

FINISHING SARBANES-OXLEY: HOLDING AUDIT COMMITTEES ACCOUNTABLE

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INTRODUCTION

In the fight to protect American investors from marketplace fraud, the foundation for safeguarding public interest starts within the four walls of a corporation.¹ Ethical business practices, effective safeguards, and strict compliance with law are essential.² After clear failures by companies to uphold these principles snowballed into the Enron, WorldCom, and Tyco scandals, The Sarbanes-Oxley Act (“SOX”)³ was passed with one goal in mind: to protect investors and restore confidence in financial reporting by fixing auditing of U.S. public companies.⁴ To accomplish this, SOX requires public companies to have an audit committee within their board of directors: a committee of independent directors⁵ charged with, among other things, oversight of independent auditors⁶

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1. Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Speech at Emory University School of Law: Looking at Corporate Governance from the Investor’s Perspective (Apr. 21, 2014), <https://www.sec.gov/newsroom/speeches-statements/2014-spch042114laa> [https://perma.cc/WY6F-JBYP] (emphasizing that good corporate governance is essential to the stability of our capital markets and our economy, as well as the protection of investors).

2. Tom Krantz, *What is SOX (Sarbanes-Oxley Act) Compliance?*, IBM (June 27, 2025), <https://www.ibm.com/topics/sox-compliance#:~:text=To%20be%20SOX%20compliant%2C%20public,the%20accuracy%20of%20financial%20disclosures> [https://perma.cc/T5Z5-GVYK].

3. The Sarbanes-Oxley Act of 2002 (“SOX”) was enacted as Public Law 107-204, and most of its provisions in Titles I through V and Title VII are codified at 15 U.S.C. § 7201 *et seq.*

However, Section 301, Section 501, Title VI, and Article XI (other than Sections 1102, 1104, and 1107) amend or are codified in the Securities and Exchange Act of 1934, as amended (“Exchange Act”), which is codified at 15 U.S.C. § 78a *et seq.*

Title VIII (other than Sections 803 and 804), Title IX (other than Section 904), and Section 1107 amend or are codified in Title 18 of the U.S.C. § 1501.

Section 803 amends 11 U.S.C. § 523(a).

Sections 804, 905, and 1104 amend or are codified in Title 28 of the U.S.C.

Section 904 amends 29 U.S.C. § 1131.

Cross-references between and citations to the provisions of SOX, the Exchange Act, and the U.S.C. are made interchangeably throughout this Note.

4. John C. Coates IV, *The Goals and Promises of the Sarbanes-Oxley Act*, 21 J. ECON. PERSPS. 91, 91 (2007).

5. An “independent director” under audit committee standards is a director who complies with all SEC and exchange requirements for independent of audit committees. Generally, these independence requirements are heightened as compared to traditional directors and prohibit accepting any compensatory fee or being an affiliated person of the issuer. *See* 15 U.S.C. § 78j-1(m)(3)(B).

6. As used in this Note, “independent auditor” refers to the external audit company that is employed to assist with audits of the company at hand.

and the financial reporting process.⁷

However, under the current framework of federal securities law, audit committees face no meaningful consequences for failing to fulfill their federally mandated duties—even when such failures expose millions of investors to risk.⁸ This gap not only weakens the very protections investors depend on but also undermines the integrity of the markets, as millions are vulnerable to preventable risk.⁹

BF Borgers (“BFB”), a recent Securities and Exchange Commission (“Commission”) settlement case, depicts just how dangerous audit committee failures can be and how quickly they can affect millions of investors.¹⁰ In fact, the Commission’s former director of the Division of Enforcement, Gurbir S. Grewal, has credited this scheme as contributing to “one of the largest wholesale failures by gatekeepers in our financial markets.”¹¹ BF Borgers and its owner, Benjamin F. Borgers, were collectively charged with deliberate and systemic failures to comply with Public Company Accounting Oversight Board (PCAOB) standards in its audits and reviews incorporated in more than 1,500 Commission filings from January 2021 through June 2023.¹² According to the Commission’s order, among three-hundred-and-sixty-nine (369) clients whose public filings in the above period incorporated BFB audits and reviews, at least 75% incorporated audits and reviews that failed to comply with PCAOB standards.¹³ None of these hundreds of audit committees reported issues with their financial statements.¹⁴

This failure to fulfill their role as gatekeepers of the financial markets underscores the need for reforms in federal securities law to hold audit committees accountable for their oversight duties.¹⁵ Currently, when a committee fails to detect egregious fraud by independent auditors within their respective Commission filings, there is no applicable consequence within SOX

7. Michael W. Peregrine & Charles W. Elson, *The Important Legacy of the Sarbanes-Oxley Act*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 30, 2022), <https://corpgov.law.harvard.edu/2022/08/30/the-important-legacy-of-the-sarbanes-oxley-act/> [<https://perma.cc/R5DA-R2QA>].

8. See discussion *infra* Part II (analyzing the current applicable federal securities laws).

9. Aguilar, *supra* note 1 (“[M]illions of households invest in stock, bonds, and mutual funds in order to save for retirement These hard-working Main Street Americans are the investors that need to be kept in mind as we think about corporate governance.”).

10. See *In re BF Borgers CPA PC*, Securities Act Release No. 11,283, Exchange Act Release No. 100,053, Accounting & Auditing Enforcement Release No. 4,500 (May 3, 2024), <https://www.sec.gov/files/litigation/admin/2024/33-11283.pdf> [<https://perma.cc/8B6D-TD44>].

11. Press Release, *SEC Charges Audit Firm BF Borgers and Its Owner with Massive Fraud Affecting More Than 1,500 SEC Filings*, SEC (May 3, 2024), <https://www.sec.gov/newsroom/press-releases/2024-51> [<https://perma.cc/EC77-6QAC>].

12. *In re BF Borgers CPA PC*, *supra* note 10, at 3.

13. *Id.* at 7.

