

No. 20-1643

United States Court of Appeals for the Second Circuit

NEW ENGLAND CARPENTERS GUARANTEED ANNUITY AND PENSION FUNDS,
Lead Plaintiff-Appellant,

STANLEY NEWMARK, IRVING LICHTMAN REVOCABLE LIVING TRUST,
JUPITER CAPITAL MANAGEMENT,
Plaintiff-Movant-Appellants,

(Caption continued on inside cover)

Appeal from the United States District Court
for the Southern District of New York
(No. 1:17-cv-01545-LAK)

BRIEF OF FORMER SEC OFFICIALS AS AMICI CURIAE IN SUPPORT OF PETITION FOR PANEL REHEARING

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Consolidated-Plaintiff,

JOEL RUBEL, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY
SITUATED,

Plaintiff,

vs.

DONALD T. DECARLO, SUSAN C. FISCH, ABRAHAM GULKOWITZ,
GEORGE KARFUNKEL, JAY J. MILLER,

Consolidated-Defendants-Appellees,

AMTRUST FINANCIAL SERVICES, INC., BARRY D. ZYSKIND, RONALD E. PI-
POLY, JR., BDO USA, LLP, RBC CAPITAL MARKETS, LLC, UBS SECURI-
TIES LLC, CITIGROUP GLOBAL MARKETS INC., KEEFE, BRUYETTE & WOODS,
INC., MORGAN STANLEY & Co. LLC,

Defendants-Appellees.

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INTEREST OF AMICI¹

Amici are former officials of the Securities and Exchange Commission (SEC) who are deeply interested in the proper application of the nation's securities laws relating to audits of public companies.

Lynn E. Turner was the SEC's Chief Accountant from July 1998 to August 2001. As Chief Accountant, he was principal advisor to the SEC Chairman and Commission on auditing, financial reporting, and disclosures.

Andrew D. Bailey, Jr. served as the SEC's Deputy Chief Accountant from January 2004 to December 2005 where he acted as the SEC representative responsible for oversight of the Public Company Accounting Oversight Board (PCAOB) and its audit standard-setting and practice inspection efforts.

Jane B. Adams was Acting Chief Accountant of the SEC in 1998, and Deputy Chief Accountant from 1997-2000. She advised and

¹ No party's counsel authored this brief in whole or in part. No party or party's counsel, and no person other than amici and their counsel, contributed money that was intended to fund preparing or submitting this brief. Plaintiffs-Appellants consent to the filing of this brief. Defendants-Appellees do not.

represented the Chairman and Commission on accounting, disclosures, financial reporting, and corporate governance matters.

Amici do not take a position on the ultimate disposition of this case or on any issues other than those addressed in this brief.

ARGUMENT

“In our complex society the accountant’s certificate[s] . . . can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.” *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964). In this case, the panel accepted that auditor BDO “disbelieved the statement that the audit was conducted in accordance with the relevant PCAOB standards.” Op. 49. The panel nonetheless affirmed dismissal because, it held, BDO’s false claim to have completed a proper audit before issuing its opinion was immaterial. *Id.* 51.

That conclusion should be reconsidered. As the SEC has observed, “[f]ew matters could be more important to investors than that of whether an issuer’s financial statements, contained in its filings with the Commission, had, in fact, been subjected to an annual audit conducted in accordance with GAAS [generally accepted auditing standards] in all material respects.” *Scalzo*, Exchange Act Rel. No. 1839, 2003 WL 21938985, at *14 (Aug. 13, 2003).

In this case, BDO’s false claims were material because had it told the truth, it could not have issued an “unqualified opinion” that AmTrust’s financial statements fairly presented its financial condition.

Indeed, BDO would have been compelled to disclaim any opinion at all. That would have raised red flags with investors, precluded AmTrust from complying with SEC audit rules, and risked AmTrust's ability to raise funds in SEC-regulated markets, *regardless* of whether a completed audit would have uncovered any problems with AmTrust's financial statements.

The panel's contrary conclusion conflicts with the views of the SEC and the PCAOB, and could have broad implications for those agencies' enforcement authority. The petition for rehearing should be granted.

