UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

CASE NO. 23-cv-23723-RNS

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

PRAGER METIS CPAs, LLC,
and PRAGER METIS CPAs LLP,

Defendants.
_____/

PLAINTIFF'S RESPONSE IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS

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I. Introduction

Plaintiff Securities and Exchange Commission ("Commission" or "SEC") brought an eleven-count civil enforcement action against two affiliated accounting and auditing firms, Prager Metis CPAs, LLC, and Prager Metis CPAs LLP (together, "Defendants" or "Prager") (DE 1, "Compl.," hereinafter, "Complaint"). The Complaint alleges Prager failed to comply with the Commission's auditor independence rule in connection with 62 audits, 11 examinations ("exams"), and 144 reviews, conducted pursuant to 87 engagement letters dated from December 2017 to October 2020, for 62 clients comprised of 54 public issuers, 4 registered broker-dealers, and 4 registered investment advisers (collectively, "SEC Registrant Clients"), while earning Prager more than $3 million in fees.

At the forefront of this case are Prager's engagement letters with its SEC Registrant Clients, which contain indemnification provisions long viewed by the Commission as violating its independence rule because such provisions create a conflict of interest between auditor and audit client and jeopardize the public's trust in the critical independence function of auditors, a fundamental tenet of our public markets.

The Commission has consistently maintained that indemnification provisions do not belong in audit engagement letters because such provisions violate auditor independence. Independent auditors hold an important role as a watchdog or gatekeeper. Indemnification provisions reduce the incentive for an independent watchdog like Prager to carry out its responsibilities of auditing, investigating, and identifying any fraud, loss, waste, theft, or unethical or illegal practices by a company. If an auditor is indemnified against a client's misconduct or misinformation, the auditor will not have sufficient incentive to, with due care and skepticism, obtain appropriate audit evidence and conduct appropriate levels of testing, as needed, e.g., in high-risk areas.

Independent auditors are charged with the responsibility of casting a skeptical eye on information they are required to certify. *Checkosky v. SEC*, 23 F.3d 452, 457 (D.C. Cir. 1994) (citing *United States v. Arthur Young & Co.,* 465 U.S. 805, 818 (1984)). The Court in *Arthur Young & Co.* explained,

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any

> employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "**public watchdog**" function demands that the accountant maintain **total independence** from the client at all times and requires complete fidelity to the public trust. 465 U.S. at 817-18 (italics emphasis in original; bold emphasis added).

Despite the critical importance of an auditor's independence, Defendants included indemnification provisions in at least 87 engagement letters over the course of nearly three years. Given that the inclusion of indemnification provisions impairs an auditor's independence, removing or greatly weakening the auditor's incentive to be objective and impartial and to conduct thorough audits, the Commission's enforcement action is critical to holding Prager, as a gatekeeper, accountable for its blatant and repeated violations.

Prager seeks the extraordinary relief of dismissal with prejudice. (DE 16, Motion to Dismiss, hereinafter "Motion"). Prager seeks to avoid liability by claiming the Commission must allege Prager's independence was *actually* impaired or impaired *in fact* and that because Rule 2-01(b) of Regulation S-X [17 C.F.R. §210.2-01(b)] ("Rule 2-01(b)") does not specifically identify indemnification agreements as prohibited, the Commission's action fails as a matter of law. Prager's arguments are wrong as a matter of law and further illustrate the importance of obtaining an injunction against Prager for its probable future violations.

II. The Court Must Accept as True the Facts of the Complaint

A. Pleading Standard

A complaint need only contain "a short and plain statement of the claim," Fed. R. Civ. P. 8(a)(2), with facts sufficient to show that the claim is "plausible." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) ("plausibility" is less than "probability"). The Court must accept as true all facts alleged in the Complaint in the light most favorable to the Commission. *Am. United Life Ins. Co. v. Martinez*, 480 F.3d 1043, 1057 (11th Cir. 2007). All reasonable inferences in the Complaint must be drawn in the Commission's favor. *Ventrassist Pty. Ltd. v. Heartware, Inc.*, 377 F. Supp. 2d 1278, 1285 (S.D. Fla. 2005) ("the motion is not a procedure for resolving a contest between the parties about the facts or the substantive merit of the plaintiff's case") (citing *Jackson v. Birmingham Bd. of Educ.*, 309 F.3d 1333, 1335 (11th Cir. 2002)). Moreover, to satisfy the liberal notice pleading standards of Rule 8(a), the Commission must do nothing more than set forth "a short and plain statement of the claim showing that the pleader is entailed to relief." *McMillian v.*

AMC Mortg. Servs, Inc., 560 F. Supp. 2d 1210, 1212 (S.D. Ala. 2008). The Court's inquiry at the motion to dismiss stage still focuses on whether the challenged pleadings "give the defendant fair notice of what the . . . claim is and the grounds on which it rests." *Id.* (quoting *Erickson v. Pardus*, 551 U.S. 89, 93 (2007)).[1] The Commission has satisfied this pleading standard, no basis exists to dismiss the Commission's Complaint, and Defendants' Motion must be denied.[2]

B. Summary of Facts Supporting the Commission's Charges Against Prager

The Complaint contains 13 pages of facts and provides a detailed chart (Exhibit 1) supporting the Commission's charges against Prager, including numerous facts and circumstances that demonstrate Prager cannot be recognized as independent. Compl. ¶¶ 33-59. The allegations of the Complaint establish that this was not a "foot fault" or one-off infraction. Prager included indemnification provisions in 87 engagement letters with 62 SEC Registrant Clients for almost three years, while earning more than $3 million in fees. Compl. ¶¶ 2, 34. The indemnification provisions impacted 62 audits, 11 exams, and 144 reviews. *Id*.