14. SEC, *supra* note 11.

15. See generally Coates, *supra* note 4, at 96–97 (“Auditors have traditionally been employed as gatekeepers to prevent, detect, and punish lying corporate agents.”) When considering the goals of Sarbanes Oxley upon its creation, it is clear that gatekeeping financial markets was the critical inquiry in the legislation and should remain a top priority in continued rulemaking.

or the Securities Exchange Act of 1934;¹⁶ all existing antifraud provisions require elements beyond those applicable to oversight roles.¹⁷ While holding an individual audit committee member liable for the entire committee's failure may be unreasonable, reforms are necessary to ensure audit committees, as a whole, are held accountable for failing to perform their oversight responsibilities.

Additionally, while investors have a private right of action against company directors under Section 11(a) of the Securities Act of 1933,¹⁸ a safe harbor in Item 407 of Regulation S-K shields audit committee members from liability for oversight failures.¹⁹ To ensure investors can hold committee members accountable, this safe harbor should be removed, thereby creating external incentives for audit committee members to exercise proper due diligence as required by law.

This Note will begin with a brief history of audit committees, their development, and their importance in the financial reporting process. It will then examine the current state of securities regulation applicable to audit committee members, highlighting its failure to accomplish the original objectives behind the Sarbanes-Oxley Act. After analyzing the shortcomings of current law, this Note will argue that the Commission must promulgate a new rule amending Sarbanes-Oxley to grant the Commission a clear enforcement mechanism against audit committees who fail in their oversight duties. Then, the Note will shift into discussing the private right of action shortcoming, advocating for modification of the abovementioned safe harbor in Item 407. The Note will conclude with a review of key policy considerations, emphasizing the importance of audit committee due diligence.

I. HOW AUDIT COMMITTEES DEVELOPED: AN OVERVIEW

An audit committee is an independent group of an organization's board of directors responsible for oversight of internal controls and key components of the company's financial reporting and disclosure processes.²⁰ Section 301 of SOX required that, no later than 270 days after enactment, "the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer²¹ that is not in compliance with the requirements of any portion of paragraphs (2) through (6)."²² These paragraphs outline several anti-fraud strengthening measures.

16. See discussion *infra* Part II.

17. See discussion *infra* Part II.

18. See 15 U.S.C. § 77k(a).

19. See 17 C.F.R. § 229.407(d)(5)(iv) (2025).

20. *Audit Committee*, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/accounting/audit-committee/> [<https://perma.cc/2Q6X-6HES>] (last visited Oct. 14, 2024).

21. "Issuer" is defined as any natural person, company, government, or political subdivision, agency or instrumentality of a government who proposes to issue any securities. See 15 U.S.C. § 78c(a)(8).

22. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–76 (footnote added).

Paragraph (2) states:

The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.²³

Thus, Section 10A(m)(1) of the Securities Exchange Act of 1934, as amended (“Exchange Act”), became effective April 25, 2003, requiring the rules of each national securities exchange and association to “prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion” of the regulation.²⁴ Additionally, the regulations require audit committees to disclose their responsibilities in Commission filings and certify the quality of independent auditors’ work.²⁵

Audit Committees play a vital role in the financial reporting system of public companies by overseeing financial reporting, internal controls, and the external, independent audit process.²⁶ As the previous Chief Accountant of the Commission, Paul Munter, stated, “Effective oversight by strong, active, knowledgeable, and independent audit committees significantly furthers the collective goal of providing high quality, reliable financial information to investors.”²⁷ Therefore, an audit committee that *actively* fulfills its oversight responsibilities is essential in setting a tone that emphasizes the importance of providing investors with accurate and reliable information.²⁸ Additionally, studies support the Commission’s stance that *active* audit committees make a difference in preventing financial misstatements and fraud, reinforcing the importance of holding audit committees liable for these critical responsibilities.²⁹

Audit committees play a key role in ensuring a company has a high “audit quality,” meaning the business creates an environment which maximizes the

23. *Id.*

24. 17 C.F.R. § 240.10A-3(a)(1) (2025).

25. See SEC, OMB 7100-0091, FORM 10-K GENERAL INSTRUCTIONS, ITEM 14.

26. *Audit committee oversight responsibilities*, DELOITTE, <https://www2.deloitte.com/us/en/pages/center-for-board-effectiveness/articles/audit-committee-responsibilities.html> [https://perma.cc/ZZ26-H9VH] (last visited Oct. 14, 2024).

27. Paul Munter, Chief Acct., SEC, *The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors* (Oct. 26, 2021), <https://www.sec.gov/newsroom/speeches-statements/munter-audit-2021-10-26> [https://perma.cc/T5CT-Q39T].

28. *Id.*

29. *Id.*

likelihood that quality and compliant audits are performed consistently.³⁰ One study even quantified audit quality using the following mathematical equation:

$$\text{Audit Quality during period } t = \text{company auditor value} + \text{audit committee size} + \text{meetings during period } t + \text{audit committee financial expertise for firm at period } t + \text{audit committee effectiveness for firm at period } t.^{31}$$

By examining audit committees in Nigeria and benchmarking their attributes to the requirements of the 2011 Commission code, the study's authors concluded that all the variables examined indeed contribute to audit quality.³² This finding demonstrates that audit committees that actively meet and effectively fulfill their federally mandated oversight duties directly correlate with improved audit quality.³³

A Canadian empirical study further supports these findings, reinforcing the critical role audit committees play in ensuring investor protection within capital markets.³⁴ The study reviewed literature on corporate oversight and its relationship with proxy governance measures linked to financial reporting quality, testing the idea that audit committees are “the ultimate monitor” of the financial accounting reporting system.³⁵ By synthesizing the results of multiple studies, the authors show that large and *active* audit committees have a clear, positive correlation with the quality of a company's audit.³⁶

Federal regulators emphasize the crucial role of audit committees in financial reporting, and empirical studies consistently link their effectiveness to higher audit quality. This underscores the critical function audit committees serve in safeguarding investors. However, for this role to be meaningfully upheld, clear enforcement mechanisms must exist to react when committees fail. As the following part demonstrates, the current federal securities framework lacks such a mechanism within Commission enforcement.

