18 February 2011

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Study Mandated by Section 929Y of the Dodd-Frank Wall Street Reform and Consumer Protection Act to Determine the Extent to Which Private Rights of Action Under the Antifraud Provisions of the Securities Exchange Act of 1934 Should Be Extended to Cover Transnational Securities Fraud [Release No. 34-631374; File No. 4-617]

Dear Ms. Murphy:

These comments are submitted by the coordinating entities of 7 separate international networks of accounting firms.[1] The member firms of these networks collectively audit the overwhelming majority of public companies around the world; they audit an even greater percentage of the companies engaged in cross-border activities.

We appreciate the opportunity to express our views regarding the study to be undertaken by the Securities and Exchange Commission ("SEC" or the "Commission") pursuant to Section 929Y of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] That study is to address whether the rule announced by the Supreme Court in *Morrison v. National Australia Bank, Ltd.* should remain in force or, instead, be overridden to authorize private suits for fraud in connection with purchases and sales of securities outside the United States.[3] As you know, the Supreme Court held in *Morrison* that private liability under Section 10(b) of the Securities Exchange Act of 1934 was limited to alleged fraud "in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[4]

U.S. accounting firms face significant exposure from securities class actions alleging wrongdoing in connection with the firms' audits of companies whose securities are traded in the United States—including claims so large that they could threaten an audit firm's continued existence. The non-U.S. member firms of our networks audit very large numbers of public companies whose securities are publicly traded on exchanges *outside* the United States, as well as thousands of other non-U.S. entities whose securities are not publicly traded. Creation by the United States of a new, extraterritorial private cause of action would impose on non-U.S. audit firms the litigation burdens and threats now faced by U.S. audit firms. We strongly oppose that step for several reasons:

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[1] A coordinating entity typically grants to a member firm the right to use the network's name in a particular geographic region and to use proprietary methodologies in return for the member firm's agreement to abide by common policies and standards of quality. Coordinating entities do not provide any services to clients.
[2] Pub. L. No. 111-203, § 929Y, 124 Stat 1376, 1871 (2010).
[3] 130 S. Ct. 2869 (2010).
[4] *Id.* at 2888.

- Increasing non-U.S. accounting firms' exposure to U.S. private litigation is not needed to promote audit quality. Accounting firms' home country regulators possess and exercise broad authority to oversee auditors and to detect and punish poor quality auditing. This regulatory oversight, supplemented by private liability deemed appropriate under local law, provides powerful incentives for audit firms to comply with, and even exceed, applicable professional standards. There simply is no evidence of a gap in monitoring, deterrence, or compensation that must be filled by the creation of new private liability under U.S. law. That is especially true in light of the provision in the Dodd-Frank Act conferring authority on U.S. regulators to combat securities fraud extraterritorially.[5]

- Extension of a private right of action under U.S. law would supersede the policy choices of other sovereign nations by effectively regulating securities transactions in those nations and thereby interfering with the jurisdiction of their regulatory authorities. That interference, in turn, would likely disrupt cross-border cooperation among regulators and governments.

- Overturning *Morrison* and authorizing extraterritorial private lawsuits likely would harm investors by increasing costs and creating a significantly greater risk of further concentration in the market for audit services, thus potentially leading to decreased competition in a market that is already relatively concentrated. The United States stands alone in concluding that combining expansive private class action rules with the permissive liability standards of U.S. law provides benefits to investors that counterbalance these harms. Because the pre-*Morrison* legal standard is unpredictable, moreover, its reinstatement would render it extremely difficult to know in advance whether any particular securities transaction might later give rise to a U.S. cause of action. This unpredictability makes it impossible to justify extraterritorial private actions by reference to deterrence principles. And any interest of the United States in providing compensation to defrauded investors is attenuated with respect to investors—whether domestic or foreign—who buy or sell securities on exchanges (or otherwise) outside the United States.

In conducting its study of this important issue, the Commission should use the comments it receives to identify the issues that should be addressed in the study. It also should develop a plan for gathering data relevant to those issues, including by reaching out to key stakeholder groups—most importantly, non-U.S. regulators and other public authorities.

<u>Background</u>

For several decades, U.S. audit firms have faced substantial litigation exposure and incurred significant costs as a result of U.S. securities class actions. Cornerstone Research reported in 2010 that 17% of securities class actions settled since 1996 had named an auditor as a defendant,

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[5] Pub. L. No. 111-203, § 929P(b).

with this percentage increasing in recent years.[6] And according to a 2008 report issued by the Government Accountability Office ("GAO"), between 1998 and 2008 "audit firms may have paid at least ten settlements or awards of $100 million or more that have resulted from private litigation."[7] At the same time, as we discuss below, there is no evidence that the merits of such suits have much if anything to do with their filing or settlement.[8]

As Professor John C. Coffee, Jr. of Columbia Law School noted in 2004, "the most ominous fact [for the future] may be that accounting irregularities tend increasingly to be the primary focus of securities class actions."[9] Recent statistics show the continuation of this trend: according to Cornerstone, "[i]n 2009 allegations related to violations of Generally Accepted Accounting Principles (GAAP) were included in more than 65 percent of settled cases. These cases continued to be resolved with larger settlement amounts than cases not involving accounting allegations."[10] And audit firms were named in a number of recent high-profile securities class actions stemming from the financial crisis. For example, according to Audit Analytics, as of late 2009, eight accounting firms had been named as defendants in eleven securities class actions based on allegations relating to Bernard Madoff's Ponzi scheme, and six firms had been named as defendants in nine securities class actions relating to the credit crisis generally.[11]

Audit firms' litigation exposure in connection with securities class actions is, of course, a significant part of the broader litigation risk that accompanies audit work. In the 12 years after the enactment of the Private Securities Litigation Reform Act of 1995,[12] the six largest U.S. auditing firms paid out $5.66 billion to resolve 362 securities class actions and other suits related to public company audits, private company audits, and all other non-audit services, with 65% of the total ($3.68 billion) related to public company audits.[13] And in mid-2008, the six largest U.S. auditing firms were defendants in 90 audit-related suits, each of which involved damage claims in excess of $100 million—ranging up to $10 billion.[14]

To be sure, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Supreme Court barred so-called "scheme liability" securities fraud suits if plaintiffs cannot satisfy the reliance requirement under section 10(b).[15] But this decision has not significantly mitigated audit firms' securities class action exposure. Although the decision reinforced that section 10(b) does not

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[6] *See* Ellen M. Ryan & Laura E. Simmons, Cornerstone Research, *Securities Class Action Settlements—2009 Review and Analysis* 8 (2010), http://tinyurl.com/4d4h9re.
[7] GAO, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, GAO-08-163, at 33 (Jan. 2008).
[8] *See infra* page 14.
[9] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms* 58-59 (Berkeley Program in Law & Economics, Working Paper Series 2004).
[10] *See* Ryan & Simmons, *supra* note 6, at 8.
[11] *See* Mark Cheffers & Robert Kueppers, *Audit Analytics, Accountants Professional Liability Scorecards and Commentary* 9, 11 (2009), http://tinyurl.com/4mn8hdy.
[12] Pub. L. 104-67, 109 Stat. 737.
[13] Arthur Levitt, Jr. & Donald T. Nicolaisen, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* VII:25 (2008).
[14] *Id.*
[15] 552 U.S. 148 (2008).

support aiding-and-abetting liability for securities fraud, the Court also made clear that "the implied right of action in § 10(b) continues to cover secondary actors who commit primary violations."[16] Securities class action suits against auditors generally allege that the audit opinion itself is a deceptive statement made to investors—a theory of primary liability that, as such, remains viable after the *Stoneridge* decision. Indeed, 9.5 percent of securities class action filings in 2009—the year after the case was decided—named an auditing firm as a defendant.[17]

Legislation overturning *Morrison* would extend this litigation regime—and the associated huge litigation costs and potential threat of disastrous liability—to non-U.S. audit firms. Just as U.S. audit firms are joined as defendants in securities class actions brought in the name of purchasers or sellers of their audit clients' securities, plaintiffs would join non-U.S. audit firms as defendants in class actions brought against non-U.S. issuer audit clients. Significantly, plaintiffs already were bringing suits against non-U.S. issuers with steadily increasing frequency in the years leading up to the *Morrison* decision,[18] and the imprimatur of statutory codification likely would only serve to accelerate this trend—as well as the frequency of suits against non-U.S. auditors. Moreover, a return to the "conduct and effects" test would expose firms to private liability based on their extraterritorial conduct under a standard that the Supreme Court derided in *Morrison* as "complex in formulation," "unpredictable [and inconsistent] in application," and "not easy to administer."[19]