Prager was retained by its 62 SEC Registrant Clients to conduct audits, exams, and reviews of among other things, financial statements and client assets under custody of an investment adviser. Compl. ¶ 59. As many as 77 engagement letters included this indemnification provision:

> In the event that we [Prager] become obligated to pay any judgment, fine, penalty, or similar award or sanction; agree to pay any amount in settlement; and/or incur any costs including legal fees, as a result of a claim, investigation, or other proceeding instituted by any third party, including any governmental or quasi-governmental body, and if such obligation is a direct or indirect result of any inaccurate or incomplete information that you [Client] provide to us during the course of this engagement, and not any failure on our part to comply with professional standards, you [Client] agree to indemnify us [Prager], and hold us harmless as against such obligations, agreement and/or costs. Compl. ¶ 34.

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[1] "The proper test is whether the complaint 'contains either direct or inferential allegations respecting all material elements necessary to sustain a recovery under some viable legal theory.'" *McMillian*, 560 F.Supp.2d at 1213 (citation omitted).

[2] In footnote 4 of the Motion, Prager argues that Prager Metis CPAs LLP should be dismissed from this action for lack of venue. As alleged in the Complaint, all employees of Prager Metis CPAs LLP, the California entity, are also employees of Prager Metis CPAs, LLC, the entity which has offices in Miami, Florida. Compl. ¶¶ 9-10. The overlap of employees and overlap of facts, including the use of the same engagement letters and indemnification provisions, warrants maintaining one case against both Defendants in this judicial district.

As many as 14 engagement letters included another indemnification provision that:

> Because of the importance of management's representations to an effective audit [or examination], the Company [Client] agrees to release and indemnify [Prager] and its personnel from any liability and costs relating to our services under this agreement attributable to any knowing misrepresentations by management. *Id*.

The Commission's independence rule provides that any provision of service that "creates a mutual or conflicting interest between the accountant and the audit client" violates independence. *See* introductory text to Rule 2-01 [17 C.F.R. § 210.2-01]. Indemnification provisions between an auditor and its audit client are a classic example of such "conflicting interest." Lest there be any ambiguity that indemnification agreements violate independence, the Commission codified its view in 1982, over forty years ago, that indemnification provisions impair auditor independence. *See* Section 602.02.f.i. ("Indemnification by Client") of the Codification of Financial Reporting Policies attached as Ex. A.[3] Compl. ¶¶ 27-28. More specifically, once an auditor or an audit client includes indemnification provisions in an engagement letter for an audit, review, or exam, the auditor is no longer independent as such provisions create a conflict of interest that "induce[s] a departure from the standards of objectivity and impartiality which the concept of independence implies." Section 602.02.f.i. of the Codification. Compl. ¶¶ 28, 35. The Codification further explains that a firm's objectivity and impartiality come into question if there are indemnification provisions because the auditor's "major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened." *Id*. Thus, the auditor's incentive to conduct a thorough audit and question management regarding management's representations is diminished because the auditor knows that he will be indemnified for management misrepresentations. Compl. ¶ 35. In short, indemnification provisions are antithetical to the concept of an auditor's arms-length independent relationship.

It is so well-known in the audit profession that indemnifications are prohibited that Prager was warned by at least two of its *own* partners about the indemnification provisions impairing

[3] The Commission created the Codification in 1982 as the "publication of a codification of certain existing Accounting Series Releases (ASRs)" previously issued by the Commission "by extracting those portions of the ASRs which provide current, meaningful guidance to registrants, ***independent accountants*** and others in complying with the Commission's requirements," and to be "updated by the issuance of [future] Financial Reporting Releases." *Codification of Financial Reporting Policies*, 1982 WL 590664, at *1-2 (April 15, 1982) (emphasis added); Compl. ¶ 27.

independence. Yet still the firm failed to correct its impairment. Starting in approximately January 2019 and again in June 2019, two different Prager partners brought the issue of the indemnifications in the engagement letters to the attention of Prager senior management, specifically warning that indemnification agreements can impair independence. Compl. ¶¶ 44-48. Prager failed to heed the warnings of these partners. More specifically, in January 2019, a Prager partner alerted via email at least two of Prager's senior managers that Prager's engagement letter contained a section called "indemnity" and warned further:

> I thought those were supposed to be removed from PCAOB [Public Company Accounting Oversight Board] letters as that can impair independence. In the [**Broker-Dealer 3**] letter that I had previously sent to you, I removed that entire section.
>
> Here is the guidance from the BD PPC template –
>
> [x] An auditor would not be considered independent if a client has agreed to indemnify the auditor against liability from an engagement, whether that liability arises from the auditor's own negligence or material misrepresentations made by management. Therefore, the engagement letter should not include an indemnification clause or language of that nature. Compl. ¶ 46.