II. CURRENT COMMISSION REGULATIONS AND INAPPLICABILITY TO AUDIT COMMITTEES

Although SOX includes several liability provisions designed to prevent

30. Osariemen Asiriwa et al., *Audit Committee Attributes and Audit Quality: A Benchmark Analysis*, 19 BUS.: THEORY & PRAC. 37 (2018) (noting that audit quality is a key measure of consumer trust and confidence in a company's financial reporting process).

31. *Id.* at 43 (summarizing variation of equation from examining audit committees in Nigeria by benchmarking their attributes against U.S. regulator systems).

32. *Id.* at 47.

33. *Id.*

34. See Luo He et al., *Board Monitoring, Audit Committee Effectiveness, and Financial Reporting Quality: Review and Synthesis of Empirical Evidence*, J. FORENSIC & INVESTIGATIVE ACCT., July–Dec. 2009, at 18.

35. *Id.*

36. *Id.* at 28.

fraud, misstatements, and unethical conduct, these provisions are largely ineffective against audit committees and their members.³⁷ This is due to various protections from liability that are extended to audit committee members.³⁸ First, lack of scienter is a defense available to audit committee members accused of misconduct.³⁹ Second, the very duty of audit committees—to oversee—does not lend itself to liability.⁴⁰ Third, the extremely forgiving expert standards applicable to those serving on an audit committee aid in avoiding liability under federal securities laws requiring “professional” or “expert” involvement.⁴¹ As these and other relevant regulations and safe harbors within are explored below, it becomes evident that these liability provisions are inapplicable to audit committees.

A. Rule 10b-5 of the Securities Exchange Act of 1934

The best-known rule in securities law, which in fact pre-dates SOX by many decades, Rule 10b-5, states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴²

As discussed below, when attempting to apply the various subsections of this

37. As two examples of fraud prevention regulations failing to reach audit committees, see 17 C.F.R. § 240.10b-5 (2025) (prohibiting securities fraud) and 17 C.F.R. § 230.17(a) (2025) (addressing fraud under the Securities Act). These regulations are discussed further *infra* Part II.A and II.B.

38. See *infra* Part II.A and II.B.

39. To establish scienter, a plaintiff must show that an individual defendant acted with “intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

40. As is the case in *BFB*, it is important to remember that the fraud scheme was carried out by an independent auditor, and that the audit committee did not play a *direct* role in the scheme. See *In re BF Borgers CPA PC*, *supra* note 10, at 2–7.

41. Under Item 407 of Regulation S-K, a company may have a financial expert serving on the committee. See 17 C.F.R. § 229.407(d)(5)(i)(A)(1) (2025). However, a safe harbor prevents the financial expert from liability as an “expert” under Section 11 of the Securities Act of 1933. See 17 C.F.R. § 229.407(d)(5)(iv).

42. 17 C.F.R. § 240.10b-5.

rule to an audit committee that fails to oversee the work of the independent auditor, issues arise that limit each respective section's applicability.

1. *Making Untrue Statements Under Subsection (b) of 10b-5.*—Subsection (b) explicitly prohibits any person, directly or indirectly, to *make* any untrue statement of a material fact or to omit to state a material fact to make the statement not misleading.⁴³ A leading case in determining what (or who) constitutes the “maker” of a statement is *Janus Capital Group, Inc. v. First Derivative Traders*.⁴⁴ Here, the Supreme Court considered whether Janus Capital Management LLC (“JCM”), a mutual fund investment adviser, could be held liable under Rule 10b-5 for false statements included in its client’s (Janus Investment Funds) prospectus.⁴⁵ Janus Capital Group, Inc. (“JCG”) created a family of mutual funds, which was a separate legal entity from JCM.⁴⁶ JCM, a subsidiary of JCG, was hired as the fund’s investment advisor.⁴⁷ The prospectuses of several investment funds falsely stated that JCM was taking steps to prevent “market timing,” even though JCG and JCM were secretly allowing it.⁴⁸

The Supreme Court ruled that JCM was not liable under Rule 10b-5 because it did not “make” the false statements in the prospectus.⁴⁹ In a 5-4 decision, the Court narrowly held that, for purposes of 10b-5, “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”⁵⁰ Without such control, a person who prepares or publishes a statement on behalf of another is not its maker; they can only suggest what to say, not “make” the statement.⁵¹

However, four dissenting justices opposed this narrow interpretation, advocating for a broader definition of ‘making a statement.’⁵² They argued that “both language and case law indicate that, dependent upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately, or together, might ‘make’ statements . . . even if a board of directors has ultimate content-related responsibility.”⁵³ They further stated that, under the majority’s rule, it seems unlikely that the Commission itself “could exercise the authority Congress has granted it to pursue primary violators who ‘make’ false statements or the authority that Congress has specifically provided to prosecute aiders and abettors to securities violations.”⁵⁴

When applying the majority rule, audit committees are plainly beyond

43. *Id.* (emphasis added).

44. 564 U.S. 135 (2011).

45. *Id.* at 140.

46. *Id.* at 138.

47. *Id.*

48. *Id.* at 138–39.

49. *Id.* at 138.

50. *Id.* at 142.

51. *Id.*

52. *Id.* at 150–51 (Breyer, J., dissenting).

53. *Id.* at 150.

54. *Id.* at 157.

liability under 10b-5 as they are not the ‘maker’ of any statement. The Commission filings are under the ultimate authority of the company itself, while the audit committee is simply overseeing and recommending the inclusion of independent auditor work.⁵⁵ Thus, they are beyond liability under the *Janus* test for ‘making’ a false or misleading statement under Rule 10b-5.