I. The Audit Report In This Case Used Standardized Language That Conveys Substantial Material Information To Investors.

Beginning with the passage of the Securities Act of 1933, Congress has required independent audits of public company financial statements. *See* 15 U.S.C.A. § 77c(b)(2)(F). An audit is an arduous process, subject to the detailed standards of the PCAOB. *See* PCAOB, Auditing Standards of the PCAOB (639 pages long).² An “audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay

² *Available at* https://assets.pcaobus.org/pcaob-dev/docs/default-source/standards/auditing/documents/auditing_standards_audits_after_december_15_2020.pdf?sfvrsn=5862544e_4.

millions of dollars.” Dep’t of Treasury, *Advisory Committee on the Auditing Profession: Final Report* VII:15 (Oct. 6, 2008) (“*Final Report*”).³

Given how detailed the audit process is, it may come as some surprise that “the auditor’s standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs.” *Final Report* at VII:15; see also Manuel F. Cohen, *Commission on Auditors’ Responsibilities: Report, conclusions, and recommendations* 71-73 (1978) (describing history behind standardized report, which has “come to be interpreted as a single, although complex, symbol”). Indeed, as explained in Judge Friendly’s seminal decision for this Court in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), the entire audit process culminates in the auditor offering an opinion as to whether the company’s financial statements have “fairly presented [its] financial position.” *Id.* at 805.

This “pass/fail model” continues to this day. PCAOB Release No. 2016-003, at 1. Specifically, the PCAOB standards relevant here required an auditor to provide “[a]n opinion as to whether the financial

³ Available at <https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1701&context=ypfs-documents>.

statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles.” PCAOB Audit Standards, AU § 508 R.08(h).⁴ This is expressed through either: (1) an “unqualified opinion” that the company’s financial statements fairly present the firm’s financial position; (2) a “qualified opinion” that includes specific exceptions; (3) an “adverse opinion” that finds the financial statements do *not* fairly present the firm’s financial position; or (4) a “disclaimer of opinion,” which foreswears offering any opinion on the financial statements. *Id.* § 508 R.10.

The audit was also required to include:

- “A statement that the audit was conducted in accordance with generally accepted auditing standards,” here, the PCAOB standards;
- “A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement”; and

⁴ Available at <https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/AU508>. This brief refers to the standards in effect at the times relevant to this case.

- “A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion.”

Id. § 508 R.08(d), (e), (g). Since 1941, the SEC’s Regulation S-X has imposed similar requirements due to the McKesson Robbins scandal. *See* 17 C.F.R. § 210.2-02(b)-(d).

When the auditor has not completed an audit, it cannot certify that it conducted an audit in compliance with PCAOB standards, make any other of the required certifications, or offer a legitimate opinion on whether the company’s financials are fairly presented. Instead, the only permissible option is to issue a “disclaimer of opinion.” That result has serious legal and practical consequences for the company, as it is no longer considered to be audited. It prevents the company from complying with the SEC’s reporting rules, precludes it from raising capital through SEC-regulated security sales, and risks delisting from major security exchanges.⁵ Accordingly, that an audit was not completed would alarm the market and affect how it perceives the integrity of management, which is always a material issue for investors.

⁵ *See* U.S. Sec. & Exch. Comm’n, Financial Reporting Manual, Topic 4, Sec. 4220.2; N.Y. Stock Exchange, Listed Company Manual § 203.01, <https://nyseguide.srorules.com/listed-company-manual/09013e2c8503fca3>.

II. The SEC And PCAOB Have Repeatedly And Correctly Found That False Certifications Of Compliance With Auditing Standards Are Material.

There should be no dispute that audit report conclusions are material to investors. Indeed, as the Supreme Court has explained, the “SEC requires the filing of *audited* financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby *encouraging public investment* in the nation’s industries.” *United States v. Arthur Young*, 465 U.S. 805, 819 n.15 (1984) (emphasis added).