Despite this clear warning, Prager continued to use engagement letter templates that contained indemnification provisions in 51 additional engagement letters after January 2019, and Prager signed accountant's reports and certifications claiming to be independent that its audit clients filed with the Commission. Compl. ¶¶ 36-43, 47, 59, and Exhibit 1.

In June 2019, yet another Prager partner emailed Prager's management and raised the issue of indemnification provisions in engagement letters stating, "I saw an indemnity clause in your engagement letter. As I recall, for issuer clients an indemnity clause may be a problem with the PCAOB/SEC." Compl. ¶ 48. However, Prager still did not update its public company audit engagement letter template to remove the indemnification provisions until December 2019, when Prager management circulated an updated template via email, stating that it should be used "for all new and unissued engagements" (i.e., only new engagements or engagements for which an audit report had not been issued yet). Compl. ¶ 49. That December 2019 email, which circulated the new template failed to state that the indemnification provisions had been removed from the template; did not explain that historical inclusion of such indemnification provisions had impaired Prager's independence; and did not suggest any remedial measures. *Id*.

Even after Prager updated its engagement letter template to remove the indemnification provisions, Prager still signed engagement letters that contained indemnification provisions on six occasions between December 2019 and October 2020. Compl. ¶ 50.

In September 2020, the PCAOB, a private-sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002, to oversee, among other things, accounting professionals who provide independent audit reports for publicly traded companies,[4] informed Prager in two PCAOB audit inspection reports ("comment forms") that Prager's inclusion of indemnification provisions in an engagement letter constituted an independence deficiency. Compl. ¶¶ 55-56 and Footnote 1. The PCAOB inspection comment forms cited to the Commission's Office of Chief Accountant ("OCA") guidance, issued on December 13, 2004 ("OCA's FAQs"), and the PCAOB stated:

> The Firm does not appear to be independent of the Issuer within the meaning of, and as required by, the Securities and Exchange Commission's Rules on Auditor Independence. **Specifically, the indemnification provision included in the firm's engagement letter with the issuer violates the independence criteria set out in Rule 2-01(b) of Regulation S-X.** Compl. ¶ 56 (emphasis added).

Notably, Prager did not heed the PCAOB's inspections deficiency warning either. Even after receiving the PCAOB's inspection comment forms, Prager signed another engagement letter containing indemnification provisions in October 2020. Compl. ¶ 57. Prager also failed to inform the PCAOB in its response that, after it circulated the new engagement letter template, it subsequently signed 5 new engagement letters that contained indemnification provisions between in or around December 23, 2019 and in or around July 7, 2020. *Id.* Prager also signed an engagement letter containing indemnification provisions in or around October 28, 2020, after Prager had responded to the PCAOB, which totals at least six engagement letters containing indemnification provisions signed after Prager updated its engagement letter template. *Id.*

Ultimately, as detailed in Exhibit 1 to the Complaint, at least ten Prager partners signed engagement letters that contained indemnification provisions while conducting the audits, reviews, and exams of SEC Registrant Clients. Compl. ¶ 11.b. Prager lacked quality control procedures to ensure that indemnification provisions were not included in engagement letters until around late 2022. Compl. ¶ 51.

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[4] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010) ("Dodd-Frank") gave the PCAOB authority over firms that perform audits of broker-dealers registered with the Commission.

Although Prager had been specifically informed about its independence deficiencies by the PCAOB and previously warned by two of its own partners, Prager failed to communicate with its SEC Registrant Clients, their audit committees, or those charged with governance at the clients, regarding Prager's independence impairment caused by the indemnification provisions in the engagement letters. Compl. ¶¶ 52-54. In multiple letters to its SEC Registrant Clients, Prager affirmatively said it was not aware of any relationships that may reasonably be thought to bear on independence. Compl. ¶ 54. Prager also signed and issued accountant's reports to its SEC Registrant Clients (which then included those reports or incorporated them by reference in certain filings with the Commission) that falsely stated that Prager was independent despite the conflicts of interest that the indemnification provisions created that rendered the firm not independent. Compl. ¶¶ 36-43, 59, and Exhibit 1. These facts and circumstances constitute a wholesale failure by Prager to comply with the Commission's independence requirements and support the violations charged in the Complaint.

Prager's conduct was not in accordance with Rule 2-01(b) because, as a result of its indemnification clauses, "a reasonable investor with knowledge of all relevant facts and circumstances would conclude that" Prager was "not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." *See* 17 C.F.R. § 210.2-01(b).

Prager's failure to be independent within the meaning of Rule 2-01(b) resulted in violations of Rule 2-02(b) of Regulation S-X [17 C.F.R. § 210.2-02(b)] ("Rule 2-02(b)") for each engagement with an issuer client, and Rule 17a-5(i) of the Securities Exchange Act of 1934 ("Exchange Act") [17 C.F.R. § 240.17a-5(i)] for each engagement with a registered broker-dealer ("BD") client, in which Prager provided an accountant's report (or consented to the inclusion of an accountant's report from a prior period), falsely purporting to be a report of an independent registered public accounting firm, that its issuer and BD clients then included (or incorporated by reference) in filings with the Commission. In addition, because of Prager's failure to be independent with respect to each audit, exam, and review, Prager aided and abetted (a) its issuer and BD clients' violations of the Exchange Act; and (b) its registered investment adviser ("IA") clients' violations of the Investment Advisers Act of 1940 ("Advisers Act"). Compl. Counts 1-11 and ¶ 4.