2. *Employing Any Device to Defraud or Engaging in Any Act which Operates as Fraud under (a) & (c).*—As for 10b-5(a), a person who employs “any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security” may be held liable for a violation of 10b-5.⁵⁶ *Lorenzo v. SEC*, a recent Supreme Court decision, analyzes whether those who do not “make” false statements but merely “disseminate false or misleading statements to potential investors *with the intent to defraud*” can be found in violation of subsection (a) or (c).⁵⁷ In *Lorenzo*, the defendant’s firm was hired to sell fifteen million dollars’ worth of debentures.⁵⁸ However, the company had publicly disclosed, and explicitly told the defendant, that its intellectual property was worthless and its total assets were below \$400,000.⁵⁹ Shortly after, the defendant sent emails to prospective investors describing the offering and falsely stating that the company had “3 layers of protection” which included “\$10 million in ‘confirmed assets.’”⁶⁰ The Commission instituted proceedings against the defendant and ultimately found him in violation of Rule 10b-5, leading to this appeal.⁶¹

Sections 10b-5(a) and (c) both require scienter, but in *Lorenzo*, the appeals court’s scienter finding was not challenged by the defendant.⁶² “After examining the relevant language, precedent, and purpose,” the Supreme Court held that “dissemination of false or misleading statements *with intent to defraud* can fall within the scope of subsections (a) and (c) of Rule 10b-5 . . . even if the disseminator did not ‘make’ the statements and consequently falls outside subsection (b) of the Rule.”⁶³ “By sending emails he understood to contain material untruths, [the defendant] ‘employ[ed]’ a ‘device,’ ‘scheme,’ and ‘artifice to defraud’” under subsection (a).⁶⁴ The same behavior also constituted engaging in an act that operated as fraud or deceit under subsection (c).⁶⁵ The Court stated a bright-line rule: “Those who disseminate false statements with

55. See 17 C.F.R. § 229.407(d)(3) (2025) for the extent of audit committee review of financial statements.

56. 17 C.F.R. § 240.10b-5(a) (2025).

57. 587 U.S. 71, 74 (2019) (emphasis added).

58. *Id.* at 75.

59. *Id.*

60. *Id.*

61. *Id.* at 76.

62. *Id.* However, it should be noted that a showing of scienter is required under this rule. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (discussing scienter requirements).

63. *Lorenzo*, 587 U.S. at 78 (emphasis added).

64. *Id.*

65. *Id.*

intent to defraud are primarily liable under Rules 10b-5(a) and (c).⁶⁶

Although *Lorenzo* does expand 10b-5 liability beyond that recognized in *Janus*, it is unlikely to apply to audit committees that fail to detect the fraud of independent auditors before financial statements are published.⁶⁷ This is because, in such circumstances, the Commission would likely struggle to prove scienter, or any intent on behalf of the audit committee to defraud investors. Without this critical element (which was not at issue in *Lorenzo*), the audit committee cannot be said to have violated 10b-5.⁶⁸ Additionally, as under subsection (b), because an audit committee is not the party making such statement, it is further removed from the likelihood of liability under this section.⁶⁹

B. Rule 17(a) of the Securities Act of 1933

To this point, this Note has focused on the Exchange Act, which primarily regulates the securities market. In addition, Congress has enacted the Securities Act of 1933, as amended (“Securities Act”), which primarily regulates the offer and sale of securities themselves. Rule 17(a) of the Securities Act of 1933 states that:

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

- (1) To employ any device, scheme, or artifice to defraud, or
- (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.⁷⁰

When comparing the language of Rule 17(a) with Rule 10b-5, clear similarities in structure are evident as both rules prohibit fraud in the offer and sale of securities.⁷¹ However, Rule 17(a) diverges from 10b-5 in two critical components. First, unlike Rule 10b-5, which requires scienter, Rule 17(a) allows

66. *Id.* at 83.

67. *See, e.g., id.*

68. *Id.* The bright line rule explicitly requires a showing of intent to defraud investors (scienter).

69. *Id.* If the committee can establish that they are not responsible for disseminating the statement, then they are not liable under the bright line test.

70. 15 U.S.C. § 77q(a).

71. *Compare id., with* 17 C.F.R. § 240.10b-5 (2025) (the rules read similar and have the same structure).

for claims based on negligence, and it does not contain the ‘maker of the statement’ requirement so often contended in Rule 10b-5.⁷² Second, “subsections (1) and (3) of Section 17(a) apply to scheme liability,” while “subsection (2) applies to misstatement liability.”⁷³

1. *Scheme Liability under 17(a)(1) and (3).*—In cases like the audit committees in *BFB*, which failed to correct financial report misstatements committed by external audit companies, scheme liability under 17(a) is unlikely to be established.⁷⁴ Under 17(a), “a ‘device’ . . . is simply that which is devised, or formed by design; a ‘scheme’ is a project, plan, or program of something to be done; and an ‘artifice’ is an artful stratagem or trick.”⁷⁵ For the same reasons that Rule 10b-5 liability is unlikely to attach to audit committees, the Commission would likely be unable to prove that audit committees actively participated in a scheme to defraud simply by failing to exercise diligent oversight.

As stated in *SEC v. Kelly*, “where the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission, courts have routinely rejected the SEC’s attempt to bypass the elements necessary to impose ‘misstatement’ liability . . . by labeling the alleged misconduct a ‘scheme’ rather than a ‘misstatement.’”⁷⁶ Because the misstatement liability under 17(a) has a high burden of proof, courts have rejected any attempt by federal regulators to circumvent the difficulties under subsection (2) by recharacterizing a misstatement as a scheme. The U.S. District Court for the Southern District of New York has held that “allow[ing] primary liability to attach to individuals who did no more than facilitate preparation of material misrepresentations or omissions actually communicated by others . . . would swallow [the] bright-line test altogether.”⁷⁷ Thus, unless the Commission could show the audit committee colluding with an external auditor in a deliberate plan to misstate financial reports, an audit committee is unable to be held liable under scheme liability of 17(a) and must instead be found to have violated 17(a)(2).⁷⁸

2. *Misstatement Liability under 17(a)(2).*—Liability under Rule 17(a)(2) requires that a defendant both communicate an untrue statement or omission and receive money or property as a result of such misstatement.⁷⁹ Additionally, liability thereunder only requires proof of acting with negligence.⁸⁰ In *SEC v.*

72. See 15 U.S.C. § 77q(a).

73. *SEC v. Kelly*, 817 F. Supp. 2d 340, 345 (S.D.N.Y. 2011).

