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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17180

In the Matter of

ELLIOT R. BERMAN, CPA
and
BERMAN & COMPANY, P.A.,

Respondents.

RESPONDENTS' REPLY BRIEF IN SUPPORT OF THEIR MOTION FOR SUMMARY DISPOSITION

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INTRODUCTION[1]

In its first-ever administrative proceeding premised on the inclusion of indemnification provisions in auditor's engagement letters, the Division attempts to engage in rule-making by enforcement. Specifically, the Division argues that limited indemnification provisions in auditor's engagement letters violate Commission Rule 2-01(b) of Regulation S-X, although, as the Division concedes, nothing in Rule 2-01(b) itself addresses indemnification provisions (Opp. Br. at 12). Importantly, no SEC ***rule*** or ***regulation,*** or PCAOB ***standard***, prohibits the limited indemnification provisions relevant to this matter (Motion at 13-16). In fact, as the Division acknowledges, authoritative PCAOB standards explicitly ***permit*** indemnification clauses for liability and costs resulting from knowing misrepresentations by management – similar to those included by Respondents in their engagement letters with MSLP. (Opp. Br. at 28; Motion at 11-12). Indemnifications from an auditor's own negligence, on the other hand, are prohibited by authoritative guidance issued by the SEC, but such a term was not included in Respondents' Engagement Letters. Specifically, the Indemnification Provisions and the Other Services Provision did not constitute an indemnification from Respondents' own negligence in fact and as a matter of law.

Unable to point to authoritative and formal rules or regulations (as opposed to informal and non- authoritative guidance, and/or staff interpretations) that prohibit indemnification clauses, the Division asks this Court to write such a rule by finding that Respondents' inclusion of limited indemnification clauses in their Engagement Letters impaired their independence. This approach, however, runs afoul of the Commission's stated views on Commission Rule 102(e)

[1] In this reply brief, defined terms shall have the same meaning ascribed in Respondents' opening brief.

(pursuant to which this proceeding was instituted), according to which "[t]he Commission does not seek to use Rule 102(e)(1)(ii) to establish new standards for the accounting profession. The rule itself imposes no new professional standards on accountants."[2] In the absence of authoritative rules prohibiting limited indemnification clauses similar to those used in this case, this Court should reject the Division's invitation to establish a new standard and dismiss the OIP's claims based on Respondents' lack of independence. The Court should also reject the Division's invitation to consider facts which are immaterial and irrelevant to this motion. As the Division conceded in its OIP, the issue of whether indemnification provisions impair an auditor's independence is purely legal, and subsequently is appropriate for summary disposition.

ARGUMENT

I. SUMMARY DISPOSITION IS APPROPRIATE IN THIS CASE

a. THE QUESTION OF WHETHER INDEMNIFICAITON PROVISIONS IN AUDTIOR'S ENGAGEMENT LETTERS IMPAIR INDEPENDENCE IS PURELY LEGAL

In its OIP, the Division claimed that the inclusion of the Indemnification Provisions and the Other Services Provision -- without more -- impaired Respondents' independence. The OIP repeatedly alleged that by simply incorporating the indemnification provisions, Respondents violated Rule 2-01(b) of Regulation S-X. More specifically, the OIP asserted that:

- "Berman & Co. failed to comply with Rule 2-01(b) of Regulation S-X, PCAOB Rule 3520 and PCAOB standards (See AU 220, 230) and AS 9) and was not independent from MSLP during the MSLP Audits because of indemnification provisions Berman included in Berman & Co.'s engagement letter." (OIP ¶9).

[2] *See* Final Rule: Amendment to Rule 102(e) of the Commission's Rules of Practice at § II. C. at https://www.sec.gov/rules/final/33-7593.htm.

- "As a result of the indemnification language in the MSLP Engagement Letters, Berman & Co. was not independent pursuant to Rule 2-01(b) of Regulation S-X." (OIP ¶53).