III. Legal Argument

A. Importance of Auditor Independence

Independence is a key principle of public accounting. Dating back to the inception of the securities laws, the Commission emphasized the need for auditors to be independent, including by avoiding contractual alliances with their public audit clients. *See In the Matter of Am. Terminals and Transit Co.*, 1 S.E.C. 701, 1936 WL 32788 *6 (September 29, 1936) (protection of investors requires that independent auditors "be free of the entangling alliances which relational and contractual connections with registrants frequently engender, but also that they approach their task with complete objectivity—critical of the practices and procedures of registrants . . . .").

The Supreme Court confirmed the Commission's views and described independent public accountants as a "public watchdog" that must maintain total independence from the client at all times and complete fidelity to the public trust. *Arthur Young & Co.,* 465 U.S. at 818 (public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional). *See also In the Matter of KPMG Peat Marwick LLP* ("*KPMG*"), 2001 WL 47245, at *13 (Jan. 19, 2001) (Commission Order noting that "[a]ccountants and their firms must be -- *and must reasonably be perceived to be* -- free from influences that would impair objective, unbiased examinations, even when the results are contrary to management's interests. As we have consistently recognized, if an auditor 'is predisposed, *or even appears predisposed*, to blindly validate management's work rather than subjecting it to careful scrutiny, the ultimate result will be a diminution of public confidence in the profession and the integrity of the securities markets.'") (emphasis added) (footnotes omitted). The Commission in *KPMG* elaborated that reports by independent public accountants "provide the assurance that outside experts have examined a filer's financial statements and have arrived at objective opinions about whether the filer's financial position, results of operations, and cash flows are presented fairly in conformity with GAAP. Independent audits thus improve the reliability of financial statements and enhance their credibility." *Id*.

B. Commission Authority Concerning Independence and the Independence Framework

As the Commission stated in a 1998 Policy Statement:

> The various securities laws enacted by Congress and administered by the Securities and Exchange Commission underscore the crucial function of independent auditors in protecting public investors by requiring, or permitting the Commission to

> require, that financial statements filed with the Commission by public companies, investment companies, broker-dealers, public utilities, investment advisers, and others be certified (or audited) by "independent" public accountants. **They also give the Commission the authority to define the term "independent."**
>
> Since the Commission's creation in 1934, it consistently has emphasized the need for auditors to remain independent.

Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence, 1998 WL 63595 (Feb. 18, 1998) (emphasis added) (footnotes omitted).

C. General Standard of Commission Rule 2-01(b) of Regulation S-X

Commission Rule 2-01 of Regulation S-X "is designed to ensure that auditors are qualified and independent of their audit clients *both in fact and in appearance*." 17 C.F.R. § 210.2-01 (emphasis added). Rule 2-01(b) provides the general standard of auditor independence that:

> 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).

The Commission's Regulation S-X is well established. In February 1940, the Commission consolidated several sets of accounting instructions from various forms into a single accounting regulation, Regulation S-X.[5] While Rule 2-01 was *amended* in 2000, it was not originally "promulgated" at that time as suggested by Prager. *See* Motion at 2. The Commission has had an independence rule in Rule 2-01 since the original adoption of Regulation S-X in 1940. Notably, the general standard found at Rule 2-01(b) and adopted pursuant to notice and comment procedures set forth in the Administrative Procedure Act, has remained unchanged for over two decades. Compare 17 C.F.R. §210.2-01(b) effective February 2001 with 17 C.F.R. §210.2-01(b) effective June 2021.[6]

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[5] *See* SEC, Sixth Annual Report of the Securities and Exchange Commission, at 170-171, here: https://www.sechistorical.org/collection/papers/1940/1940_0630_SECAR_1.pdf.

[6] *See Revision of the Commission's Auditor Independence Requirements*, 2000 WL 1726933 (Nov. 21, 2000) (adopting release to the 2000 amendment to Rule 2-01; cites to the Codification).

The Rule does not, nor is it required to, outline every circumstance that could impair independence. Hence Rule 2-01(b) is the ***general standard***. The Introductory Text for Rule 2-01 addresses this very point, stating in part, "Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) through (c)(5) of this section reflect the application of the general standard to particular circumstances. ***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).***" 17 C.F.R. §210.2-01 (emphasis added).