74. See *id.* at 345–46.

75. *Malouf v. SEC*, 933 F.3d 1248, 1260 (10th Cir. 2019) (quoting *Lorenzo v. SEC*, 587 U.S. 71, 78 (2019)) (internal quotations omitted).

76. *Kelly*, 817 F. Supp. 2d at 343.

77. *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 467 (S.D.N.Y. 2004).

78. It is important to again note that the core of this Note goes to audit committees who are *not* participating in a scheme to defraud, or any separate cause of action for such acts. This Note covers instead failure to oversee, a critical first step in maintaining integrity in the financial reporting system.

79. See 15 U.S.C. § 77q(a)(2).

80. See *id.*

Shanahan, the district court dismissed the claims against the defendant because of failure of proof.⁸¹ The Commission presented no evidence “with respect to the degree of care that an ordinary careful person would use under the same or similar circumstances, whether Mr. Shanahan, Jr., exercised reasonable care . . . [and] absolutely no evidence regarding Mr. Shanahan, Jr.’s duties as a member of [board].”⁸² This left the jury to speculate as to whether the duty truly existed and whether the defendant failed to perform such duty.⁸³

The Eighth Circuit agreed with the district court, highlighting just how high the burden under 17(a)(2) is for the SEC to hold a member of a board responsible.⁸⁴ It discussed the complexity in determining whether a defendant was negligent or engaged in the fraudulent practices and how evidentiary navigation of “complex issues” is required to determine if fraudulent practices occurred.⁸⁵ These complexities listed by the Court include “opinions accounting, [p]lan administration, the intricacies of securities filings,” the allocation of responsibilities between a company’s “professionals, outside auditors, inside and outside counsel, board of directors, and . . . [c]ommittees,” reliance on other professionals, and several other considerations.⁸⁶ This decision underscores the significant evidentiary burden under Rule 17(a)(2) and demonstrates why pinning liability for communicating a financial statement on a single committee—such as an audit committee—is likely unreasonable when multiple entities are involved in the process.

Additionally, 17(a)(2) requires receiving money or property in exchange for the communication of such false statement, an element not clearly defined by the courts. For example, in *SEC v. Wolfson*, a defendant ‘clearly’ received money or property by receiving a consulting fee for preparing a document in which he violated 17(a)(2).⁸⁷ However, in *SEC v. Forman*, the court held that when a defendant received a set, predetermined bonus not tied to a company’s performance, receiving money in exchange for the misstatement was not proven.⁸⁸ In *Forman*, the Commission also argued that the misstatement artificially increased the company’s stock price, thereby benefiting the defendant as a stakeholder.⁸⁹ However, the court rejected this claim due to the lack of evidence linking the misstatement to the stock price increase.⁹⁰ Given this precedent, it is unlikely that an audit committee member’s salary alone will be evidence of receiving money in exchange for a misstatement, absent proof that the salary is directly tied to performance of the company based on such

81. 646 F.3d 536 (8th Cir. 2011).

82. *Id.* at 545–46.

83. *Id.* at 546.

84. *Id.*

85. *Id.*

86. *Id.*

87. 539 F.3d 1249, 1264 (10th Cir. 2008).

88. *SEC v. Forman*, No. 07-11151-RWZ, 2010 WL 2367372, at *8 (D. Mass. June 9, 2010).

89. *Id.*

90. *Id.*

statement.⁹¹ Furthermore, the Commission's independence requirements limit the monetary fee that committee members may receive from an issuer.⁹² While this technical inquiry will depend on case-specific factors, it further raises the evidentiary burden for the Commission when considering the role of an audit committee.

Because 17(a) aims to target those who are primary violators of fraud provisions (much like 10b-5), an audit committee is not likely to be held liable under these statutes for failure of their oversight responsibilities.⁹³ This, however, does not diminish the importance of proper oversight by the committees.⁹⁴ It instead shows again that a statute explicitly enforcing proper oversight is a necessary next step for SOX.

C. Officer and Director Bars

Officer and director bars are among the most effective enforcement mechanisms available to the Commission, used to prevent an individual from serving as an officer or director of a public company following misconduct.⁹⁵ When Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990,⁹⁶ it did so in response to the "wide range of securities law violations in the large and increasingly complex securities markets."⁹⁷ This regulation remains central to the Commission's regulation of conduct within United States markets. In fact, in 2024, the Commission obtained orders barring 124 individuals from service as officers or directors of public companies—the second-highest number of such bars in a decade.⁹⁸

In defining the elements required for an officer and director bar, *SEC v. Patel* is a landmark case, serving to define substantial unfitness through the creation of a six-factor test.⁹⁹ The court identified the following factors as relevant in resolving issues of substantial unfitness: "(1) the 'egregiousness' of the underlying securities law violation; (2) the defendant's 'repeat offender' status; (3) the defendant's 'role' or position when he engaged in the fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the

91. *See id.*

92. *See* 15 U.S.C. § 78j-1(m)(3)(B).

93. *See* SEC v. Wolfson, 539 F.3d 1249, 1264 (10th Cir. 2008).

94. Violations of both statutes are frequently alleged by the SEC. *See Forman*, 2010 WL 2367372; *Wolfson*, 539 F.3d at 1249.

95. Jon Carlson, *Securities Fraud, Officer and Director Bars, and the "Unfitness" Inquiry after Sarbanes-Oxley*, 14 FORDHAM J. CORP. & FIN. L. 679, 685 (2009).

96. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. This is the Act which gave the Commission the power to enforce and use officer and director bars.

97. Carlson, *supra* note 95, at 684.

98. Press Release, SEC, *SEC Announces Enforcement Results for Fiscal Year 2024* (Dec. 17, 2024), <https://www.sec.gov/newsroom/press-releases/2024-186#:~:text=In%20addition%2C%20in%20fiscal%20year,bars%20obtained%20in%20a%20decade> [https://perma.cc/W5ZC-K2KJ].