Indeed, that test permits particularly absurd results as applied to non-U.S. auditors that provide services to non-U.S. issuers of securities that trade exclusively on overseas markets. For example, such a non-U.S. audit firm could be targeted by a securities class action suit alleging massive damages for the firm's statements in connection with the audit of the foreign issuer, so long as plaintiffs state in their complaint facts alleging either that the issuer engaged in sufficient conduct in, or that the issuer's conduct had sufficient effects in, the United States. And plaintiffs could state such a claim even if the audit firm had no reasonable expectation that the issuer would engage in any improper conduct in (or impose any harmful effects in) the United States. So long as the plaintiffs alleged that such conduct by the issuer did in fact occur, and that the audit firm was involved in the alleged fraud and made a deceptive public statement in furtherance of it, the firm might well have to defend the suit. In other words, actions by the non-U.S. issuer could pull the non-U.S. audit firm into a U.S. securities class action lawsuit even

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[16] *Id.* at 166; *see also Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.").

[17] Jordan Milev et al., NERA, *Trends 2010 Year-End Update: Securities Class Action Filings Accelerate in Second Half of 2010; Median Settlement Value at an All-Time High* 7 (Dec. 14, 2010).

[18] *See* Cornerstone Research, *Securities Class Action Filings: 2010 Year in Review* 13 (Jan. 20, 2011), http://tinyurl.com/4m3shgu (noting that suits against foreign issuers increased dramatically as a percentage of total securities class actions between 1996 and 2010, from 6 percent to 15.9 percent); Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 Colum. J. Transnat'l L. 14, 41 (2007) (finding that the rate at which multinational class actions based on foreign transactions were being filed in U.S. court was increasing).

[19] *Morrison*, 130 S. Ct. at 2878.

though the audit firm had no way of knowing that, by undertaking the audit, it had exposed itself to such a risk.[20]

As we explain below, particularly in light of the regulation and oversight of auditors and securities markets in other countries, there can be no justification for creating a new private cause of action that could have such a result. Moreover, by giving rise to the risk that audit firms would be subject to liability in such unpredictable circumstances, the creation of a new private cause of action for securities fraud could have many significant adverse consequences for U.S. and foreign businesses and investors.

Home Country Regulators Possess And Utilize Broad Authority To Promote Quality Auditing and To Detect And Deter Wrongdoing

Our respective networks strongly support high professional standards and compliance by member firms in all of their operations with applicable regulatory and legal frameworks. Further, strong professionalism and standards of ethics, a concern for reputation, and a desire to remain competitive, as well as the regulatory oversight under which the member firms in our networks operate, provide powerful additional incentives for auditors to comply fully with applicable rules and standards.

The regulators of securities markets outside the United States, including but not limited to regulators in the overseas markets that are most significant, are firmly committed to maintaining the fairness and transparency of those markets for the protection of investors, and to detecting and punishing wrongful conduct by any market participant. As discussed in the summary of a sample of national regulatory laws set forth in the Appendix to this letter, this commitment extends to the activities of auditors. In almost all of these jurisdictions, the regulatory bodies responsible for the oversight of, and the initiation of enforcement actions against, auditors are either the same as, report directly to, or cooperate closely with, those authorities responsible for the regulation of the securities markets.[21] Moreover, as the Public Company Accounting Oversight Board ("PCAOB" or the "Board") has recognized, in many of these markets regulators and enforcement authorities have broad oversight authority over accounting firms within their jurisdiction, including comprehensive powers to investigate alleged wrongdoing and to impose sanctions in the event wrongdoing has in fact occurred.[22] Penalties can include criminal penalties and the suspension or revocation of an auditor's license to practice.[23]

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[20] There would of course be a separate question whether a U.S. court could assert personal jurisdiction over a non-U.S. audit firm that did not perform any professional services in the U.S.

[21] *See* App. at A-4-A-5 (Germany), A-7 (Hong Kong), A-8 (Japan), A-10-A-11 (Netherlands), A-12-A-13 (Switzerland), A-15 (United Kingdom).

[22] *See, e.g., id.* at A-4-A-5 (Germany), A-6-A-7 (Hong Kong), A-8-A-9 (Japan), A-10-A-11 (Netherlands), A-14-A-15 (United Kingdom). *See* PCAOB, *Final Rule Concerning the Timing of Certain Inspections of Non-U.S. Firms, and Other Issues Relating to Inspections of Non-U.S. Firms*, PCAOB Release No. 2009-003, at 4 (June 25, 2009), http://tinyurl.com/4zaonoh (noting that "[s]ince 2003, . . . a number of jurisdictions have developed their own auditor oversight authorities with inspection responsibilities or enhanced existing oversight systems"); *see also* Daniel L. Goelzer, Acting Chairman, PCAOB, *Testimony Concerning Accounting and Auditing Standards: Pending*

Moreover, regulation by home country authorities furthers the same goals as regulation in the United States. "Securities regulations in the EU and United States have a similar emphasis on investor protection, fair and orderly markets, and price transparency."[24] And "all of the major financial centers of the world," including "the United States, the United Kingdom, Hong Kong, Luxembourg, Singapore, and Amsterdam," "report above-average levels of regulatory staffing and budgets."[25] Home country authorities also are much better situated than U.S. authorities to police local securities markets—including the activities of audit firms in those markets. Local regulators and enforcement authorities are more knowledgeable about local market characteristics and participants and about the sectors in which wrongdoing is most likely to occur. And because they can utilize compulsory process within the country in which the alleged fraud occurred, they are often best able to obtain relevant evidence and impose effective sanctions.

By their actions, U.S. regulatory authorities have confirmed that home country regulators are, indeed, effective. For example, the Commission has entered into numerous agreements to cooperate with non-U.S. securities regulators in investigations and enforcement matters.[26] Pursuant to these agreements, the Commission and the regulators of other nations routinely share information and evidence, help each other in document production and procuring witness testimony, and engage in joint enforcement efforts.[27] And the PCAOB also "has established contact or cooperative arrangements with numerous non-U.S. regulators."[28] For example, 29 of the Board's 82 inspections of non-U.S. firms in 2009 "were performed on a joint basis with the local auditor oversight authority pursuant to negotiated cooperative arrangements."[29]

Proposals and Emerging Issues (May 21, 2010), http://tinyurl.com/4vvwb38 (noting that "[s]ince the establishment of the PCAOB, more than 30 countries have established or empowered bodies to inspect public accounting firms").

[23] *See* App. at A-5 (Germany), A-10-A-11 (Netherlands).

[24] Tanja Boskovic et al., *Comparing European and U.S. Securities Regulations*, World Bank Working Paper No. 184, at 14 (2009), http://tinyurl.com/4cm8xxa.

[25] Howell E. Jackson, *The Impact of Enforcement: A Reflection*, 156 U. Pa. L. Rev. PENNumbra 400, 404 (2008). In its studies of securities regulation in France and Germany, for example, the IMF has declared the effectiveness of such regulation in both countries. *See* International Monetary Fund, *France: Financial Sector Assessment Program*, IMF Country Report No. 05/186, at 193 (Apr. 2005), http://tinyurl.com/4mn8hdy; International Monetary Fund, *Germany: Financial System Stability Assessment*, IMF Country Report No. 03/343, at 41 (Nov. 2003), at http://tinyurl.com/4bkws3m.

[26] For example, the Commission (along with 71 other regulatory authorities) has signed the International Organization of Securities Commissions ("IOSCO") Multilateral Memorandum of Understanding. *See* IOSCO, List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, at http://tinyurl.com/4lx8x3c. It also has signed bilateral enforcement cooperation memoranda with 20 foreign regulatory authorities. *See* Office of International Affairs: Cooperative Arrangements with Foreign Regulators, at http://tinyurl.com/4kekwak.

[27] Michael D. Mann et al., *Developments in the Internationalization of Securities Enforcement*, 1743 PLI/Corp 789, 793-95 (2009); *see also SEC Speaks in 2010*, 1784 PLI/Corp 519, 541-42 (2010).