D. Engagement Letters Are Not Ordinary Contracts

Engagement letters are not mere ordinary contracts for services. Audit engagement letters are themselves subject to prescribed audit standards. *See* PCAOB Auditing Standard ("AS") 1301, *Communications with Audit Committees*, which, among other things, requires the auditor to communicate to the client's audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the *terms* of the audit engagement with the audit committee.[7] This understanding includes communicating to the audit committee: (a) the objective of the audit; (b) the responsibilities of the auditor; and (c) the responsibilities of management. PCAOB AS 1301.06 requires this understanding of the *terms* of the audit engagement to be recorded in an engagement letter that is provided to the audit committee annually. The engagement letter encapsulates a list of the responsibilities of both the auditor and management, and also refers to the professional standards by which the engagement will be governed and may also describe any limitations of the services being provided.[8]

E. Indemnification Agreements in Engagement Letters with Audit Clients Impair Auditor Independence

i. Indemnification provisions create the appearance of a lack of independence

The Court should reject Prager's argument that indemnification agreements cannot, on their own, violate the Commission's auditor independence rule and cannot form a basis for the Commission's action against them. It has been the Commission's long-standing position that indemnification provisions in engagement letters impair independence. Prager does not dispute

[7] PCAOB AS 1301: https://pcaobus.org/oversight/standards/auditing-standards/details/AS1301

[8] A few of the engagement letters relevant in this case were for interim reviews rather than audits. PCAOB AS 4105 addresses engagement letters for interim reviews and provides similar requirements: https://pcaobus.org/oversight/standards/auditing-standards/details/AS4105

this. Motion at 5. Indemnification provisions between an auditing firm and its client create the very type of situation which lead to the appearance of a conflict of interest[9] and lack of independence, regardless whether the indemnification provision was ever invoked.[10] As the Commission has publicly explained, "if investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities." *Revision of the Commission's Auditor Independence Requirements*, 2000 WL 1726933, at *2 (Nov. 21, 2000) ("Adopting Release"). "The Commission's independence requirements have always included consideration of investor perceptions." *Id*. at *7. Specifically referencing the Supreme Court decision in *Arthur Young & Co.,* 465 U.S. at 819, n. 15, which emphasized the importance of the connection between investor confidence and the appearance of independence, the Commission reiterated that "it is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. *Id*. at *6 (emphasis in original).

Prager ignores this concept of "appearance" or perception of independence, and instead falsely argues that the Commission must allege Prager was "actually impaired" to establish a violation of Rule 2-01. Motion at 2. But no authority exists requiring the Commission to allege Prager was "actually impaired" or impaired in fact.[11] Although ignored by Prager, the concept of "appearance" of independence is found in the general standard set forth in Rule 2-01(b). As the Commission explained in the Adopting Release, the appearance of independence is an objective

[9] The introductory text to Rule 2-01(b) provides that, when applying Rule 2-01(b), one of the factors for consideration is whether the accountant-client relationship or the provision of a service "[c]reates a mutual or conflicting interest between the accountant and the audit client." It is this factor that indemnification provisions principally violate.

[10] Whether Prager invoked the indemnification provisions is irrelevant for purposes of assessing the sufficiency of the Commission's pleading in this action. Prager notes that the indemnification provisions were purportedly never invoked to suggest that this would absolve Prager of liability. First, this fact is not alleged in the Complaint and is thus outside the four corners and should be disregarded at this stage of the matter. Second, and more importantly, even if it is true that Prager did not invoke the indemnification provisions, this does not impact the independence analysis, a conflict of interest exists nonetheless, and Prager lacks the requisite independence required under Rule 2-01(b) of Regulation S-X.

[11] Prager conflates the requirement that an auditor must be "independent" with the concept that the auditor must perform a good audit. There is no requirement that the Commission allege that Prager did not perform a good audit.

test, keyed to the conclusions of reasonable investors with knowledge of all relevant facts and circumstances. 2000 WL 1726933, at *7. Thus, the concept of "appearance" of independence as opposed to actual impairment, is within the actual text of Rule 2-01(b), as emphasized below:

> **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).

In Commission enforcement actions, a finding of actual impairment or impairment in fact has not been required to allege a lack of auditor independence. One such example is found in *In the Matter of Ernst & Young LLP et al.* ("*EY*"), 2016 WL 4983302 (Sept. 19, 2016), a settled administrative and cease-and-desist proceeding. The *EY* matter was based on allegations under the general standard of independence that an auditing firm's employee and member of the audit engagement team had a close personal relationship with the chief accounting officer at the audit client, which created the appearance of a violation of independence between auditor and client. Additionally, the prohibition of a close personal relationship with the audit client is not specifically identified in the non-exclusive circumstances that are inconsistent with independence in Rule 2-01(c) of Regulation S-X [17 C.F.R. § 210.2-01(c)] ("Rule 2-01(c)"); however, it is well understood that this is the type of relationship that would impair independence. The Commission has brought other cases based on alleged violations of the Commission's independence rule for actions not specifically identified in Rule 2-01(c). *See In the Matter of Ernst & Young LLP*, 2021 WL 3410672 (Aug. 2, 2021) (settled order in administrative and cease-and-desist proceeding against auditing firm and its partners alleging independence violations related to competitive bid process); *In the Matter of Ernst & Young LLP*, 2014 WL 3401161 (July 14, 2014) (settled order in administrative and cease-and-desist proceeding against auditing firm alleging auditing firm improperly advocated for an audit client in violation of the Commission's independence rules.).

