UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

ADMINISTRATIVE PROCEEDINGS RULINGS
Release No. 4017/July 22, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17180

In the Matter of ELLIOT R. BERMAN, CPA and BERMAN & COMPANY, P.A.	ORDER DENYING MOTION FOR SUMMARY DISPOSITION

On March 25, 2016, the Securities and Exchange Commission issued an order instituting proceedings (OIP) against Respondents. The OIP alleges four areas of misconduct in Respondents' audits of a public company client: (1) lack of auditor independence; (2) failure to make disclosures concerning related party transactions as required by Generally Accepted Accounting Principles (GAAP); (3) failure to properly recognize improper accounting for sales incentives; and (4) failure to recognize that the client did not disclose its sponsorship commitments and international sales as required by GAAP. OIP ¶ 4. The second and third areas also involve allegedly inappropriate reliance on management representations.

On May 27, Respondents moved for summary disposition in the first of those four areas—"the claims relating to Respondents' alleged lack of independence"—arising from three provisions in Respondents' engagement letters "that would indemnify or reimburse Respondents in certain limited circumstances." *See* Motion at 4 & n.1. Respondents' engagement letters indemnified them from "liability and costs resulting from known misrepresentations by management" and "fraud caused by or participated in by the management of the Company." Motion Ex. A at 7, Ex. B at 7. The engagement letters also included an "Other Services" provision that provided "costs and time spent in legal matters or proceedings arising from our engagement, such as subpoenas, testimony or consultation involving private litigation, arbitration or government regulatory inquiries at your request or by subpoena will be billed to you separately and you agree to pay the same." *Id.* Ex. A at 7, Ex. B at 6. Respondents request summary disposition based on the contention that the foregoing provisions do not impair auditor independence.

On June 10, the Division filed its opposition. Respondents replied on June 29.

"The hearing officer may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 17 C.F.R. § 201.250(b). Generally, "[t]he facts of the pleadings

of the party against whom the motion is made shall be taken as true . . . ." *Id.* § 201.250(a). The OIP alleges that various facts and circumstances demonstrate Respondents' lack of independence, including but not limited to the aforementioned indemnity and other services provisions. *See* OIP ¶¶ 72-74, 78-82. Thus, even if such provisions do not per se impair independence, the Division could still argue those provisions operated to impair Respondents' independence here, in light of additional facts, such as Respondents' alleged failures to conduct necessary audit work regarding management representations. *See id.* ¶¶ 32, 37, 47, 63-64, 66-67, 71. Taken as true, those facts would tend to demonstrate that the provisions did in fact impair independence.

Because the parties have presented a genuine, good faith dispute as to whether these provisions, considering all other relevant facts and circumstances, impaired independence, the issue is inappropriate for summary disposition. *See* 17 C.F.R. § 201.250(a), (b). This is not, as Respondents suggest, amenable to a decision solely as a matter of law. On the one hand, Respondents correctly contend that: (1) PCAOB standards and Commission "rules and regulations . . . do not contain a blanket prohibition on indemnification provisions"; (2) "PCAOB Standards explicitly permit indemnification clauses for . . . knowing misrepresentations and fraud by management"; and (3) the Commission's Codification of Financial Reporting Policies "does ***not*** . . . prohibit indemnification clauses based on management fraud or knowing misrepresentations." Motion at 5, 11-16 (citing standards and codification). On the other hand, Respondents concede the Division's point that "the SEC's independence rules may be more restrictive than the adopted PCAOB Standards; and that in such circumstances an auditor must comply with the SEC's rules." *Id.* at 12. The parties also agree that, while not a Commission rule or regulation, the longstanding position of the Commission's Office of the Chief Accountant (OCA), published among answers to frequently asked questions (FAQs[1]) in 2004, is that indemnification clauses like those used by Respondents impair auditor independence. Motion at 14-15 (citing FAQs); OIP ¶ 12 (quoting FAQs, noting the "'Commission's long standing view' that 'when an accountant enters into an indemnity agreement with a registrant, his or her independence would come into question'" and "' . . . a clause that the registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence.'").

Rule 2-01 of the Commission's Regulation S-X, codified at 17 C.F.R. § 210.2-01, governs whether an auditor is independent. The "Preliminary Note" to Rule 2-01 provides in pertinent part that:

> The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in § 210.2-01(b). . . . [I]n determining whether an accountant is independent, *the*

[1] Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Question 4 under "Other Matters," (December 13, 2004), *available at* www.sec.gov/info/accountants/ocafaqaudind121304.htm (last modified Mar. 12, 2014) *and* https://www.sec.gov/info/accountants/ocafaqaudind080607.htm (last modified Oct. 16, 2014).

> *Commission will consider all relevant facts and circumstances*. . . . [A]ccountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships . . . that are not explicitly described in the rule.

17 C.F.R. § 210.2-01(emphasis added). Respondents do not appear to have consulted with OCA on the indemnity or other services provisions of their engagement letters. *See* Opp. at 5 (citing Elliot R. Berman's investigative testimony). However, the failure to undertake the "encouraged" consultation is not a violation of the rule. Rule 2-01(b) provides how the Commission makes a determination of auditor independence:

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, *the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client*, and not just those relating to reports filed with the Commission.

17 C.F.R. § 210.2-01(b) (emphasis added).

Rule 2-01 does not expressly address indemnity provisions or other services provisions in an auditor's engagement letter, but as the preliminary note indicates, the rule is not meant to address all circumstances that raise independence concerns. While the challenged indemnity provisions do not by themselves appear to violate PCAOB standards, all agree that the Commission's determination can be more restrictive than PCAOB's, and that the PCAOB rules contemplate that fact.[2] Thus, Respondents may be liable under Rule 2-01 even if their engagement letters did not conflict with less restrictive PCAOB independence standards.

Though OCA's position is that certain indemnity provisions, by themselves, impair independence, that guidance does not represent a binding rule. The clear import of Rule 2-01 is that "all" relevant facts and circumstances be considered in making a determination of independence. Based on the parties' presentation of all such facts, it would then be possible to determine what particular facts, either by themselves or in tandem, established whether Respondents' independence was impaired, or whether a reasonable investor would so conclude. *See* 17 C.F.R. § 210.2-01(b). While the other services provision may not be, in the strict sense, an indemnification clause, the parties' wrangling on that point mostly misses the mark because the provision itself and how it was used are nonetheless potentially relevant circumstances to the overall issue of independence.

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[2] *See* PCAOB Rule 3500T, *available at* https://pcaobus.org/Rules/pages/section_3.aspx; PCAOB Interim Ethics and Independence Standard ET § 191.188-89, *available at* https://pcaobus.org/Standards/EI/Pages/ET191.aspx.

Respondents may ultimately prevail under Rule 2-01(b). However, at this preliminary stage, they have not presented a persuasive case for deciding the allegations of auditor independence without first affording the Division the opportunity to present at the hearing all relevant facts and circumstances that should inform that determination.

The motion for summary disposition is DENIED.

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Jason S. Patil
Administrative Law Judge