[28] *See* PCAOB, *Cooperation with Non-U.S. Regulators*, http://tinyurl.com/5thp273; *see also* App. at A-15 (noting that "[i]n January 2011, the POB and the PCAOB in the US signed an information sharing agreement aimed at increasing the level of cooperation on and effectiveness of the oversight and inspection of audit firms").

[29] PCAOB, 2009 Annual Report, at 30, http://tinyurl.com/4c4uueq.

Some may argue that regulatory standards are not uniform across the world and that, in particular countries, the regulatory standards applicable to auditors may not measure up to the standards of the most sophisticated markets. Such arguments are misplaced. To begin with, regulatory systems should not be evaluated based on whether they use the same approaches and standards as the United States. Non-U.S. systems necessarily will have different rules, processes, and procedures because, among other reasons, they were developed in the context of different legal systems. Despite possible differences in approach, the alternative regulatory systems employed by other countries can be, and are, effective at ensuring high-quality audits. Moreover, the United States, together with other countries and in cooperation with the auditing profession, has been working through a variety of fora to enhance the effectiveness of auditor oversight worldwide.[30] And other nations are taking meaningful steps to improve their existing auditor oversight regimes: in 2006, for example, the European Union ("EU") enacted a directive requiring the creation of an effective system of public oversight for statutory auditors and audit firms within each Member State.[31] Auditor oversight is improving outside the EU as well. In January of 2011, the European Commission recognized the "equivalence of the audit oversight systems in 10 third countries," and noted that since 2008 "more than 20 third countries have established public bodies to supervise the work of auditors and at least another 10 are in the process of establishing one."[32]

Further, the lesser reliance by some countries on formal enforcement actions does not necessarily indicate that auditors subject to those countries' regulation are more likely to violate the securities laws than audit firms subject to U.S. regulation.[33] Rather, many foreign regulatory bodies are inclined "to resolve enforcement actions informally and without public disclosure," and some regulators rely more heavily than the SEC on private parties to assist enforcement efforts.[34] As Professor Howell E. Jackson of Harvard Law School has observed, "alternative

[30] These efforts have been pursued through, among other avenues, the International Forum of Independent Audit Regulators ("IFIAR") and the PCAOB's International Auditor Regulatory Institutes ("IARI"). IFIAR, an organization of 37 independent audit regulators (including the PCAOB), was established in September 2006 to "[s]har[e] knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms," "[p]romot[e] collaboration and consistency in regulatory activity," and "[p]rovid[e] a platform for dialogue with other organizations that have an interest in audit quality." IFIAR, 2009 Activity Report, at 2, http://tinyurl.com/4npevh6; *see also* App. at A-2. The PCAOB established the IARI in 2007 "to provide a forum for open discussion among regulators around the world about approaches to auditor oversight and improvements to audit quality." PCAOB, PCAOB Concludes Fourth International Auditor Regulatory Institute (posted Nov. 21, 2010), http://tinyurl.com/49oxv6e.

[31] *See* The Directive 2006/43/EC of the European Parliament and the Council (May 17, 2006); *see also* App. at A-1-A-2.

[32] Press Release, European Commission, Commission decision lays the foundation for reinforced international cooperation on the supervision of auditors (Jan. 19, 2011), http://tinyurl.com/6fr5jox; *see also* App. at A-1-A-2.

[33] *See* Jackson, *Impact of Enforcement*, supra note 25, at 407.

[34] *Id.* at 404; *see also id.* at 407-08; Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, Harvard Law School John M. Olin Center for Law Economics and Business Discussion Paper Series, Paper No. 638, at 29 (Mar. 2009) (also published in the Journal of Financial Economics, Vol. 93 (2009)), http://tinyurl.com/49qlvxt.

mechanisms of social control are plausible substitutes for the formal enforcement actions that characterize the regulatory activity in the United States and a few other jurisdictions."[35]

Finally, in appropriate circumstances and to the extent necessary, U.S. regulation and U.S. authorities can serve as a backstop to foreign regulatory efforts. The PCAOB has broad authority to conduct inspections of non-U.S. audit firms, has already conducted inspections of non-U.S. audit firms in a significant number of countries, and has announced its intention to inspect firms in 31 countries in 2011.[36] And in the unlikely event that a particular alleged fraud by an audit firm involving securities purchased on markets outside the United States raises a critical need for U.S. intervention, the SEC and the U.S. Department of Justice can step into the breach, with their ability to do so now fortified by the extraterritorial enforcement authority conferred by the Dodd-Frank Act.[37]

In sum, creation of a new form of extraterritorial private liability cannot be justified on the ground that auditors need additional incentives to provide high-quality services. Strong professionalism, standards of ethics, a concern for reputation, and a desire to remain competitive provide strong reasons for auditors to comply with all applicable professional standards and laws. Moreover, effective national regulatory systems are in place to ensure compliance. Regulators and enforcement authorities of national markets are charged with responsibility for investigating and punishing wrongdoing; and this, in turn, can be supplemented in appropriate circumstances by U.S. regulatory action.

Creating New Private Liability Would Conflict with the Rights Of Sovereign Nations To Supervise And Oversee Their Respective Markets And Market Participants, And Likely Would Disrupt Relationships With Non-U.S. Regulators and Governments

Sovereign nations have an inherent right to determine the regulations that will apply to activity within their borders. That right plainly encompasses deciding how to regulate participants in a nation's own securities markets. Extending private rights of action in U.S. courts to encompass trading in securities outside the United States plainly would trump other nations' regulatory decisions due to the practical effect of applying the U.S. legal rules in conjunction with the U.S. litigation system. Because of that effect alone, any expansion of private liability is unwarranted.

The Commission, the PCAOB, and other U.S. enforcement authorities (such as the Department of Justice) rely to a significant degree on assistance from other national regulators in overseeing auditors and in investigating and prosecuting securities fraud when the activity in question is based outside the United States. If the United States were to create a private cause of action that

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[35] *See* Jackson, *Impact of Enforcement*, *supra* note 25, at 407.
[36] List of Jurisdictions in which there are Firms whose Inspections the Board Intends to Conduct in 2011, http://tinyurl.com/6hkpbub.
[37] Private litigation, by contrast, cannot be calibrated in this manner. Once a private cause of action is authorized, the circumstances in which it is invoked are left to the discretion of private litigants. A private lawsuit therefore could be filed even though the home country regulators had instituted enforcement actions and imposed significant sanctions on the wrongdoers, or were considering doing so.

imposes its policy choices on the rest of the world, it could alienate other nations and diminish enforcement and other forms of cooperation.

Other nations' decisions not to provide a private remedy with all of the characteristics of U.S. class actions reflect their determinations that the costs of such a remedy outweigh its benefits. Thus, many nations do not permit class actions, and do not utilize the U.S. approaches to pre-trial discovery of information, jury trials, or allocation of responsibility for paying attorney's fees. And in many nations, actions grounded in fraud or similar concepts require proof that the plaintiff actually relied on the false information—a stark contrast to the "fraud on the market" rule that applies in U.S. cases. As the Supreme Court explained in *Morrison*, "the regulation of other countries often differs from ours as to what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available in litigation, what individual actions may be joined in a single suit, what attorney's fees are recoverable, and many other matters."[38]

The same differing policy choices are present with respect to private claims against auditors. In the view of many countries, "regular inspections provide better guarantees for the quality of the audits compared to unlimited civil liability rules which constrain access to this highly concentrated market."[39] In accordance with this view, some countries limit the circumstances in which such claims may be asserted;[40] and others cap the amount of damages that an auditor may be required to pay.[41] Empirical research demonstrates the legitimacy of these policy determinations, which are perfectly consistent with a commitment to effectively regulate the market for audit services and punish any related wrongdoing.[42]

Allowing purchasers or sellers of securities in foreign countries to sue in U.S. courts would enable them to circumvent other nations' policy choices—and to apply the United States' policy broadly around the world as long as the plaintiffs could point to some tangential connection between the United States and the alleged fraud. To again quote the *Morrison* Court, the "probability of incompatibility with the applicable laws of other countries" is "obvious."[43]

[38] 130 S. Ct. at 2885.
[39] *European Commission Recommendation on limitation of auditors' liability: Frequently asked questions*, MEMO/08/366, at 2 (hereinafter Audit Liability FAQs), http://tinyurl.com/6245l3f.
[40] *See Caparo Industries plc v. Dickman & Ors*, [1990] 2 AC 605 (defining purpose of a statutory audit and to whom auditors owe a duty of care in the UK; absent special circumstances, no duty of care owed to potential investors, existing individual shareholders or other third parties who rely on the statutory audit opinion).
[41] For example, German law limits an auditor's contractual liability in normal circumstances (currently to 4m Euro for public companies). *See* Handelsgesetzbuch [HGB] [Commercial Code] § 323 (Ger.).
[42] *See* Jochen Bigus, *Does a Liability Cap Distort Auditors Incentives to Take Care?*, paper presented at conference on Financial Market Regulation in Europe, Jan. 18-19, 2008, Munich, at 24-25, http://tinyurl.com/5u9apgp (finding that because of reputational effects, there is no inconsistency between legal liability caps and efficient levels of auditor care, and that unlimited liability may in fact lead to overcompensation and overdeterrence); *see also* Audit Liability FAQs at 2 (noting that "[d]uring the public consultation in early 2007, a majority of respondents (including investors) from countries where a liability cap already exists (e.g. Germany, Austria or Belgium) supported a Commission initiative and did not believe that their domestic cap had had adverse effects on audit quality").
[43] 130 S. Ct. at 2885.