Prager's statement that the instant action is "entirely without precedent" is both irrelevant and untrue. Merely because the Commission may not have enforced a factual situation exactly as the one presented in this case, does not mean the Commission's case is legally without merit or is

worthy of dismissal with prejudice as Prager requests. The Commission has brought a number of settled cases related to auditor's lacking independence, some of which are cited in this response.[12] Additionally, in 2017, the Commission entered an order via a settled public administrative and cease-and-desist proceeding that included violations of independence rules and Rule 2-02(b), for the inclusion of indemnification provisions in engagement letters. *In the Matter of Elliot R. Berman, CPA, et al.*, 2017 WL 33718 (Jan. 3, 2017). The *Berman* matter involved violations related to the inclusion of indemnification provisions in engagement letters, as well as additional alleged violations. The *Berman* litigated administrative complaint (*In the Matter of Elliot R. Berman, CPA et al.*, 2016 WL 1168569 (March 25, 2016)) and settled administrative order were both issued before any of the conduct at issue in this case against Prager. In the *Berman* settled order, the Commission states:

> 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 letters. Despite not being independent, Berman & Co. issued audit reports that represented that Berman & Co. was independent. As a result, Berman & Co. willfully violated, and Berman willfully aided and abetted and caused violations of, Rule 2-02(b)(1) of Regulation S-X. 2017 WL 33718, at *2.

Additionally, the issue of lack of independence because of indemnification provisions has been litigated by private litigants. *See Taylor, Bean & WhitakerPlan Trust, v. PricewaterhouseCoopers, LLP*, 2015 WL 9998054 (Circuit Court of Florida, Eleventh Judicial Circuit, Complex Business Litigation Division, Miami-Dade County) (Dec. 6, 2015) (Order granting partial summary judgment against auditing firm that lacked independence because it included prohibited indemnification language). Thus, not only does the Commission understand that indemnification provisions impair independence, but private litigants also enforce against violations of independence caused by indemnification provisions.

In apparent confusion, Prager relies on provisions of the American Institute of Certified Public Accountants' ("AICPA") Code of Professional Conduct ("AICPA Code"), claiming that certain provisions of the AICPA Code support Prager's argument that indemnification agreements

[12] *See KPMG*, 2001 WL 47245, at *14 (Commission noted that in its adjudicatory capacity, it has issued decisions over the last six decades finding impaired independence in a variety of situations).

do not impair independence (Motion at 12), but in fact, the AICPA Code does the opposite. First, the AICPA Code does not apply to the audits at issue in this case as it applies only to private—i.e., non-SEC registrant audits—and therefore the AICPA Code has no bearing on the Commission's authority and Prager erroneously relies on those provisions. Second, both the PCAOB and AICPA have publicly held that pursuant to Commission rules and regulations, indemnification provisions impair independence. *See* PCAOB AS 1301, footnote 1 to Appendix C -- Matters Included in the Audit Engagement Letter ("Certain matters should not be included in an engagement letter; for example, under Securities and Exchange Commission, Section 602.02.f.i. of the Codification of Financial Reporting Policies, indemnification provisions are not permissible for audits of issuers"); AICPA Code Section 1.400.060 ("Indemnification and Limitation of Liability Provisions").[13] Further, in this case the PCAOB provided Prager with inspection comment forms with deficiencies because Prager was not independent "within the meaning of, and as required by, the Securities and Exchange Commission's Rules on Auditor Independence. Specifically, the indemnification provision included in the firm's engagement letter with the issuer violates the independence criteria set out in Rule 2-01(b) of Regulation S-X." Compl. ¶¶ 55-58.

Additionally, as set forth in the Complaint, the view that auditors are prohibited from entering into indemnification provisions with their clients is not a secret or even a novel conclusion. Other agencies (the Department of the Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) also issued similar guidance, recognizing the Commission's position that auditors that include indemnification provisions in engagement letters are not independent. Compl. ¶ 32. The Commission articulated its opinion concerning indemnifications in an Accounting Series Release in 1941. Accounting Series Release No. 22, Independence of Accountants—Indemnification by Registrant, 1941 WL 307233 (March 14, 1941) (an indemnification impairs an accountant's independence under Rule

[13] PCAOB AS 1301: https://pcaobus.org/oversight/standards/auditing-standards/details/AS1301; AICPA Code: https://us.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014-december-15-content-asof-2020-June-20-code-of-conduct.pdf. The AICPA, through Rule 101.01, directs its members to follow the more restrictive independence requirements of the Commission, and specifically, AICPA Code Section 1.400.060 states that members (such as Prager) must follow laws, regulations, or ***published interpretations*** that the Commission has issued on indemnifications impairing independence.

2-01 of Regulation S-X) (this release was rescinded when the Commission incorporated it into the Codification).

ii. It is of no significance that indemnification provisions are not specifically identified in Rule 2-01(b)

Prager argues that because indemnification provisions are not specifically identified as prohibited in Rule 2-01(c), the Commission cannot allege that Prager's inclusion of indemnification provisions in its engagement agreements impaired its independence. Motion at 2, 7-13. Prager misstates the Commission's rule and ignores the explicit language of Rule 2-01 cited above, which specifically explains that "***[t]he 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),"*** and accountants ***"are encouraged to consult with the Commission's Office of the Chief Accountant ["OCA"] before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the rule."*** 17 C.F.R. §210.2-01 (emphasis added). The Commission's independence rule – embodied in Rule 2-01 – is clear that the relationships and circumstances referenced in part (c) of the Rule are not an exclusive list of the only circumstances which result in impairment of an auditor's independence. Additionally, the federal securities laws, which are largely principles-based, should be construed broadly and flexibly, not technically and restrictively, to effectuate their remedial purpose. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