99. *See* 61 F.3d 137 (2d Cir. 1995).

violation; and (6) the likelihood that misconduct will recur.”¹⁰⁰ Officer and director bars are important remedies within securities regulation as company executives are generally less motivated to reform behavior when only punished with fines.¹⁰¹ However, as discussed below, their applicability to audit committees is likely limited.

1. Audit Committees’ “Role” in Fraud Is Minimal.—Due to the pure oversight nature of an audit committee with respect to any fraud committed by an independent auditor, the audit committee’s “role” in the fraud is minimal under Barnard’s definition. As stated in her article:

[T]he first post-threshold question federal courts should consider when presented with a substantial-unfitness inquiry is whether the defendant’s unlawful conduct occurred while he was acting as an officer or director of a public company or whether he was acting in some nonexecutive capacity. The answer to this question should prove significant ¹⁰²

Audit Committee members are often also company executives but are performing as an independent committee separate of their executive function.¹⁰³ Additionally, as illustrated in *BFB*, the audit committee’s misconduct involved a failure to properly oversee an independent auditor—not the direct act of making the misstatements at issue.¹⁰⁴ Thus, their role in the fraud scheme itself is limited.

2. Lack of Scienter.—Under the Remedies Act, a court cannot enter a suspension or bar order absent a finding of scienter.¹⁰⁵ When outlining the elements considered by the court in *SEC v. Patel*, Barnard defined scienter by relying on *Sundstrand Corp. v. Sun Chemical Corp.*:

A defendant’s conduct may be intentional but, at a minimum, it must be “highly unreasonable, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have

100. *Id.* at 141 (listing factors suggested in a law review article by Jayne W. Barnard entitled *When Is a Corporate Executive “Substantially Unfit to Serve”?*, 70 N.C. L. REV. 1489, 1492–93 (1992)).

101. Carlson, *supra* note 95, at 685.

102. Jayne W. Barnard, *When Is a Corporate Executive “Substantially Unfit To Serve”?*, 70 N.C. L. REV. 1489, 1513 (1992).

103. See 17 C.F.R. § 240.10A-3(b)(1)(i) (2025) (“Each member of the audit committee must be a member of the board of directors of the listed issuer and, must otherwise be independent.”).

104. *In re BF Borgers CPA PC*, *supra* note 10.

105. Barnard, *supra* note 102, at 1515 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (holding that § 10(b) requires scienter), and *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (holding that 17(a)(1) requires scienter)).

been aware of it.”¹⁰⁶

A finding of scienter in cases involving a failure of oversight duties is highly unlikely, as establishing scienter requires showing an individual defendant acted with intent to deceive, manipulate, or defraud.¹⁰⁷ Because audit committees failing in their oversight role likely only amounts to negligence, not intentional misconduct, this falls short of the necessary threshold for a showing of scienter and prevents effective application of officer and director bars to such committees.

3. *Economic Stake*.—According to Barnard, “[l]ack of an economic stake need not insulate defendants from entry of a Remedies Act order, but the presence of an economic stake in a scheme to defraud investors should serve as an aggravating factor tending to favor such an order.”¹⁰⁸ This element serves as a prime example of why the officer and director bar does not work for audit committees. Unless the committee actively participated in the fraud scheme (a separate crime from failing to fulfill oversight duties), there would be no financial gain in merely failing to fulfill their duty to properly oversee the independent auditor.¹⁰⁹ While this does not dispose of the possibility of a bar, this consideration in conjunction with the rest of the above analysis, demonstrates why this remedy is unlikely to be enforceable against audit committees for failure in oversight capacity.

D. Rule 102(e)

Promulgated pursuant to authority granted by Section 602 of SOX, Rule 102(e) gives the Commission the power to suspend or bar a professional from appearing before the Commission, or revoke a firm’s registration.¹¹⁰ Specifically, the rule states:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: . . .

- (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
- (iii) To have willfully violated . . . Federal securities laws ¹¹¹

106. *Id.* at 1515–16 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

107. *Hochfelder*, 425 U.S. at 197. As discussed *supra* note 39, scienter can be shown through an actual intent to defraud or recklessness.

108. Barnard, *supra* note 102, at 1517.

109. See *supra* Part II.B.2 for a further discussion on the considerations of salary and financial gain in conjunction with the actions of the audit committee.

110. 17 C.F.R. § 201.102(e) (2025).

111. *Id.*

With respect to licensed accountants, improper professional conduct includes intentional conduct, reckless conduct, and two types of negligent conduct: a single instance of highly unreasonable conduct that violates applicable professional standards or repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards.¹¹²

Checkosky v. SEC, a 1998 case from the D.C. Circuit, sparked a critical amendment to Rule 102(e) that shaped the current reading.¹¹³ In *Checkosky*, the court found the Commission had not clearly articulated what constitutes “improper professional conduct” under 102(e).¹¹⁴ In response, the Commission amended the rule, with the final version published in October 1998.¹¹⁵ The Commission described the amendment as clarifying “the Commission’s standard for determining when accountants engage in ‘improper professional conduct’ under Rule 102(e)(1)(ii).”¹¹⁶ The amendment was intended to cover violations of professional standards that demonstrate *an accountant’s* lack of competence to practice before the commission.¹¹⁷

Further, this amendment came to fruition as the Commission aimed to underscore the importance of the role and the need for “*auditors* [to] exercise due care in their audit of a company’s financial statements.”¹¹⁸ In its final notice, the Commission explained:

Investors have come to rely on the accuracy of the financial statements of public companies when making investing decisions. Because the Commission has limited resources, it cannot closely scrutinize every financial statement. Consequently, the Commission must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements. In short, both the Commission and the investing public rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information.¹¹⁹

This amendment makes clear the intent of the Commission when promulgating and amending Rule 102(e)—it applies specifically to professional standards governing *accountants*.¹²⁰

Notably, audit committee members are not required to be *accountants* under SOX. While SOX itself does not define “accountant,” under PCAOB Rule 1001,

112. 17 C.F.R. § 201.102(e)(iv).

113. 139 F.3d 221 (D.C. Cir. 1998).

114. *Id.* at 223.