Such intrusion on other nations' sovereignty will not go unnoticed—indeed, Australia, France, and the United Kingdom filed friend-of-the-Court briefs in the *Morrison* case "complain[ing] of the interference with" their securities regulation system that resulted from extraterritorial extension of private liability under U.S. law.[44] And as Professor Coffee has noted, "the United States' foreign neighbors must fear that a global class action in a U.S. court may threaten the solvency of even their largest companies and could have an adverse impact on the interests of local constituencies, including labor, creditors and local communities."[45] In that event, "other countries may not view the United States as a 'good neighbor.'"[46]

The concern is particularly acute because, as the United States noted in the *amicus* brief it filed in *Morrison*, the U.S. government lacks the power to control the circumstances in which a private remedy is invoked.[47] Thus, while government enforcement actions can be limited to circumstances in which a U.S. government authority has assessed all of the considerations discussed above and determined that extraterritorial enforcement is nonetheless appropriate, private actions are brought by self-interested plaintiffs, and adjudicated by judges who generally lack the power and expertise to adequately consider such factors.

The consequence of overturning *Morrison* thus will almost certainly be to upset relations with other nations, which may make them less likely to cooperate with the United States on regulatory and enforcement matters. As crucial as such cooperation is in the wake of the global financial crisis, it also is fragile. For example, to date, the PCAOB has been unable to conduct a number of inspections in countries in the EU and elsewhere because of, among other things, the current lack of cooperative arrangements.[48] As the Board itself observed, these actions deprived "investors in U.S. markets who rely on those firms' audit reports . . . of the potential benefits of PCAOB inspections of those auditors."[49] In other contexts, foreign nations have enacted retaliatory measures in response to U.S. efforts to enforce its laws extraterritorially. For example, "[m]any countries have objected to the extraterritorial application of U.S. antitrust (and other) laws, and several of these"—including Australia, Canada, France, South Africa, and the

[44] *Id.* at 2886.
[45] John C. Coffee, Jr., *Global Class Actions*, Nat'l Law J., June 11, 2007.
[46] John C. Coffee, Jr., *Securities Policeman to the World?: The Cost of Global Class Actions*, N.Y.L.J., Sept. 18, 2008.
[47] Brief for the United States as *Amicus Curiae* at 28, 2010 WL 719337, *Morrison*, 130 S. Ct. 2869 (No. 08-1191) ("As a federal law-enforcement agency, the SEC can be expected to take account of national interests when it determines whether particular enforcement suits represent sound uses of its resources and the resources of the federal courts. The overarching concern of individual plaintiffs, in contrast, is redressing their own injuries," and "such plaintiffs have little incentive to consider whether resolution of their securities-related grievances represents a wise use of federal judicial resources.").
[48] *See* Tammy Whitehouse, *PCAOB Persists with Inspection Plans Abroad*, Compliance Week, Feb. 8, 2011.
[49] PCAOB, Issuer Audit Clients of Non-U.S. Registered Firms in Jurisdictions where the PCAOB is Denied Access to Conduct Inspections, http://tinyurl.com/4nftxb6. Due largely to Congress's inclusion in the Dodd-Frank Act of a provision allowing the PCAOB to share inspection information with foreign auditor oversight authorities, *see* PCAOB Statement upon Signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 2010), http://tinyurl.com/6kgsrmy, the Board is now gradually regaining its ability to conduct inspections in certain countries, *see* Whitehouse, *supra* note 48.

United Kingdom—"have enacted [blocking and claw-back] legislation designed to blunt the effect of these laws as applied to their own citizens or residents."[50]

Overturning *Morrison* also could prompt non-U.S. jurisdictions to retaliate by extending their regulatory authority—and different regulatory and enforcement standards—to encompass transactions involving purchases or sales of securities within the United States. "Until the United States is ready to contemplate a system in which even the claims of U.S. investors, based on U.S. trading, are subject to the laws of another country, it is inappropriate to solve the problem of multiple proceedings by suggesting that they all take place in U.S. courts."[51] Escalating regulatory extensions would only enhance tensions and make cooperation less likely. And the resulting multiple burdens, with the corresponding increase in costs, would harm U.S. investors.

<u>Overturning *Morrison* Would Harm Investors</u>

The costs that would be imposed on investors as a result of the creation of a new U.S. cause of action far outweigh any possible benefits that they might obtain.

The extraordinary litigation burden on audit firms has been the subject of considerable study in Europe and the United States.[52] On top of the ever-present specter of potentially catastrophic liability, large U.S. audit firms have been burdened by the need to spend a meaningful percentage of their audit-related revenues—15.1% in FY 2008—on litigation protection.[53]

Creation of a new cause of action—by subjecting non-U.S. firms to new substantial litigation exposure—likely would result in an increase in audit costs.[54] And these costs will not be borne only by wrongdoers, or even only by investors in companies found to have engaged in fraud; rather, they will be spread among all investors.[55] The nature of the U.S. litigation system is such

[50] Derek Devgun, *Crossborder Joint Ventures: A Survey of International Antitrust Considerations*, 21 Wm. Mitchell L. Rev. 681, 702 (1996).

[51] Buxbaum, *supra* note 18, at 61.

[52] *See* European Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, 2008/473/EC, http://tinyurl.com/4zdjshl (noting that "unlimited joint and several liability may deter audit firms and networks from entering the international audit market for listed companies in the Community," and concluding that "the liability of auditors and audit firms, including group auditors, carrying out statutory audits of listed companies should be limited" "except in cases of intentional breach of duties by the statutory auditor or the audit firm"); London Economics & Professor Ralf Ewert, Study on the Economic Impact of Auditors' Liability Regimes, Final Report to EC-DG Internal Market and Services 177 (Sept. 2006), http://tinyurl.com/4j5g8pb (concluding based on surveys and empirical studies that "unlimited liability may in certain cases imply that the costs of unlimited liability exceed the benefits from a welfare point of view"). *See also* Levitt & Nicolaisen, *supra* note 13; GAO, supra note 7.

[53] Levitt & Nicolaisen, *supra* note 13, at VII-25.

[54] *See, e.g.*, Ananth Seetharaman et al., *Litigation Risk and Audit Fees: Evidence from UK Firms Cross-Listed on U.S. Exchanges*, 33 Journal of Accounting and Economics 91 (2002) (confirming that "audit fees will reflect risk differences across liability regimes").

[55] *See Central Bank*, 511 U.S. at 189 (noting that "the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute"); Testimony of Adam C. Pritchard Before the U.S.

that it is not possible to predict whether or when a lawsuit will be filed, and many lawsuits that are filed are costly to defend even if not meritorious. Auditors will therefore be forced to recover these costs from all clients.[56]

Expanded U.S. litigation exposure could also diminish competition in the audit market. Policymakers in the United States and Europe have identified expanding competition in the provision of audit services to public companies as an important goal.[57] If exposure to U.S. private lawsuits, and the accompanying costs and risks, were an inevitable consequence of auditing public companies with cross-border operations, audit firms might well be reluctant to take on that additional work.[58] Such an obstacle to increased competition would harm both companies and their investors.