- "Berman included indemnification provisions in the MSLP Engagement Letters. As a result of the indemnification provisions in the MSLP Engagement Letters, Berman & Co. was not independent as required by Rule 2-01(b)." (OIP ¶57).

- "As a result of including indemnification provisions in the MSLP Engagement Letters, Respondents also violated professional standards because Berman & Co. was not independent during the MSLP Audits and the work papers do not contain sufficient evidence that independence was evaluated." (OIP ¶60).

In its Opposition Brief, the Division continues to maintain that the actual inclusion of the indemnification provisions in the Engagement Letters impairs independence. In particular, the Division asserts that:

- "Berman included indemnification provisions in the MSLP Engagement Letters. As a result, Berman & Co. was not independent as required by Rule 2-01(b)." (Opp. Br. at 17).

Because there is no dispute that Respondents included in their Engagement Letters limited indemnification provisions, the question of whether doing so impairs independence in violation of Rule 2-01(b) is purely legal. With no genuine issue with regard to any material fact, Respondents' motion is appropriate for summary disposition and the OIP's claims based on Respondents' lack of independence should be dismissed for the reasons detailed *infra* and in Respondents' opening brief.

B. THE FACTS AND CIRCUMSTANCES CITED BY THE DIVISION - EVEN IF CONSIDERED BY THIS COURT – ARE IRRELEVANT TO THIS MOTION

Despite the very clear position taken by the Division in the OIP (as discussed above), the Division now argues that "even if the text of the indemnification provisions alone did not impair

auditor independence under Rule 2-01(b)," summary disposition would be inappropriate "because Respondents do not address the other facts pleaded by the Commission evidencing their lack of independence." (Opp. Br. at 13). Specifically, the Division refers to other independence-related violations asserted in the OIP, such as the alleged failure to document and supervise the audits relating to *independence*, the alleged failure to issue accurate audit reports relating to *independence* and the alleged failure to exercise due care and professional skepticism relating to *independence*. (Opp. Br. at 13). Such circular logic, however, makes no sense as it assumes that including indemnification provisions impairs independence – a conclusion that Respondents vehemently reject.

The Division also argues that Respondents ignore the allegations relating to other audit failures and aver that "the indemnification provisions also contributed to Respondents' other unrelated audit failures," such as those concerning related party disclosures, sales incentives and international sales. (*Id.* at 14). But the determination of whether an indemnification clause impairs independence, is not – and should not – be dependent on the Court's finding of other unrelated alleged violations after-the-fact. Holding otherwise would mean that such determination would be contingent on whether or not the auditors also violated other SEC rules or regulations. Put differently, the Division argues that where auditors included indemnification provisions and are found to have violated other unrelated SEC rules, the Court should find that the indemnification provisions impaired independence, but where the auditors included those ***same*** indemnification provisions but are found to have not violated other SEC rules, the Court should find that those provisions did not impair independence. Such a result simply cannot be right. Thus, this Court should reject the Division's argument and conclude that this motion is appropriate for summary disposition.

II. RESPONDENTS DID NOT WILFULLY VIOLATE RULE 2-01(B)

In its opposition brief, the Division asserts that Respondents were aware of the supposed prohibition against including indemnification clauses in engagement letters and blatantly disregarded same. (Opp. Br. at 3). The Division spuriously suggests that Respondents "falsified" the Engagement Acceptance Forms (*id.* at 15, note 6) and asserts that Respondents' "conduct was reprehensible." (*Id.*). These unwarranted attacks on Respondents' conduct, however, are unjust, untrue and contradicted by the undisputed facts in this matter, as demonstrated below.

a. Respondents Were Unaware of Any SEC Rules and Regulations and/or PCAOB Standards That Prohibit Limited Indemnification Provisions in Engagement Letters -- Such as the Ones Included Here -- Because None Exist[3]