115. Amendment to Rule 102(e) of the Commission’s Rules of Practice, 63 Fed. Reg. 57164 (Oct. 26, 1998) (codified at 17 C.F.R. pt. 201).

116. *Id.*

117. *Id.*

118. *Id.* at 57164–65 (emphasis added).

119. *Id.* at 57165.

120. *Id.* (emphasis added).

as approved by the Commission, the term “accountant” means a natural person who either (1) is a certified public accountant, (2) holds a degree in accounting or a license or certification authorizing them to engage in the business of accounting, or (3) holds a degree in a field other than accounting and participates in audits—excluding individuals engaged solely in clerical or ministerial tasks.¹²¹

To serve on an audit committee, one must simply be an independent director of the publicly traded corporation.¹²² Because audit committees are neither comprised of “accountants” nor acting as accountants, they are likely beyond the scope of liability for violations of Rule 102(e).¹²³ This reading is further supported by the fact that no publicly available case law demonstrates the Commission bringing a successful 102(e) claim against an audit committee or audit committee member.¹²⁴ Thus, even if an argument could be made that audit committees are exposed to liability under Rule 102(e), such an application of the rule is far from established and has never been successfully pursued by the Commission.

After analyzing Rule 10b-5, 17(a), 102(e), and officer and director bars in relation to audit committees, a violation of a committee’s federally mandated oversight duty likely does not rise to the level of liability under these existing rules. That does not mean, however, that audit committee diligence is not important to the integrity of financial markets. As previously discussed, multiple empirical studies demonstrate a direct correlation between an audit committee actively fulfilling their oversight duties and higher audit quality. Moreover, in recent years, the Commission has emphasized its commitment to holding companies accountable for fulfilling mandated duties in publicly reported documents.¹²⁵ In fact, the Division of Enforcement stated, “it is foundational to the proper operation of the securities markets that public companies provide materially accurate information to investors Charging individuals for securities law violations, where appropriate, is essential for accountability and deterrence and for enhancing public trust in the markets.”¹²⁶ Therefore, to allow the Commission to continue its goal of enhancing public trust and preventing the disclosure of materially inaccurate information, audit committees must be diligent in executing their oversight responsibility. Holding audit committees liable will incentivize diligent oversight, improve audit quality, and boost public

121. Pub. Co. Acct. Oversight Bd., Bylaws and Rules, Rule 1001(a)(ii).

122. 17 C.F.R. § 240.10A-3 (2025). Only one person on the committee needs to have enough relevant experience to be deemed the boards “financial expert,” but they too are not required to be an accountant. *See* 17 C.F.R. § 229.407(d)(5)(i)(A)(1) (2025).

123. *See* 17 C.F.R. § 240.10A-3; 17 C.F.R. § 229.407(d)(5)(i)(A)(1) (under the federal regulations, audit committees have no requirement to have even one accountant as a member).

124. This point was determined by independent research on legal research platforms including Lexis and Westlaw with no results indicating that the Commission has used 102(e) as a cause of action as against the audit committee for failure to oversee the work of independent auditors.

125. SEC, *supra* note 98.

126. *Id.*

confidence in the market—a critical focus of the Commission in recent years.¹²⁷

III. A REGULATION ALLOWING THE COMMISSION ENFORCEMENT OVER AUDIT COMMITTEE MISCONDUCT

In creating a regulation allowing the Commission to enforce audit committee oversight roles, it is important to strike a balance between the public interest in effective oversight of financial reporting and the committee's limited role in the creation of such financial documents. Additionally, company executives are generally less motivated to reform their behavior when punished only with fines.¹²⁸ For this reason, a regulation in which the committee may be punished by a bar from future service as a committee member or director of any public company may represent the most appropriate balance between effectiveness and punitive response. Additionally, because a bar would not constitute a claim modeled on common law, it would likely avoid the constitutional concerns raised in the recent *Jarkesy* decision, allowing the Commission to impose such penalties without implicating the jury trial requirement addressed in that case.¹²⁹

A. The Jarkesy Issue

On June 27, 2024, the Supreme Court in *SEC v. Jarkesy* ruled that the Seventh Amendment's right to trial by jury applies to certain enforcement actions brought by the Commission, severely limiting what actions can be requested in administrative proceedings.¹³⁰ The court held that any claim modeled on a common law cause of action and seeking a remedy available only in courts of law is entitled to a jury trial in an Article III court.¹³¹ Thus, defendants facing monetary penalties are entitled to trial by jury.¹³² However, non-common law remedies, such as a bar from the privilege of appearing before the Commission, may still proceed through administrative hearings.¹³³

127. *Id.*

128. Barnard, *supra* note 102, at 1517.

129. *See SEC v. Jarkesy*, 603 U.S. 109 (2024).

130. *Id.* at 139–40.

131. *Id.* at 133 (“To determine whether the claim implicated the Seventh Amendment . . . We examine[] whether the matter was from [its] nature ‘subject to a suit at common law.’”) (some internal quotation marks omitted).

132. *Id.* at 151 (Gorsuch, J., concurring) (discussing how the “in-house civil-penalty scheme” violated Article III).

133. *Id.* (“Because the action the SEC seeks to peruse is not the stuff of equity or admiralty jurisdiction but the sort of suit historically adjudicated before common-law courts, the Seventh Amendment [applied].”) However, since a bar from the privilege of appearing before the Commission is *not* a suit historically adjudicated before common law courts, it may peruse in administrative hearings.

*B. Example Regulation-Bar from Serving on Any Public
Company Board of Directors*

In creating this regulation, the Commission could simply amend the Rules of Practice, codified under 17 C.F.R. § 201.100.¹³⁴ The Commission Rules of Practice serve as a comprehensive procedural framework for how the SEC conducts investigations, hearings, and behaviors that constitute enforcement actions.¹³⁵ A regulation prohibiting a director from serving on an audit committee would be a natural fit within this framework.¹³⁶ Borrowing structure and form from Rule 102(e), a model regulation could read:

(e) *Suspension of ability to serve on audit committee—*

(1) **Generally.** The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it as a member of any audit committee or public company board of directors to any person who is found by the Commission after notice and opportunity for hearing in the matter:

(i) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct;
or

(ii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder;
or

(iii) To have engaged in intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable mandated duties of audit committees; or

(iv) The following negligent conduct:

(A) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an audit committee (or member thereof) knows, or should know, that heightened scrutiny is warranted.