Even more troubling is the serious risk that an audit firm could be destroyed, regardless of the merits of the matter, by an adverse jury verdict, or even the threat of such a result, in litigation seeking catastrophic-sized damages.[59] This risk is particularly acute in the context of U.S. securities class actions. It arises from the combination of the multi-billion dollar damages claims in such suits and audit firms' inability to shoulder such gigantic liability, as a consequence of a

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Senate Committee on the Judiciary, *Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009*, at 4 (Sept. 17, 2009), http://tinyurl.com/4thqkpv ("Shareholders will bear those costs; securities class action are not a free lunch.").

[56] *See* Diana R. Franz et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. Acct. Auditing & Fin. 117 (1998) (finding that litigation against an audit firm harms the stock price of even the auditor's other clients).

[57] *See* Levitt & Nicolaisen, *supra* note 13, at VIII (making recommendations to increase competitive pressures in the U.S. market for public company audits); European Commission Staff Working Document, Summary of the Impact Assessment Accompanying Commission Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms, SEC(2008) 1974, at 4 (2008), http://tinyurl.com/6bv6llo (stating as objective for any policy action "encourag[ing] more auditors to audit listed companies").

[58] *See* GAO, supra note 7, at 55 (observing that "[t]he risk of being sued appears to reduce some audit firms' willingness to seek out additional public company clients. We reported in 2003 that litigation risk was a barrier for smaller firms seeking to audit larger public companies because of the difficulty of managing this risk and of obtaining affordable liability insurance."); Audit Liability FAQs at 1 ("In the light of the current audit market structure, liability risks arising from the increasing litigation trend combined with insufficient insurance cover may deter auditors from providing audit services for listed companies."); *cf. Central Bank*, 511 U.S. at 189 (noting that the "uncertainty and excessive litigation" of aiding-and abetting liability could mean that "newer and smaller companies may find it difficult to obtain advice from professionals").

[59] *See* Levitt & Nicolaisen, *supra* note 13, at VII:26-VII:27 (stating finding by some members that "[d]ata provided by the accounting profession and testimony from academics, legal, and insurance experts make clear that the threat of the loss of a major auditing firm due to litigation is real. Such a loss would threaten the sustainability of the public company auditing profession as a whole, with serious adverse consequences to the stability of our capital markets and the confidence and protection of investors."); GAO, *supra* note 7, at 32-33 (highlighting risk faced by audit firms "that civil litigation could result in their insolvency or inability to continue operations"); Interim Report of the Committee on Capital Markets Regulation, at 88 (Nov. 2006) (noting that "audit firms are exposed to financial ruin by liability lawsuits," and that "[t]he demise of another U.S. audit firm would impose huge costs to U.S. shareholders"); European Commission Staff Working Document, Impact Assessment accompanying Commission Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms, SEC(2008) 1975, at 36 (hereinafter Impact Assessment), http://tinyurl.com/4hee7ck ("Constantly high liability risks might be one of the reasons for a future collapse of one of the Big 4 networks.")

combination of their own lack of resources, the unavailability of insurance for such claims, and the contagion effect of private actions upon the reputation of audit firms.[60] Both IOSCO and IFIAR have recognized the risk of such a litigation-induced collapse.[61]

Creating an extraterritorial private cause of action would extend this threat to non-U.S. audit firms because they predominantly audit the non-U.S. public companies with securities that trade on foreign exchanges. And the complexity and risks of the U.S. system may well present greater obstacles for non-U.S. audit firms than they do for domestic firms, because the former are less experienced in navigating the U.S. litigation system. In addition, the vast majority of non-U.S. firms are smaller than U.S. firms; the level of risk that can pose catastrophic consequences is likely to be lower for such smaller firms—and, as a result, could be more likely to be realized.

Destruction of an audit firm, particularly if a major firm in a key jurisdiction, would harm corporations and investors in several ways. First, as the European Commission staff observed in 2008, "[t]he loss of another major audit network would have *serious consequences* for the European and global capital markets both in terms of auditor choice and the actual availability of audit."[62] Second, the disappearance of an audit firm would lead talented individuals to seek other opportunities rather than remaining in an industry subject to such catastrophic risks. Third, such an event would diminish confidence in the long-term sustainability of the audit profession and capital markets during a period of global financial instability. All of these factors would be deleterious to capital markets and the users of financial statements.

Some may contend that these costs to investors are outweighed by the benefits of obtaining a monetary recovery through the U.S. litigation system. But the United States has no legitimate interest in expending precious judicial resources to provide compensation to citizens of other nations, particularly when those nations have determined that compensation is not appropriate. And the U.S. investors that participate in non-U.S. markets are for the most part sophisticated investors—institutions and wealthy individuals—that understand the right of every nation to determine the laws and rules that govern the purchases and sales of securities within its jurisdiction.[63] The Commission itself has put it well in implementing the Securities Act's registration requirements: "[p]rinciples of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore."[64]

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[60] *See* Aon, *Big 4 US Professional Indemnity Insurance Programs*, at 3 (reporting in 2008 that "[t]he past seven years have seen a growing number of claims exceed insurance limits by ever-increasing margins, such that the commercially available insurance is becoming somewhat irrelevant in the settlement of what might now be considered 'very large' claims").
[61] *See* European Commission, Impact Assessment, supra note 59, at 14.
[62] *Id.* at 36.
[63] *See* Offshore Offers and Sales, Securities Act Release No. 6863, Exchange Act Release No. 27,942, 55 Fed. Reg. 18306, 18308 (May 2, 1990) (noting that "as investors choose their markets," so "they choose the laws and regulations applicable in such markets"); *see also* Buxbaum, *supra* note 18, at 56 n.170 ("It is . . . difficult to imagine that investors would expect U.S. regulatory law to follow them in their foreign trading, especially given the level of sophistication of investors involved in cross-border investment.").
[64] 55 Fed. Reg. 18308.

Indeed, new costs and threats would be imposed on U.S. audit firms as well—costs that would be borne by investors in the U.S.-registered companies that these firms audit. When private plaintiffs sue a non-U.S. audit firm in a U.S. court, they often join as a defendant the U.S. audit firm from the same network as the non-U.S. firm—even if the U.S. firm performed no relevant audit work. Typically, they argue that the U.S. firm is liable on some sort of vicarious liability theory (bases of liability generally not recognized in other jurisdictions). These claims impose costs and risks on the U.S. firm in connection with audit work that it did not perform. Exposing non-U.S. audit firms to more securities class action claims in U.S. courts will thus inevitably expand the number of claims against U.S. firms as well, and produce in the United States the very same adverse effects: increased costs to U.S. investors, a greater risk of catastrophic liability, and a diminution in competition.

Finally, a new U.S. private action cannot be justified on the ground that it would benefit investors by promoting audit quality. To begin with, as discussed above, very significant regulatory and other incentives already exist for quality auditing. Moreover, new private liability would not enhance those incentives in any way.

If an extraterritorial U.S. cause of action existed, an auditor outside the United States likely would not know when he provided his services whether he might be exposed to U.S. litigation; that exposure would depend upon whether a private lawsuit was filed years later that asserted a previously unknown link between the alleged fraud and the United States. Indeed, as mentioned above (*see* supra page 4-5), an auditor that provided services for a non-U.S. issuer might not even realize that the issuer was engaging in sufficient conduct in the United States to subject the auditor to private liability under U.S. securities laws. Thus, in most if not all cases, the possibility of future U.S. liability could not have any effect on the auditor's performance of his work. By contrast, in all of their engagements, auditors are influenced by the strong commitment to professional standards held by them and their networks, and by the oversight of their home country regulators.

The threat of U.S. liability would not provide an incentive for quality auditing for another reason: in the U.S. system, an audit firm's litigation burden is unrelated to the quality of its work. Research has demonstrated that the filing of securities class action lawsuits is triggered by declines in stock price and the amount of the defendant's insurance coverage, not the merits of the claims.[65] And settlement decisions are similarly unrelated to the merits, driven instead by the defendants' fear of draconian liability and other factors.[66]

The clear harm that a new cause of action would inflict on investors—in terms of increased audit costs and potentially decreased competition, as well as the increased risk of the disruption and adverse consequences that would flow from destruction of an audit firm—and the lack of any

[65] *See, e.g.*, Patrick M. Garry et al., *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. L. Rev. 275, 287 n.98 (2004) (citing studies).
[66] *See* Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. Penn. L. Rev. 755, 831 (2009).

legitimate countervailing benefit, provide yet another reason to decline to authorize these extraterritorial claims.