The Division claims that the two Indemnification Provisions and the Other Services Provision violate the general standard of auditor independence requirements of Rule 2-01(b) of Regulation S-X (Opp. Br. at 1). Rule 2-01(b), however, only broadly provides that an auditor must be independent when conducting an audit. It does ***not*** indicate that indemnification provisions impair an auditor's independence or otherwise forbid such arrangements. While Respondents accept that the rule does not enumerate all circumstances that raise independence concerns, it is undisputed that authoritative PCAOB standards explicitly ***permit*** indemnification clauses for liability and costs resulting from knowing misrepresentations and that nothing in Rule 2-01(b) contradicts or restricts that. Moreover, the only SEC-issued authority that specifically addresses indemnifications mentions only indemnifications from an auditor's own negligence and does not prohibit indemnifications from management misrepresentations.

[3] For ease of reference, Respondents have attached as Attachment 1 a chart that lists all authoritative standards or rules cited by the Division and Respondents, and indicated whether or not indemnification is referenced or mentioned in those rules/standards.

Indeed, as discussed in Respondents' opening brief, PCAOB's Interim Ethics and Independence Standard ET § 191 clearly concludes that indemnification provisions for liability from known misrepresentation by management are permissible. (See Motion at 11-12).[4] PCAOB Auditing Standard AU 310, *Appointment of the Independent Auditor,* similarly provides that engagement letters "may include other matters, such as the following: ... Any limitation of or other arrangements regarding the liability of the auditor or the client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management." AU 301.07. (*Id.*). And while both these standards may be overruled by more restrictive SEC ***rules*** or ***regulations*** (see PCAOB Rules 3500T and 3520), none exist here. (*Id.* at 13-16).[5]

Notwithstanding these facts, the Division relies in its opposition brief on the FAQs released by the SEC's Office of Chief Accountant ("OCA FAQ") in 2004 which opine that indemnity clauses for liability resulting from management's knowing misrepresentations do impair independence. (Opp. Br. at 18). But the OCA FAQ are explicitly prefaced by the statement that they "are not rules, regulations or statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them." Consequently, the OCA FAQ cannot serve to restrict further the PCAOB standards, which permit limited indemnification provisions such as those included here. (Motion at 15).

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[4] The Division argues that even if ET 191 applied to SEC registrants, it would only permit one of the Indemnification Provisions that indemnifies for "knowing misrepresentations by management." (Opp. Br. at 28). The Division cannot explain, however, why there is a meaningful difference between knowing misrepresentations -- which are allowed -- and fraud caused by or participated in by management– which are not allowed.

[5] The Division's contention that "Rule 2-01(b) is more restrictive than PCAOB Ruling 94 in ET 191 because Rule 2-01 prohibits indemnification related to "knowing misrepresentation by management" (Opp. Br. at 28) exemplifies the fallacy of this argument as there is nothing in Rule 2-01 itself that prohibits, let alone mentions, indemnification agreements.

The understanding that there are no authoritative rules that restrict the inclusion of limited indemnification provisions in engagement letters was confirmed by Mr. Berman during his testimony before the SEC. When asked whether he conducted research on indemnification clauses in engagement letters, Mr. Berman referred to ET 191 noting that "I reviewed the PCAOB standards... and there's a reference to – I believe it's ET 191... And it references the fact that indemnification clauses in engagement letters are specifically allowable and they do not impair independence." (Ex. A to Opp. Br., 535:1-18). When asked whether Mr. Berman considered the OCA FAQ, he responded that "this is just guidance" and read into the record the preface to the guidance which states that "[t]he answers to these frequently asked questions represent the views of the office of the Chief Accountant. They are not rules, regulations or statements of the Securities and Exchange Commission. Further, the Commission has neither approved or – nor disapproved them." (*Id.* 607:1-12). As Mr. Berman explained, "[s]o this is not a rule or a regulation. The PCOB [sic] standards indicate you follow the more restrictive rule. And this is a view of the OCA. This is not a rule." (*Id.* 607:14-17). Significantly, Mr. Berman testified that had the SEC rule mentioned indemnification, he would have acted differently. In his own words: "I would have expected maybe [the rule] would have said something. Then I would have evaluated differently." (*Id.* 609:1-11).

