrated that the statements at issue had artificially inflated the stock previously. Goldman used expert testimony to argue that there was a mismatch between the generic challenged statements about the company's business principles and conflict-of-interest management procedures and the specific corrections announcing regulatory enforcement actions and investigations into certain transactions. Because of this mismatch, Goldman argued, the stock price drop was not attributable to the challenged statements. The district court certified the class.

Upon review, the Second Circuit reversed, finding that there was an insufficient match between the challenged statements and the corrective disclosures. The court concluded that when a plaintiff relies on inflation maintenance theory, it cannot simply "identify a specific back-end, price-dropping event" and match it to "a front-end disclosure bearing on the same subject" unless "the front-end disclosure is sufficiently detailed in the first place." Instead, the specificity of the statement and alleged correction must "stand on equal footing." The Second Circuit also noted that in conducting the "mismatch" analysis, other indirect evidence of price impact could be considered, including whether there was "pre- or post-disclosure discussion in the market regarding a generic front-end misstatement."

The Second Circuit has confirmed with this opinion that the opportunity to rebut the presumption of reliance to defeat class certification in a securities class action is meaningful. Where the only connection between vague challenged statements and specific, severe alleged corrective disclosures is the general subject matter, the case is not appropriate for class certification because there is no common method of proving shareholders relied on the vague statements.

For more detail, see Gibson Dunn's client alert on the case.

UK Supreme Court Strikes Down Litigation Funding

The UK Supreme Court made its ruling in *R* (*on the application of PACCAR Inc and others) (Appellants*) *v Competition Appeal Tribunal and others (Respondents)*, [2023] UKSC 28, on July 26, 2023, holding that litigation funding agreements could amount to "claims management services," meaning they fall within the statutory definition of damages-based agreements. As a result, litigation funding agreements that are tied to the recoveries in proceedings will generally be

unenforceable in England and Wales unless they comply with the Damages-Based Agreements Regulations 2013, and such litigation funding agreements will always be unenforceable in the context of opt-out class actions. The Court's opinion was issued in the context of an antitrust class action against five major European truck manufacturers in the wake of a cartel decision by the European Commission.

Gibson Dunn has issued a client alert discussing the ruling and its implications in further detail.

NYSE and Nasdaq Listing Standards on Clawbacks Take Effect

On October 2, 2023, the New York Stock Exchange and Nasdaq listing standards requiring companies to adopt clawback policies pursuant to SEC Rule 10D-1 went into effect. Under those standards, listed companies have until December 1, 2023 to adopt policies to claw back incentive compensation that is received after the effective date for financial performance that is subject to a restatement.

Gibson Dunn issued client alerts on the matter at the time the final SEC rules were adopted in October 2022 and when the delayed effective date of the listing standards was proposed to the SEC in June.

New York DFS Proposes Second Amendment to Cybersecurity Regulation

On June 28, 2023, the New York Department of Financial Services ("NYDFS") published a Revised Proposed Second Amendment to its Part 500 Cybersecurity Rules applicable to "covered entities." The Revised Proposed Second Amendment comes months after the NYDFS released the first proposed second amendment in November 2022, and intends to address comments received in response to that version. Among other updates, the revised proposal reduces requirements for audits, risk assessment, and penetration testing, reduces governance requirements, changes notification requirements, expands requirements for multi-factor authentication, changes requirements for incident response and business continuity and disaster recovery plans, clarifies certification requirements, and clarifies certain penalties.

Gibson Dunn has issued a client alert discussing Revised Proposed Second Amendment and its implications in further detail.

California Broadens Restrictions on Employee Non-Competes

Beginning on January 1, 2024, California's existing restrictions on employee non-compete agreements will expand to include out-of-state agreements and will create new enforcement rights for employees to challenge their agreements. Plaintiffs may bring suit under the law seeking injunctive relief and actual damages, and may also seek to recover attorneys' fees. The legislation, signed into law on September 1, 2023, is intended to respond to an increasingly remote talent market and promote the freedom of movement of employees. Questions remain as to how broadly the law will apply in practice, including whether the law will apply retroactively and whether it will apply to employees located outside of California.