Suggested Elements Of SEC Study

The statutory provision mandating this study states that the Commission "shall solicit public comment and thereafter conduct a study . . ."[67] In moving from the comment solicitation stage to the study stage, the Commission's first step should be to identify the issues that must be addressed in the study—the submissions received in response to the request for comments should be very useful in helping the Commission accomplish this task.

Next, the Commission should obtain detailed views on those issues from key stakeholders. That process should include soliciting the views of non-U.S. accounting and financial services regulators (and of non-U.S. governments generally) regarding (a) the ability of those non-U.S. regulators to detect and punish wrongdoing by audit firms; (b) the effect of expansive U.S. private liability on other nations' regulatory systems; and (c) the potential impact on the cost and availability of audit services of exterritorial private lawsuits in the United States.

The Commission also should meet with representatives of non-U.S. audit firms to discuss further the views expressed in this letter. And the Commission should consider obtaining the views of other representatives of the accounting profession outside the United States, including the national constituent organizations of the International Federation of Accountants ("IFAC") and IFAC's Transnational Auditors Committee (*see* www.ifac.org/TransnationalAuditors/).

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Thank you for considering these views. Please contact any of the undersigned if you would like further information regarding the views expressed herein, or to arrange a meeting with a representative group to discuss these issues.

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[67] Pub. L. No. 111-203, § 929Y.

Sincerely,

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BDO International Limited

Susan Yashar
Deputy General Counsel—Regulatory
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APPENDIX[1]

Auditor Regulatory/Enforcement Regimes in France, Germany, Hong Kong, Japan, the Netherlands, Switzerland and the UK

Overview

The national auditor regulatory and enforcement regimes of these seven countries broadly speaking follow the same structure, consisting of an independent body or bodies responsible for:

- Establishing the framework of financial reporting and auditing standards at a national level;
- Overseeing regulation of statutory auditors, including registration, professional standards etc.;
- Conducting independent inspections of audit quality – at the firm and individual engagement levels; and
- Enforcing an independent disciplinary system for the investigation and enforcement of breaches of technical or professional standards.

The precise implementation varies at the national level, but a common theme is increasing cooperation with both relevant national supervisory and enforcement bodies and with their international counterparts.

The European Context

The EU Statutory Audit Directive (the "Directive"), agreed in 2006 and implemented in most EU Member States, reserves the responsibility for registering and regulating audit firms to each EU Member State, but establishes the principle of mutual recognition and requires much closer cooperation between Member States on the regulation of EU audit firms.

The Directive includes provisions on the regulation of auditors ("third country auditors") of companies from outside the EU that issue securities traded on EU regulated markets. These provisions are designed to protect European investors by strengthening confidence in the audits of non-EU companies traded on European markets.

The following developments have occurred in Europe to January 2011:

- Adequacy and Equivalency decisions (which impact the ability of EU Member States to enter into cooperative arrangements with non-EU countries and rely on the oversight systems of non-EU Countries) were approved by the EU with regard to ten countries.[2] The extent to which there will in fact be reliance and cooperation will be determined by arrangements signed between the relevant EU member state and the third country.

[1] This appendix is based on publicly-available information obtained principally from government authorities' websites and published sources.
[2] Australia, Canada, China, Croatia, Japan, Singapore, South Africa, South Korea, Switzerland and the US.

- A transitional period (until July 31, 2012) was granted to auditors from a further twenty countries,[3] allowing them to continue audit activities in the EU pending further assessments of their audit regulatory systems (but subject to minimum requirements to provide relevant information to maintain investor protection, such as provision of the last inspection report, a description of the firm's internal quality control system, etc.).

- A protocol was developed, which EU oversight bodies can consider, setting out the detailed basis for cooperation and information sharing between regulators, in accordance with the Directive.

International Forum of Independent Audit Regulators

National audit regulators also cooperate through the International Forum of Independent Audit Regulators (IFIAR) to which most significant national regulators, including the PCAOB in the US, belong.[4]

IFIAR is chaired by the Managing Director of the Netherlands Authority for Financial Markets and its Vice-chair is the Director of Audit at the UK's Financial Reporting Council. IFIAR's stated objectives are:

- To share knowledge of the audit market environment and practical experience of independent audit regulatory activity;

- To promote collaboration in regulatory activity; and

- To provide a focus for contacts with other international organisations which have an interest in audit quality.

Examples of practical steps that the IFIAR has taken in 2010 include:

- Discussions with the global leadership of the six largest audit firm networks to understand better their global quality control procedures and strategy and to receive their commitment to address the root causes of common audit inspection findings;

- Supporting the development of independent inspections around the world by facilitating audit inspection workshops led by leading national regulators (e.g. the FRC in the UK) through which experience and best practice can be shared.

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[3] Abu Dhabi, Bermuda, Brazil, Cayman Islands, Dubai International Financial Centre, Egypt, Guernsey, Hong Kong, India, Indonesia, Isle of Man, Israel, Jersey, Malaysia, Mauritius, New Zealand, Russia, Taiwan, Thailand and Turkey.

[4] In addition, the following organizations are observers of IFIAR meetings Financial Stability Board (FSB); Public Interest Oversight Board; International Organisation of Securities Commission (IOSCO); Basel Committee of Banking Supervisors; International Association of Insurance Supervisors (IAIS); World Bank; European Commission.

France

Introduction and Background

The independent body in charge of oversight of the audit profession in France is the “Haut Conseil du Commissariat aux Comptes” or High Council of Statutory Auditors (the H3C), established under the Attorney General. The H3C monitors the professional conduct and the independence of the statutory auditor, together with Compagnie Nationale des Commissaires aux Comptes (CNCC), the national society of auditors in France.

The H3C has two key tasks:

- Provide oversight of the profession;
- Ensure compliance with ethics and in particular the independence of auditors.

In this context, the H3C is charged with:

- Organizing controls over the activity of professionals;
- Advising on the Code of Ethics of the profession;
- Issuing an opinion on professional standards;
- Identifying and promoting best practices;
- Defining and overseeing the direction and scope of periodic inspections.

In addition, the H3C is the appellate body of regional chambers of the CNCC in disciplinary matters and in matters of registration.

Oversight of Statutory Audit

The H3C’s role is supervisory in that it defines and oversees the implementation of the activities of the CNCC with regard to the tasks outlined above. It is an advisory body regarding all the tasks described above except for discipline, where it stands as an appeal body.

Monitoring of Quality

The H3C has oversight of the external quality control program run by the CNCC.

Professional Discipline and Enforcement

Regarding all issues related to discipline, the “Chambre Régionale de Discipline” or regional chambers of the CNCC, have sole authority at first instance. The H3C has the jurisdiction of appeal on disciplinary matters.

Cooperation Between Regulatory Bodies

The H3C is a member of IFIAR and the European Group of Auditor Oversight Bodies (EGAOB).

Germany

Introduction and Background

Since January 1, 2005, public oversight of the Wirtschaftsprüferkammer (WPK) (the Chamber of Public Accountants) in Germany has been the responsibility of the Abschlussprüferaufsichtskommission (APAK) (Auditor Oversight Commission (AOC), in English).

The creation of the AOC follows national, European and international initiatives to strengthen the quality, independence and integrity of the audit profession and is an important element of the framework for ensuring confidence in the statutory audits performed. The AOC now has primary responsibility for supervision of the activities of the WPK (of which all public accountants are mandatory members), but it is itself supervised by the Federal Ministry of Economics and Technology. The Federal Ministry appoints the members of the AOC and also retains a state supervisory role.

Oversight of Statutory Audit

The AOC is responsible for overseeing the following areas of the work of the WPK in relation to its members who are entitled to carry out statutory audits:

- professional examinations
- aptitude tests for qualified auditors from abroad
- licensing of public accountants (Wirtschaftsprüfer and vereidigte Buchprüfer)
- licensing of audit firms
- revocation of licenses
- registration of public accountants and audit firms
- disciplinary oversight
- external quality assurance
- adoption of professional rules

The AOC exercises its responsibilities by way of comprehensive rights to be kept informed about relevant issues, to participate in meetings of bodies of the WPK, to inspect proceedings of the WPK relevant to public oversight, to have decisions of the WPK submitted for review, to issue instructions as to the decisions of the WPK, and to be consulted in key areas.