b. <u>Respondents Did Not Violate Section 602.02f.i. of the Codification</u>

As discussed in Respondents' opening brief, the Codification of Financial Reporting Policies (the "Codification") is the only formal and authoritative guidance that the SEC issued on the topic of auditor indemnification. (Motion at 13-14). Section 602.01f.i. of the Codification provides, in relevant parts, that indemnification provisions, which shield auditors from liability for their own negligent acts, impair independence. In particular, the Codification states that:

> "When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability **for his own negligent acts**, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened." Section 602.01.f.i. of the Codification of Financial Reporting Policies (emphasis added).

It is therefore not surprising that the Division argues, without pointing to any specific language, word or phrase in the Engagement Letters, that the Indemnification Provisions and the Other Services Provision were impermissible because they "did not only indemnify Respondents against management misrepresentations and fraud, but also against their own negligence." (Opp. Br. at 20). The Division argues that the Indemnification Provisions "while referring to 'known misrepresentations by management' and 'fraud caused by or participated in by the management of the Company," necessarily include Indemnification for auditor negligence." (*Id.* at 22). The reasoning behind this argument is that "by including these indemnification provisions in an engagement letter, the auditor is indemnified, so long as a [sic] he can point to a known misrepresentation made by management, even if he was negligent in conducting his audit, including accepting that misrepresentation." (*Id.* at 23).

This ludicrous interpretation, however, is not supported by the actual language of the relevant provisions and flies in the face of Florida law, which governs the interpretation of these provisions. More specifically, neither the Indemnification Provisions, nor the Other Services Provision, provide that Respondents shall be held harmless from liability for their own negligent acts. Simply put, the words "negligence" or "negligent" do not appear in those sections. And while the Division argues that the provisions "necessarily" or impliedly include the auditor's own negligent acts, Florida law prohibits reading into an agreement an indemnity for one's own negligent conduct, without a clear and express intent to do so. As explained by the Florida

Supreme Court in *Cox Cable Corn, v. Gulf Power*, indemnification provisions which attempt to indemnify a party against its own acts are viewed with disfavor in Florida, and will only be enforced if they "express an intent to indemnify against the indemnitee's own wrongful acts in clear and unequivocal terms." 591 So.2d 627, 629 (Fla. 1992). (*See* Motion at 19-20). Indeed, the more logical interpretation of the Indemnification Provisions is that Respondents will be held harmless from liability for management fraud or misrepresentations, but only if they were not negligent during their audit. (*Id.*).

Likewise, and as explained at length in Respondents' opening brief, the Other Services Provision was intended to, and did, cover payment for services by Respondents which were otherwise not included in the Engagement Letter, and is not a "hold harmless" provision. (Motion at 17-19). The Division argues that even if Respondents are correct in this interpretation, Respondents impermissibly "used [the provision] to indemnify themselves against their own negligent acts." (Opp. Br. at 22, 34-5).[6] But the facts here belie this argument. As discussed more fully in Respondents' opening brief, MSLP reimbursed Respondents for the time they spent responding to the SEC's document requests and subpoenas, preparing for Mr. Berman's testimony, and testifying before the SEC on April 2-3, 2014 – all in the SEC's investigation of MSLP. (Motion at 21). Indeed, it is not unusual for auditors of a company that is being investigated by the SEC to receive subpoenas for documents and testimony and comply with same. Here, it is undisputed that the testimony and documents were provided in relation to the investigation of MSLP, not proceedings against the Respondents, and as such, reimbursement was allowed – and requested – in accordance with the Other Services Provision. Once it became

[6] Here, again, the Division blatantly seeks to ignore the language of the actual provision and instead points to events that allegedly occurred after-the-fact. This argument should be rejected solely on that ground. *See also* Section I.A, *supra*.

clear that the SEC was pursuing an action against Respondents, they appropriately and ethically sought no further reimbursement from MSLP for its legal fees and costs. (*Id.* at note 19). Accordingly, Berman & Co. never sought indemnification for costs and expenses it incurred in defending itself, and this fact has no bearing on this motion.