Merely because Rule 2-01 does not specifically include a prohibition on indemnification provisions does not mean it "rejects the proposition." Motion at 19. In fact, as noted above, Rule 2-01(c) is "non-exclusive," and Rule 2-01 makes clear that it does not list all the circumstances that impair independence. There is no support for Prager's argument that indemnification agreements must be specifically identified in Rule 2-01 to be used as a basis for the Commission's action against Prager for their lack of independence, and the Court should deny Prager's Motion.

iii. The relevant facts and circumstances would allow a reasonable investor to conclude that Prager was not capable of exercising objective and impartial judgment

The Commission has adequately alleged relevant facts and circumstances under which a reasonable investor could conclude that Prager did not appear capable of exercising objective and impartial judgment. These include that Prager's engagement letters with its SEC Registrant

Clients included indemnification provisions (*see e.g.,* Compl. ¶ 3), despite clear guidance and notice from the Codification that such provisions were prohibited; that Prager was warned by two Prager partners that indemnification provisions impaired independence (Compl. ¶¶ 44-49); that Prager continued to include indemnification provisions in engagement letters despite warnings from these two partners and the PCAOB (Compl. ¶¶ 44-50, 55-58); that even after Prager circulated a new engagement letter template which omitted the indemnification provisions, that on at least 6 occasions, indemnification provisions were still used (Compl. ¶¶ 50, 57); that Prager did not explain to Prager's staff that indemnification provisions had been removed from the template or explain that historical inclusion of such indemnification provisions had impaired Prager's independence (Compl. ¶ 49); that Prager did not inform its audit clients or their audit committees of the indemnifications as a relationship that "may reasonably be thought to bear on independence," as required by PCAOB Rule 3526 or affirmatively stated that no such relationships existed (Compl. ¶¶ 52-54); that Prager did not suggest remedial measures to its staff and only instructed the use of the revised template for new engagements or engagements for which an audit report had not been issued yet (Compl. ¶ 49); that even after the PCAOB identified the indemnification provisions as "violat[ing] the independence criteria set out in Rule 2-01(b) of Regulation S-X," Prager executed at least 1 additional engagement letter with an indemnification provision (Compl. ¶¶ 56-58); that Prager did not inform the PCAOB that it had included indemnification provisions since 2017 and that Prager's management had been on notice of the issue since at least January 2019 but had not taken corrective action (Compl. ¶ 57); and that Prager signed accountant's reports and certifications that Prager's clients then included in filings with the Commission after the warnings by the Prager partners and notice from the PCAOB. (Compl. ¶¶ 36-43, 59, and Exhibit 1). These facts, which must be taken as true, more than satisfy the pleading standard and support the Commission's causes of action against Prager, including that Prager aided and abetted the violations of its SEC Registrant Clients.

Prager also argues that the Commission's aiding and abetting charges fail because the emails identified in the Complaint do not support a "reasonable inference of actual knowledge." Motion at 18. First, actual knowledge is not required to plead aiding and abetting. To establish aiding and abetting liability, the Commission must show the Defendants knowingly or recklessly provided substantial assistance to another person in violation of any provisions. *SEC v. Goble*,

682 F.3d 934, 947 (11th Cir. 2012). Second, sufficient facts (including those cited above) are alleged to satisfy the pleading standard. Prager nit-picks over whether the emails from its partners support that Prager had actual knowledge of its lack of independence. As indicated above, actual knowledge is not required, and Prager omitted a key part of an email, included in Paragraph 46 of the Complaint – that makes it clear Prager was told in blunt terms that it could not include indemnification provisions; the portion of that email reads:

> [x] An auditor would not be considered independent if a client has agreed to indemnify the auditor against liability from an engagement, whether that liability arises from the auditor's own negligence or material misrepresentations made by management. Therefore, the engagement letter should not include an indemnification clause or language of that nature. Compl. ¶ 46.

Ultimately, the Court should not accept Prager's invitation to weigh evidence at the pleading stage. The Commission's Complaint sufficiently pleads each of its 11 counts, and Prager's Motion should be denied.

Neither is the Court required to decide whether Rule 2-01(b) calls for a "blanket ban" on indemnification provisions as Prager describes. Motion at 9. That issue is not presented in this case, and instead, the Commission has identified numerous facts and circumstances, as alleged, under which a jury could determine Prager violated the securities laws and aided and abetted the violations of its SEC Registrant Clients. Prager seeks to ignore the totality of the facts and circumstances alleged in the Complaint and instead focuses on a single fact, admittedly an important fact, that Prager repeatedly utilized indemnification provisions in its engagement letters. As indicated above, the Complaint alleges several facts and circumstances that go beyond the inclusion of indemnification provisions and warrant denial of Prager's Motion to Dismiss.

iv. The Commission is not seeking to enforce its own guidance or that of its Office of the Chief Accountant