This is coupled with obligations on the WPK to report in a timely fashion, and in an adequate way, on individual proceedings and decisions.

The AOC publishes an annual work plan and an annual progress report.

Monitoring of Quality

The WPK is primarily responsible for quality assurance, but this responsibility is subject to the oversight of the AOC in accordance with its obligations and rights outlined above.

Professional Discipline and Enforcement

Under the Public Accountants Act, disciplinary oversight of the audit profession in Germany is organised into a two-tier system. Minor violations of professional rules are investigated and sanctioned by the WPK under the public oversight of the AOC.

Severe violations of professional rules are sanctioned by special divisions of the criminal courts. A charge is brought by the chief public prosecutor's office at the Berlin District Court after its own investigations. First instance decisions are the responsibility of a division of the Berlin District Court, from which an appeal lies to a panel of the Higher Regional Court of Berlin. Further appeals will be decided by a panel of the Federal High Court in Leipzig.

Cooperation Between Regulatory Bodies

The AOC is a member of IFIAR and the European Group of Auditor Oversight Bodies (EGAOB) and, in cases of professional supervision with cross-border importance, is the contact for authorities from abroad. The AOC cooperates in case of cross-border oversight proceedings concerning statutory auditors with the relevant authorities abroad.

At a national level, the system of auditor oversight described above refers only to the compliance with rights and duties of statutory auditors. There is a separate regime in Germany for the oversight of companies that prepare financial statements and their compliance with relevant accounting standards,[5] but there is interaction between the two systems. Any indications of breaches of the auditor's duties found by the accounting enforcement authorities have to be reported to the auditor oversight authorities for further investigation.

[5] Financial statements of public interest companies are reviewed regularly and based on random tests at the first level by the Financial Reporting Enforcement Panel and, if necessary, at a second level by the Federal Financial Supervisory Authority.

Hong Kong

Introduction and Background

Responsibility for the regulation of auditors in Hong Kong remains primarily with the Hong Kong Institute of Certified Public Accountants (the HKICPA),[6] although the Financial Reporting Council[7] is an independent statutory body with responsibilities for investigating accounting and audit irregularities.

The HKICPA is the only statutory licensing body responsible for regulation of the accounting profession in Hong Kong. Its duties include:

- Registering accountants and issuing practising certificates
- Regulating the professional conduct and standards of members
- Setting codes of ethics and standards of accounting and auditing
- Regulating the quality of entry to the profession through its qualification programme and related courses
- Providing continuing education and other services to members
- Promoting the accountancy profession both in Hong Kong and overseas

The roles of the FRC are:

- To conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities
- To enquire into possible non-compliances with financial reporting requirements on the part of listed entities
- To require listed entities to remove any non-compliance identified

Oversight of Statutory Audit

The Professional Accountants Ordinance states that one of the objects of the HKICPA shall be to preserve and maintain its integrity and status and to discourage dishonorable conduct and practices and, for this purpose, to hold enquiries into the conduct of professional accountants.

[6] Incorporated by the Professional Accountants Ordinance (Chapter 50 of the Laws of Hong Kong) on 1 January 1973.
[7] Established on 1 December 2006, set up under the Financial Reporting Council Ordinance, enacted on 13 July 2006.

The Hong Kong Society of Accountants has laid down fundamental principles upon which it has based its Ethics Statements. These principles deal with the acceptance of assignments, technical and professional standards and personal conduct.

The detailed guidelines deal with independence, confidentiality, unlawful acts or defaults by clients or members, advertising and publicity, obtaining professional work, changes in a professional appointment, fees, management consulting services, ethics and tax practice, clients' monies, restrictions on providing company secretaries and corporate directors to audit clients, and the financial and accounting responsibilities of directors.

Monitoring of Quality

The HKICPA operates a scheme of Practice Review. A review will be carried out on all firms in practice once every four years or so.

Professional Discipline and Enforcement

The HKICPA investigates complaints against practicing members in respect of alleged failure to observe auditing standards. Such investigations are generally carried out by the HKICPA's Disciplinary Committee and may result in the suspension of the guilty party's practicing certificate. The HKICPA may also receive referrals of matters for investigation from the FRC.

The FRC may initiate an investigation into possible auditing and reporting irregularities committed by auditors and reporting accountants of listed entities—either in its own right or upon receipt of a complaint. The FRC will normally direct the Audit Investigation Board (the "AIB") to act as the investigator and conduct an investigation; but in exceptional circumstances, it may decide to conduct the investigation itself. The FRC is an investigatory body only and is not itself empowered to discipline or prosecute. Any auditing or reporting irregularities that it identifies must be referred to the HKICPA for follow-up action.

Cooperation Between Regulatory Bodies

Aside from interaction between the FRC and the HKICPA, any non-compliance found by the FRC's (or AIB's) investigations relevant to the Listing Rules will be referred to the Securities and Futures Commission or The Stock Exchange of Hong Kong Limited for follow-up action.

The FRC has established co-operation arrangements with Mainland Chinese regulators on investigations and enquiries within the scope of the FRC's remit. Inquiries into the conduct of Mainland audit firms are also subject to Mainland law, and formal investigations of such firms will in practice be carried out by the Chinese Ministry of Finance and China Securities Regulatory Commission, either themselves or as agents of the FRC.

Japan

Introduction and Background

The CPAAOB (Certified Public Accountants and Auditing Oversight Board), established on April 1, 2004 under the Certified Public Accountants (CPA) Law, is an independent regulatory body established within the Financial Services Agency (FSA), consisting of one chairperson and one full-time and eight part-time commissioners.

Its board members are appointed by the Prime Minister with the consent of the Diet (parliament). The Board exercises its statutory authority independently of the FSA. The term of the members is three years.

The CPAAOB has an Executive Bureau to handle its administrative duties. The Executive Bureau consists of two divisions – the Office of Coordination and Examination and the Office of Monitoring and Inspection.

Oversight of Statutory Audit

The CPAAOB has the following three responsibilities:

- Review of quality control reviews and inspections (see below)
- Implementation of the CPA Examinations
- Deliberation of disciplinary actions against CPAs and audit firms

Monitoring of Quality

The Office of Monitoring and Inspection is in charge of oversight of the quality control review.

The Japanese Institute of Certified Public Accountants (JICPA) conducts reviews of quality control practices at audit firms and provides recommendations to audit firms as deemed necessary. Although the JICPA's quality control review was originally conducted as a self-regulatory mechanism of the audit profession, it was formally incorporated into the CPA Law in May 2003.

The CPAAOB reviews and examines reports of quality control reviews by the JICPA and, if deemed necessary, conducts on-site inspections of the JICPA, audit firms, etc.

If the results of oversight show that quality control reviews have not been conducted properly, that the quality control of audits of CPAs/audit firms has been notably insufficient, or that their audit engagements have not conformed to laws, regulations and standards, the Board will recommend that the Commissioner of the Financial Services Agency take administrative actions and/or other measures necessary to ensure the proper operation of the JICPA and audit firms.

Professional Discipline and Enforcement

The Office of Coordination and Examination is responsible for general affairs, deliberation of disciplinary actions against CPAs and audit firms, and implementation of CPA examinations. Sanctions include suspension or revocation of licenses to audit for both audit firms and individuals.

Cooperation Between Regulatory Bodies

The CPAAOB is a member of IFIAR.

Netherlands

Introduction and Background

The Netherlands Authority for the Financial Markets (the AFM) has been responsible for supervising the operation and conduct of the financial markets since 1 March 2002, with its remit including savings, investment, insurance, accounting and loans.

In 2006, the Audit Firms Supervision Act (AFSA) introduced public oversight by the AFM of audit entities that provide audit reports that are relevant to the Dutch capital markets. Since October 1, 2006, audit firms have needed to obtain a license from the AFM in order to perform statutory audits in the Netherlands.

The AFSA, which was designed to implement the European Statutory Audit Directive (2006/43/EC), introduced the shared responsibility for the supervision of the accounting profession by the Royal Netherlands Institute of Registered Accountants (NIVRA) and the Financial Markets Authority (AFM), with self-regulation now being supplemented by public accountability and external supervision of the statutory audit function.

Oversight of Statutory Audit

The AFM will only grant a license to auditors that have demonstrated that they comply with the standards laid down in the AFSA. If the applicant intends to also perform statutory audits for Public Interest Entities (PIEs), the applicant must also demonstrate compliance with additional standards.