But an audit’s conclusions are only as reliable as the process that produced them. Accordingly, the SEC and PCAOB have repeatedly taken the position that an auditor’s false claim to have completed a proper audit is material and violates federal securities laws and SEC rules. For example, in *Weld Asia Assocs.*, PCAOB Release No. 105-2017-046 (Dec. 13, 2017), the PCAOB explained that an “auditor violates Section 10(b) of the Exchange Act . . . by issuing an audit report stating that the audit has been performed in accordance with PCAOB standards when he or she knows, or is reckless in not knowing, that the statement is false.” *Id.* ¶ 34. “These statements,” the Board emphasized, “are ***clearly material.***” *Ibid.* (emphasis added). Quoting a Commission-level

decision from the SEC, the Board explained: “[*f*]ew matters could be more important to investors than that of whether an issuer’s financial statements, contained in its filings with the Commission, had, in fact, been subjected to an annual audit conducted in accordance with [PCAOB standards] in all material respects.” *Ibid.* (quoting *Scalzo, supra*, at *14) (emphasis added); see also, e.g., *Hood & Assoc. CPAs*, PCAOB Release No. 105-2013-012, ¶¶ 51 & n.52 (Nov. 21, 2013) (collecting further agency decisions).

The views of these specialist enforcement agencies are clearly correct. Take this case, for example. Whether BDO was telling the truth when it certified it had reached its unqualified opinion regarding AmTrust’s financial statements would have been a matter of enormous significance to the market. Had BDO told the truth—*i.e.*, that it had *not* complied with PCAOB standards because it had *not* finished the audit before issuing its opinion—BDO could not have made the certifications required for giving AmTrust an unqualified opinion; indeed, it would have been required to issue a “disclaimer of opinion.” *See supra* 7-8. That would have raised enormous red flags for investors, precluded AmTrust from complying with the SEC’s reporting requirements, and endangered

its ability to raise capital or have its stock traded on national exchanges.

Ibid.

III. The Generality Of The Standardized Audit Representations Does Not Render Them Immaterial.

The panel nonetheless concluded that the “audit statements to which the Appellants point were ‘so general’ in this case ‘that a reasonable investor would not depend on [them] as a guarantee.’” Op. 51 (quoting *ECA v. JP Morgan Chase, Co.*, 553 F.3d 187, 206 (2d Cir. 2009)). That conclusion is enormously consequential and wrong.

Audit reports “express[] the auditor’s opinion using standardized language.” PCAOB Release No. 2013-005 at 17. That standardized language is effectively dictated by PCAOB standards and SEC rules, which prescribe a series of statements the audit opinion must include. *See supra* 6-7. In fact, the PCAOB provides an exemplar that tracks the standards’ language and which the report in this case followed nearly verbatim, as does nearly every audit of every major company in the country. *Compare* AU R.08(j) (attached as Appendix to this brief) *with* JA246-47.

While this standardized language could be characterized as “general” in a sense, it is not the kind of vague generality this Court has

found immaterial in other cases. The panel’s citation to *ECA* illustrates the point. There, the Court found immaterial a company’s claim to have “risk management processes [that] are highly disciplined and designed to preserve the integrity of the risk management process.” 553 F.3d. at 205. Those kinds of statements are “too general to cause a reasonable investor to rely on them” because they convey no concrete information about what the company’s *actual* risk management practices are.

In contrast, certifying compliance with PCAOB standards informs investors with extraordinary precision exactly how the audit was performed. It is a well understood symbol that clearly conveys the audit was completed *without* exception, and that no material matters were left unresolved that are required to be brought to the attention of the investor. When that symbol is modified, it informs the investor that red flags exist.

Nor are the statements rendered immaterial simply because auditors cannot “guarantee” that the audited company’s financial

statements are completely accurate.⁶ Investors rarely have access to perfect information. A company may represent, for example, that its vehicle has “passed all safety tests.” *See In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 259 (2d Cir. 2016). The statement may be general in the same sense as the audit statements here. And there’s no guarantee the cars will turn out to be safe in practice. But the claim the vehicles were tested pursuant to a known set of rigorous standards is undoubtedly material, providing an important data point investors will rely on in valuing the company’s stock.