Prager argues that OCA's FAQs and Codification are "*nonbinding guidance* that cannot serve as the independent basis for the Commission's claims against Prager." Motion at 9. Prager misunderstands and misrepresents the Commission's causes of action against them. The Commission does not seek to enforce provisions of OCA's FAQs or the Codification, but rather use these sources in the Complaint as background of the independence requirements and a way of explaining the Commission's long-standing view that indemnification provisions impair independence, which is widely known within the accounting industry and should not come as a

surprise to Prager. (Compl. ¶¶ 27-30). The Commission's Complaint sets out the statutory basis for each of its eleven causes of action (Compl. ¶¶ 60-125), none of which rely on the enforcement of OCA's FAQs or the Codification. In fact, the Commission does not bring a cause of action for violation of the general standard of independence set forth in Rule 2-01(b), but rather the Commission's causes of action against Prager specify that Prager's failure to be independent consistent with Rule 2-01(b) resulted in the various violations and aiding and abetting of others' violations, as set forth in Counts 1-11. (Compl. ¶¶ 60-125).

v. Indemnifications which exempt the auditor's own negligent conduct are still problematic

Prager argues that the indemnification provisions in its engagement letters which do not indemnify Prager from its own failures to comply with professional standards, do not run afoul of the independence rules.[14] Motion at 14. Prager's argument misses the mark. First, the auditor (Prager) is required to be independent, then, the *independent* auditor is required to perform work with due professional care. An evaluation of whether Prager performed with due professional care cannot even begin as Prager was not independent from the start. *See* PCAOB AS 1015[15] (which Prager reference in its Motion at 15) that states:

> .01 Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.
>
> .02 The statement in the preceding paragraph requires the ***independent auditor*** to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an ***independent auditor's organization*** to observe the standards of field work and reporting. https://pcaobus.org/oversight/standards/auditing-standards/details/AS1015

[14] Conversely, then Prager must admit that the engagement letters, which do not specifically carve out indemnification for its own negligence, must be violative.

[15] The Commission's causes of action do not rely on enforcement of PCAOB standards of professional conduct. As indicated above, such an analysis is not even relevant as Prager was not independent as required by Rule 2-01(b). Indeed, even if the PCAOB standards were relevant, they do not support Prager's arguments as the standards specify that "indemnification provisions are not permissible for audits of issuers." *See* PCAOB AS 1301, footnote 1 to Appendix C: https://pcaobus.org/oversight/standards/auditing-standards/details/AS1301.

PCAOB AS 1015.07 also specifies the need for "professional skepticism" which is "an attitude that includes a questioning mind and a critical assessment of audit evidence."[16] Prager's indemnification provisions impair professional skepticism and are antithetical to auditor independence as they insulate Prager from liability resulting from inaccurate or incomplete information (or knowing misrepresentations for some engagement letters) that the SEC Registrant Client may provide to Prager. If an auditor is indemnified against a client's inaccurate or incomplete information or knowing misconduct, the auditor will not be incentivized to, with due care and skepticism, obtain audit evidence, conduct a thorough audit, question management regarding suspect representations, or conduct additional testing in high-risk areas. Therefore, Prager's references to PCAOB General Auditing Standards do not absolve Prager from liability, but rather highlight the need for professional skepticism, which is impaired using indemnification provisions.

In further support of Prager's argument that its use of indemnification provisions was permissible, Prager cites the Commission's Codification §602.02.f.i. But the Codification does not support Prager's argument. The introduction to Section 602.02 of the Codification (Section 602.02.a.) provides that "the guidelines and illustrations presented in this section cannot be, nor are they intended to be, definitive answers on any aspect of this subject," and further explains that they "are designed to apprise the practitioners of *typical situations* which have involved loss of independence, whether in appearance or in fact, and by so doing to place them on notice of these and similar potential threats to their independence." Ex. B, Section 602.02.a. of the Codification.

Prager takes out of context Codification Section 602.02.f.i, which provides a response to a specific inquiry that included an indemnification provision with a carve-out for "willful misstatements or omissions." It follows that the response in the Codification also mentions the carve-out in its response. But the main take-away from the Codification is that once an auditor includes indemnification provisions in an engagement letter for an audit, review, or exam, the auditor is no longer independent as such provisions "induce a departure from the standards of objectivity and impartiality which the concept of independence implies." Section 602.02.f.i. of the Commission's Codification. The firm's objectivity and impartiality come into question

[16] PCAOB AS 1015.07: https://pcaobus.org/oversight/standards/auditing-standards/details/AS1015 .

because the auditor's "major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened." *Id.* Thus, the auditor's incentive to conduct a thorough audit and question management regarding management's representations is diminished because the auditor knows that it will be indemnified for management misrepresentations. Prager's inference that the Codification allows some types of indemnification provisions, while disapproving of others, is wholly unfounded and unsupported.

IV. Conclusion

The Commission's Complaint adequately pleads that Prager was not independent pursuant to Commission Rule 2-01(b) of Regulation S-X when it included indemnification provisions in engagement letters with its SEC Registrant Clients. Further, Prager included those provisions despite clear guidance and notice from the Codification and OCA's FAQs, and continued including indemnification provisions for several months after being put on actual notice by two partners and by the PCAOB that Prager's engagement letters contained the independence-impairing indemnification provisions. For all the foregoing reasons, the Court should deny Defendants' motion to dismiss in its entirety.

Dated: January 3, 2024

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on January 3, 2024, I electronically filed the foregoing with the Clerk of Court by using the CM/ECF system, which will send a notice of electronic filing to counsel of record, or service will be by means denoted below, upon the below list of counsel or *pro se* parties.

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