The AFM conducts its supervision by means of a combination of inspections, enforcement and transfer of standards, and in so doing expressly monitors signals originating from the market and findings from its own control organization.

From June 28, 2008, the public oversight has been extended to require registration with the AFM of 'third-country audit entities' (i.e., audit entities located outside the European Union and the European Economic Area, including the United States) that provide audit reports concerning the annual or consolidated accounts of companies incorporated outside the European Union and the European Economics Area whose transferable securities are admitted to trading on the regulated market of Euronext Amsterdam N.V. in the Netherlands.

Monitoring of Quality

The AFSA sets rules concerning the quality of audit entities and auditors which the AFM monitors, partly by reliance on and oversight of NIVRA's obligations of monitoring and inspection but also by means of its own inspections of firms and individual engagements.

Professional Discipline and Enforcement

If the AFM identifies any breaches, it can impose sanctions. It may issue instructions or public warnings, place institutions under undisclosed custody, withdraw licenses, cancel or refuse registrations or file reports with the Public Prosecution Service. The AFM is also authorized to impose fines and orders for periodic penalty payments.

Cooperation Between Regulatory Bodies

The AFM is a member of IFIAR[8] and the European Group of Auditor Oversight Bodies (EGAOB).

Within the European Union the AFM participates in the European Securities and Markets Authority (ESMA) (formerly known as CESR), which is both an advisory body for the European Commission and a cooperative body for the securities regulators involved. At the global level the International Organization of Securities Commissions (IOSCO) is the most important organization for securities regulators. As one of the 15 largest capital markets in the world, the Netherlands is a member of IOSCO's Technical Committee.

The AFM also works closely on a bilateral basis with a large number of its fellow supervisory authorities in other countries. The law allows the AFM the freedom to make written agreements with national and international supervisory authorities in the form of a covenant, a Memorandum of Understanding (MoU) or an Exchange of Letters.

[8] The AFM's Managing Director is the current chair of the IFIAR.

Switzerland

Introduction and Background

The Federal Audit Oversight Authority (FAOA)[9] was established in response to the enactment of the Sarbanes-Oxley Act in the United States and similar developments within the European Union with the task of ensuring that audits are conducted correctly and are of a high quality.

The FAOA meets its task by a combination of licensing and inspection, where necessary in conjunction with other national regulatory bodies.

Oversight of Statutory Audit

The FAOA operates a licensing office and maintains a public register with the names of natural persons and legal entities that provide auditing services required by law.

The FAOA determines the auditing standards with which state-regulated audit firms have to comply when auditing public companies. In so doing, the FAOA refers to nationally and internationally accepted standards. If there are no such standards, or if those which do exist are inadequate, the FAOA can issue its own standards or add to or annul existing standards.

Monitoring of Quality

The FAOA carries out inspection of state-regulated audit firms at both firm and individual engagement level, and these inspections include both formal and substantive aspects. The "firm review" encompasses checks as to whether the licensing requirements have been met and whether there is a suitable and functional internal quality assurance system. The "file review" involves the inspection of audit work papers for public company engagements to determine whether quality assurance requirements and applicable professional standards have been met. Inspections take place at least every three years.

Cooperation Between Regulatory Bodies

The FAOA is a member of IFIAR and also has the authority to enter into cooperation arrangements with foreign audit oversight authorities.

In terms of national cooperation, legislation requires the FAOA and the other oversight authorities established in accordance with specific legislation to coordinate their oversight activities to avoid duplication.

In practice, cooperation with the Swiss Financial Market Supervisory Authority (FINMA) is important as FINMA is responsible for supervising the firms which audit banks and insurance companies. Responsibilities have been divided. The FAOA is responsible for the "firm review" of the relevant audit firms and responsibility for the "file reviews" is split. FINMA is

[9] Established on 1 September 2007 in connection with the revision of the Law of Obligations and the introduction of the Auditor Oversight Act of 16 December 2005.

responsible for the file reviews relating to banks and insurance companies, while the FAOA is responsible for the others.

The FAOA and the stock exchanges are also obliged to coordinate their oversight activities. As the only stock exchange in Switzerland, the SIX Exchange Regulation (SER) carries out supervisory activities over issuers in the area of compliance with accounting standards. If an issuer is sanctioned by SIX over its audited statutory or consolidated financial statements, the FAOA investigates the role of the auditor. The FAOA investigates only whether statutory and professional audit requirements have been met—not whether accounting standards have been correctly applied. Conversely, the FAOA informs the SER of pending cases and rulings which could be of concern to the SER.

United Kingdom

Introduction and Background

Auditor regulation in the UK is carried out under the auspices of the Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. Its Chair and Deputy Chair are appointed by the UK Secretary of State for Business, Enterprise and Regulatory Reform.

The FRC, through its six operating bodies (the Accounting Standards Board, the Auditing Practices Board, the Board for Actuarial Standards, the Professional Oversight Board, the Financial Reporting Review Panel and the Accountancy and Actuarial Discipline Board) sets standards for corporate reporting and actuarial practice, monitors and enforces accounting and auditing standards, oversees the regulatory activities of the professional accountancy bodies and operates independent disciplinary arrangements for public interest cases involving accountants and actuaries.

The operating bodies principally concerned with the regulation, monitoring, discipline of and enforcement against auditors are the Professional Oversight Board (POB) and the Accountancy and Actuarial Discipline Board (AADB).

Oversight of Statutory Audit

The POB was set up in 2004, marking a significant shift from what had been essentially self regulation to a mixed system, in which both the POB and the accountants' professional bodies have major responsibilities.

Audit firms who wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, a Recognized Supervisory Body (RSB). Individuals responsible for audit at registered firms must hold an audit qualification from a Recognized Qualifying Body (RQB).

The POB exercises oversight of RSBs and RQBs by

- Checking that each body still has effective arrangements in place to meet all the statutory requirements for continued recognition, and making recommendations;

- Reviewing and testing the way in which each body's regulatory systems are applied in practice and making recommendations; and

- Evaluating the effectiveness of an aspect of the regulatory system, for example complaints handling or audit firm monitoring, and making recommendations.

The POB has a statutory obligation to report to the UK Secretary of State annually on the way in which the POB has carried out its responsibilities and to provide a summary of the results of inspections by the RSBs.

Monitoring of Quality

Through its Audit Inspection Unit (AIU), the POB reviews directly the quality of the statutory audits of listed and other major public interest entities and the firms' policies and procedures supporting audit quality. The AIU currently inspects all Big Four firms on an annual basis and issues public and private reports on individual firms and specific audit engagements and an Annual Report on its inspections. The POB approves the AIU's strategy and work program, as well as the public and private reports and Annual Report issued by the AIU.

Professional Discipline and Enforcement

The Accountancy & Actuarial Discipline Board ("AADB") is the independent, investigative and disciplinary body for accountants and actuaries in the UK. Its role is the investigation and, where appropriate, hearing by disciplinary tribunal of public interest cases. Cases of 'public interest' are either referred to the AADB by one of the accountancy bodies or the AADB also has the power to call in cases of its own volition.

The AADB has the power to impose penalties and sanctions, including fines of an unlimited amount and the suspension or revocation of a firm's or individual's licence to audit.

Cooperation Between Regulatory Bodies

The FRC (and the POB) are members of EGAOB and IFIAR and cooperate extensively with other national and international regulatory bodies in the area of audit policy, quality and effective oversight and enforcement.

In January 2011, the POB and the PCAOB in the US signed an information sharing agreement aimed at increasing the level of cooperation on and effectiveness of the oversight and inspection of audit firms. The Statement of Protocol paves the way for joint work on inspections, including exchanges of information (with the ability for the PCAOB to pass that information to the SEC) and interviews of firm personnel.

Specifically, in relation to third country auditors, working through the EGAOB, the POB has registered over 87 audit firms from 39 countries.

At a national level, the FRC in January 2011 concluded a new Memorandum of Understanding (MOU) with the Financial Services Authority (FSA), the body which regulates the UK's financial services industry, to enable a greater degree of cooperation and information exchange between the two regulators. Under the agreement, the FSA will work more closely with the AIU (whose scope has been extended recently to include the audits of all banks incorporated in the UK to better support markets and the prudential regulator), to enable both organisations to improve their oversight of the audits of FSA authorised firms, and will assist each other in the performance of their respective functions by the greater sharing of timely information.