Investors likewise may rely on companies’ financial statements provided to them by management, even though they sometimes may be inaccurate. But in doing so, they are relying on, and taking into account, the symbol of the auditors which states the auditor has done their job.

IV. The Materiality Of An Audit’s Claimed Compliance With Audit Standards Does Not Depend On Whether A Proper Audit Would Have Uncovered Financial Misstatements.

The panel held out that the standard audit report language may not “*always* fail the materiality test” and faults the Complaint in this

⁶ Even if an auditor cannot guarantee that the *results* of the audit will be accurate, they *can* guarantee that they complied with the PCAOB rules governing the audit *process*.

case for “fail[ing] to allege any link” between BDO’s misleading claim to have conducted a PCAOB-compliant audit and “the material errors in AmTrust’s” financial statements. Op. 50-51 (emphasis added). But even with that qualification, the decision still works a significant and unwarranted change in the law.

Whether a statement is material depends on whether investors would have relied on it “at the time the alleged misstatement occurred.” *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 165 (2d Cir. 2000). A statement does not become immaterial (or material) in hindsight, based on later disclosures. In *Vivendi*, for example, a company misled investors about “its *risk* of bankruptcy” but did not ultimately go bankrupt. 838 F.3d at 262. That, however, did not prevent the misrepresentation from being the legal cause of investors’ injury when the true state of the company’s finances became known and its stock price fell. “Fraud,” the Court explained, “depends on the state of events when a statement is made, not on what happens later.” *Ibid.* (citation omitted); *cf. Knight v. U.S. Fire Ins. Co.*, 804 F.2d 9, 13 (2d Cir. 1986) (where insurance company would have conducted investigation if insured had made

truthful disclosures, “the materiality of the nondisclosure does not depend on what an investigation would have revealed.”).

A flawed audit process is material to investors because it increases the *risk* investors will overpay for a company’s stock in reliance on inaccurate financial statements. A misleading audit report, stating an audit was properly completed when it was not, increases the risk to an unknowing investor. The misrepresentation does not retroactively become immaterial simply because the risk of financial misstatement did not ultimately materialize. *See AJ Robbins CPA, LLC and Allan Jeffrie Robbins, CPA*, PCAOB No. 105-2021-001, 56-59 (June 21, 2023) (“As the courts, the SEC, and the PCAOB have stated, ‘An auditor who fails to audit properly under [the auditing standards] should not be shielded because the audited financial statements fortuitously are not materially misleading.’”).

Finally, to the extent the panel may have believed the BDO statements immaterial because the alleged audit failures were insignificant, *see* Op. 51, that conclusion is wrong as well. Based on their long experience with performance of audits, auditing standards, and/or regulating audits, amici can assure the Court that the violations were

egregious. Investors would find such lapses material not only because BDO omitted steps that might have turned up serious inaccuracies in AmTrust's financial statements, but also because BDO's conduct would call the auditor's integrity and competence into question, undermining faith in the results of the tests and inquiries it *did* perform.

CONCLUSION

For the foregoing reasons, the petition for rehearing should be granted.

September 13, 2023

Respectfully submitted,

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APPENDIX

AU Section 508 R.08(j) provides in relevant part:

The form of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

CERTIFICATE OF COMPLIANCE

1. This document complies with the type-volume limit as set out in Fed. R. App. P. 29(b)(4), because it contains 2,554 words.

2. This document complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type-style requirements of Fed. R. App. P. 32(a)(6) because this document has been prepared in a proportionally spaced typeface using Microsoft Word 2016 in 14-point New Century Schoolbook LT Std font.

/s/ Kevin K. Russell
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Counsel for Amici

CERTIFICATE OF SERVICE

I hereby certify that on September 13, 2023, I caused the foregoing brief to be electronically filed with the U.S. Court of Appeals for the Second Circuit through the Court's CM/ECF system. Parties represented by registered CM/ECF users will be served by the CM/ECF system.

/s/ Kevin K. Russell
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