In sum, the Division's contention that the three clauses at issue indemnify Respondents for their own negligent acts or conduct is unsupported by fact or law. Therefore, contrary to the Division's unsupported position, the Other Services Provision, as well as the Indemnification Provisions, did not impair Berman & Company's independence and did not violate the Codification or other authoritative rules.

c. Respondents Did Not Violate Any Regulators' Published Interpretations

Unable to point to a clear SEC rule or regulation or PCAOB standard providing a blanket prohibition on indemnification provision in auditor engagement letters, the Division now points to AICPA ET 501-09 501-8, issued in 2008, arguing that "accountants must follow the guidance of regulators, including published interpretations." (Opp. Br. at 31). In particular, this interpretation states that:

> "Certain ***governmental bodies, commissions, or other regulatory agencies (collectively, regulators)*** have established requirements through laws, regulations, or published interpretations that prohibit entities subject to their regulation (regulated entity) from including ***certain types of indemnification*** and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or that provide that the existence of such provisions causes a member to be disqualified from providing such services to these entities... Members should also consult Ethics Ruling No. 94, "Indemnification Clause in Engagement Letters," of ***ET section 191, Ethics Rulings on Independence, Integrity, and Objectivity*** [sec. 191 par. .188–.189] and Ethics Ruling No. 102, "Indemnification of a Client," of ET section 191 [sec. 191 par.

> .204–.205] under Rule 101, *Independence*, for guidance related to use of indemnification clauses in engagement letters and the impact on a member's independence." (Emphasis added).

This argument, however, misses the mark. First, the AICPA interpretation makes crystal clear, again, that the "laws, regulations or published interpretations," which accountants are required to follow, need to be made by "governmental bodies, commissions, or other regulatory agencies." These rules cannot be made by the Commission staff, and consequently the OCA FAQ, which were released by the SEC's Office of Chief Accountant, are non-binding as they explicitly state that they "are not rules, regulations or statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them." (For the full cite, *see* Motion at 15). Though the Division erroneously conflates the views of the Commission with those of the Office of Chief Accountant, it is evident that accountants are required to follow rules and regulations issued by regulators, but are not required to follow non-authoritative views of Commission's staff, especially when they are in conflict with authoritative standards.

Second, there are no "published interpretations" **by the SEC** which address the issue of auditors' indemnification. While the SEC issues interpretative releases from time to time,[7] none address indemnification provisions. The only time the Commission has spoken on the topic of indemnification is in the Codification, which only prohibits indemnification from one's own negligence. That is why ET 501-8 refers only to "**certain types** of indemnification and limitation of liability provisions" and does not state that **all** indemnification provisions are prohibited. If indeed all indemnification provisions were prohibited by the SEC -- as the Division argues – then the 2008 AICPA interpretation would not use the phrase "certain types of

[7] The SEC interpretative releases are located at https://www.sec.gov/rules/interp.shtml.

indemnification" and would not refer to Ethics Ruling 94, ET 191, which permits indemnification terms, and is still an active and effective PCAOB standard for public companies.[8]

d. Respondents Did Not "Falsify" the Engagement Acceptance Forms

Last, but not least, Respondents represented to MSLP through the course of their engagement that they were unaware of any relationships that would impair their independence. Thus, when accepting the engagement with MSLP, Respondents filled out Engagement Acceptance Forms for both the years ending December 31, 2010 and 2011. (OIP ¶19). Sections 11(h) and 7(h) of the Engagement Acceptance Forms inquired whether there were "any relationships with the client or conflicts ***that might impair independence***? Explain "Yes" answers." (Ex. B to Opp. Br., emphasis added). Under sub-section vii. "Indemnification?," Respondents answered "No." (*Id.*) Though the Division would have this Court believe that Respondents "falsified their audit workpapers by claiming there were no indemnification agreements with MSLP," (Opp. Br. at 3), that is simply false. As demonstrated above, the forms did not inquire whether indemnification provisions existed, but rather whether indemnification agreements existed which "might impair Respondents' independence." The answer to that question was – and continues to be – "No." As explained *supra*, the only impermissible indemnification clause which would impair independence is that which indemnifies auditors against their own negligence. Because the two Indemnification Provisions and the Other