For additional insights on the legislation, please see Gibson Dunn's client alert.

In addition, on October 13, 2023, Governor Newsom also signed into a law a new requirement for California employers and non-California employers with California employees to notify current or former employees who were employed after January 1, 2022 that their noncompete agreements are void. This notification must be completed in writing by February 14, 2024—failure to comply can result in civil penalties.

California Passes Legislation Establishing Climate-Related Reporting Requirements

The California Legislature recently passed, and Governor Gavin Newsom signed, two wide-reaching bills that will impose significant and mandatory climate-related reporting requirements for large public and private companies doing business in the state. Specifically, the bills will ultimately require annual disclosure of audited Scope 1, 2, and 3 greenhouse gas ("GHG") emissions and biennial disclosure related to certain climate risks. In support of the bills, the Legislature cited concerns such as the effect of climate change on the state's economy, companies' roles in contributing to and addressing climate-related risks to their own businesses and the state's economy, and the ability of the state to develop emissions reduction requirements, as well as the lack of transparency and consistency resulting from current voluntary emissions disclosure. Although the bills rely on existing reporting frameworks and standards established by international organizations, it is expected that the compliance costs will be significant for many companies.

For additional insights on the legislation, please see Gibson Dunn's client alert.

Other Recent SEC and PCAOB Enforcement and Regulatory Developments

Enforcement Actions

- On July 28, 2023, the PCAOB announced settled orders with five separate firms for alleged violations involving communications with their clients' respective audit committees, including providing non-audit services without receiving prior approval from the issuers' audit committees.
- On August 29, 2023, the PCAOB issued a settled order against Warren Averett, LLC, an Alabama-based firm and a member of BDO Alliance USA, alleging its non-audit services for a biotechnology firm impaired the independence of BDO in issuing an unqualified audit report for the same client.
- On September 12, 2023, the SEC issued a settled order against Marcum LLP's National Assurance Services Leader for allegedly failing to sufficiently address and remediate deficiencies in Marcum's quality control system, primarily in connection with audits of special purpose acquisition companies (SPACs). The matter relates to a previous SEC enforcement action against Marcum on June 21, 2023, as discussed in our last Update.
- On September 29, 2023, the SEC announced charges against Prager Metis CPAs, LLC and its California firm, Prager Metis CPAs LLP, for alleged violations of auditor independence rules based on the inclusion of indemnification provisions in engagement letters for audits, reviews, and examinations.

Other Developments

- On September 12, 2023, SEC Chair Gary Gensler testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs at a hearing regarding Oversight of the U.S. Securities and Exchange Commission. In his prepared statement, Chair Gensler touted the SEC's 750 enforcement actions and 3,000 examinations conducted in 2022, as well as the SEC's continued focus on proposing new and updated rules and receiving and considering public comments.
- The PCAOB experienced a number of personnel changes in the third quarter of 2023. Division of Registration and Inspections Director George Botic was announced as the replacement for outgoing Board Member Duane DesParte, whose term expires on October 24. The Board announced that Christine Gunia will be Acting Director of Registration and Inspections. Meanwhile, Division of Enforcement and Investigations Deputy Director (Accountant) Raymond Hamm left the PCAOB in July, after which the Division reshuffled its senior staff, with Michael Davis becoming Chief of Staff, Kyra Armstrong becoming Counsel to the Director, William Ryan becoming Chief Counsel, and John Abell becoming Chief Accountant, with Michael Plotnick remaining Chief Trial Counsel.

In addition to the Accounting Firm Advisory and Defense Practice Group Chairs listed above, this Update was prepared by David Ware, Timothy Zimmerman, Benjamin Belair, Adrienne Tarver, Monica Limeng Woolley, Douglas Colby, and Nicholas Whetstone.

For further information about any of the topics discussed herein, please contact one of the Accounting Firm Advisory and Defense Practice Group Chairs, or the Gibson Dunn attorney with whom you regularly work.