[8] If the PCAOB believed standard ET 191 did not apply to public companies as the Division contends in its OIP and opposition brief, the PCAOB would eliminate this standard. But this standard is currently effective for public companies regardless of what the Commission's ***staff*** or the PCAOB ***staff*** say in non-authoritative materials.

Services Provision do not seek to indemnify Respondents against their own negligent conduct, Respondents' reply in the Engagement Acceptance Forms was true and accurate.[9]

Likewise, Respondents' letter to the MSLP Audit Committee (attached as Ex. C. to the Opp. Br.), stated that "[w]e are not aware of any relationships between our Firm and the Company that, in our professional judgment, may reasonably be thought to bear on our independence." Again, this statement reflects Respondents' understanding that the limited indemnification provisions included in the Engagement Letters did not impair their independence and consequently their representation was both truthful and accurate.

In sum, contrary to the Division's overtly false accusations, Respondents' representations to MSLP in their Engagement Acceptance Forms and letter to the Audit Committee accurately reflected Respondents' understanding that there were no relationships between them and MSLP that would impair their independence.

CONCLUSION

For the foregoing reasons, and the reasons stated in Respondents' opening brief, Respondents respectfully request that the Court grant their motion for summary disposition and dismiss all claims related to the auditor's independence.

[9] In this context, the Division notes that the Engagement Acceptance Forms state that the "SEC expects accountants to comply with the independence requirements established by the PCAOB... as well as the requirements promulgated by the Commission and the staff" (Opp. Br. ¶20). The SEC staff does not, however, promulgate requirements, it is only the Commission that does so and there are no requirements issued by the Commission or other regulators, relevant to these audits, that prohibit all indemnification provisions.

Dated: June 29, 2016

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing was delivered on this 29 day of June 2016 to: Securities and Exchange Commission, Brent Fields, Secretary, 100 F Street, N.E., Mail Stop 1090, Washington, D.C. 20549; ALJ@SEC.GOV; and Mark L. Williams, Trial Attorney, U.S. Securities and Exchange Commission, Denver Regional Office, 1961 Stout St., Suite 1700, Denver, CO 80294, williamsml@SEC.GOV.

By: _____
Lilly Ann Sanchez, Esq.

Authoritative Standard/Rule	**Reference to Indemnifications**
SEC's Codification of Financial Reporting Policies	Prohibits indemnifications from an auditor's own negligent acts only.
Rule 2-01(b) of Regulation S-X, *Qualifications of Accountants*	None
PCAOB Interim Ethics and Independence Standard ET §191, *Ethics Rulings on Independence, Integrity, and Objectivity* (Ruling Number 94 at par. 188-189)	Explicitly states that an auditor's indemnification from a client's knowing misrepresentations would *not* impair independence.
PCAOB Interim Auditing Standard §310, *Appointment of the Independent Auditor*	Includes indemnifications arising from knowing misrepresentations to the auditor by management as an example of a permissible term to include in engagement letters, with a parenthetical that such liability limitation arrangements *may* be restricted by the SEC.
PCAOB Auditing Standard No. 9, *Audit Planning*	None
PCAOB Interim Auditing Standard §220, *Independence*	None
PCAOB Rule 3520, *Auditor Independence*	None
PCAOB Interim Independence Standard ET §101, *Independence*	None
PCAOB Interim Ethics Standard ET §102, *Integrity and Objectivity*	None
AICPA ET §501, *Acts Discreditable*	Makes reference to certain regulators, such as the SEC, that prohibit *certain types* of indemnification agreements. (i.e., from negligent acts per the Codification)