(B) Repeated instances of unreasonable conduct, each resulting in a violation of applicable audit

134. See 17 C.F.R. pt. 201 (2025).

135. *Id.* This regulation covers everything from penalties against accountants to business hours, hearing officers, filing with the commission, and definitions, among other things.

136. *Id.* Because this regulation covers such a broad scope of administrative action, adding another cause for administrative action seems a natural fit.

committee standards, that indicates a lack of competence to serve on such audit committee.¹³⁷

By adopting the form of Rule 102(e), this proposed regulation would give the Commission broad authority to investigate and address a wide range of audit committee misconduct.¹³⁸

With a regulation like this in place, audit committees would face a direct consequence for failing to fulfill their federally mandated duties. When audit committees fail to perform adequate oversight, as was the case in *BFB*, the Commission would have multiple avenues under this model regulation to hold them accountable because of the broad scope of the regulation. This framework would enable the Commission to develop its case and pursue liability against audit committees, provided it can meet its burden of proof.¹³⁹ By establishing a clear procedure for addressing audit committee shortcomings, this regulation would create a powerful incentive for committees to diligently fulfill their responsibilities and enhance oversight quality.

C. Implementing the Regulation Via Commission Rulemaking Under the Administrative Procedure Act

Because the Commission is tasked with overseeing the securities market and possesses the most comprehensive knowledge of current regulations, its staff is best positioned to develop a regulation that appropriately balances the interests of audit committee members with the need to address potential negligence in oversight.¹⁴⁰ When proposing new regulations, the Commission has a specific rulemaking process that ensures their compliance with the Administrative Procedure Act (APA), the federal law governing agency rulemaking.¹⁴¹ The APA first requires notice of proposed rulemaking to be

137. This model regulation was based in structure and form on 102(e), with language changes that allow for the regulation's applicability to audit committee members. See 17 C.F.R. § 201.102(e) (2025). As discussed previously, 102(e) is an incredibly well-written regulation from the Commission's perspective. However, with its scope limited to only accountants, it is unable to be used against audit committee members. Thus, an "easy" solution is to simply follow 102(e) in form and language, with slight adjustments as done above.

138. See *id.* The Commission may pursue for violation of securities law, or a demonstration of a lack of integrity or competence, making the scope very broad. This would translate to the new regulation if the language of 102(e) is used.

139. Traditionally, the Commission uses the "preponderance of the evidence" standard. See *In Re M.V. Gray Investments, Inc.*, Release No. 9180, 1971 WL 120492 (May 20, 1971).

140. See *Mission*, SEC (Aug. 9, 2023), <https://www.sec.gov/about/mission> [<https://perma.cc/G5UE-S86Z>]. As the government entity focused on securities law, they are the "subject matter experts" and best situated to amend the Commission rules.

141. *Suggestions for How Individual Investors Can Comment on SEC Rulemaking: Updated Investor Bulletin*, SEC (May 14, 2024), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-39> [<https://perma.cc/6QJ3-WRS4>]. This gives a detailed overview of the Commission's rule-making process.

published in the Federal Register, which includes a statement of time, place, and nature of the public rulemaking proceedings, reference to the authority under which the rule is proposed, and the terms or substance of the rule or a description of the issues involved.¹⁴² Following this notice, the agency must afford interested parties the opportunity to participate in rulemaking through submission of views and arguments during a period that must be, at a minimum, thirty days in length.¹⁴³ All persons must also have the right to petition for “the issuance, amendment, or repeal of a rule.”¹⁴⁴ The Commission’s “standard” rulemaking process is more than sufficient for both complying with the APA and giving the Commission power to propose this rule via agency rulemaking.¹⁴⁵ Through the Commission’s process, the rule would go through a concept release, proposing release, and adopting release process with public input twice throughout the process.¹⁴⁶

IV. AMENDING INVESTORS’ PRIVATE RIGHT OF ACTION AGAINST AUDIT COMMITTEES

When a company sells its securities to the public, Section 11 of the Securities Act allows investors to sue for damages if any part of a registration statement¹⁴⁷ contains false or misleading information of a material nature, or omits material information that makes the registration statement misleading.¹⁴⁸ Such claims may be brought against the company issuing the securities (the “issuer”), the directors of the issuer, and every accountant and other expert (“experts”) who have prepared or certified any report used in the registration statement.¹⁴⁹ Because audit committee members are by definition directors, they are included as potential defendants, along with the issuer’s independent auditors.¹⁵⁰ Generally, a private action for damages under Section 11(a) may be brought by any person acquiring such security, unless it can be shown that said purchaser knew of the misstatement or omission.¹⁵¹ The action must be brought within one year after the discovery of the misstatement or omission, or after such discovery should have been made through the exercise of reasonable

142. Administrative Procedure Act, 5 U.S.C. § 553.

143. 5 U.S.C. § 553(d).

144. 5 U.S.C. § 553(e).

145. SEC, *supra* note 141.

146. *Id.*

147. Securities Act of 1933, Pub. L. No 73-22, § 11 (codified at 15 U.S.C. § 77k(a)). The Registration statement is a document filed with the Commission that includes, among other things, the prospectus that offers the securities for sale and the company’s audited financial statements. *See What is a Registration Statement?*, SEC (Nov. 12, 2024), <https://www.sec.gov/resources-small-businesses/going-public/what-registration-statement> [<https://perma.cc/8EMW-NFE3>].

148. *See* 15 U.S.C. § 77k.

149. *Id.*

150. *Id.*; Audit Committee Disclosure, 64 Fed. Reg. 73389 (Dec. 30, 1999) (codified at 17 C.F.R. pts. 210, 228, 229, 240).

151. 15 U.S.C. § 77k. No reliance on the misstatement or omission must be shown.

diligence, but no more than three years after the security was initially offered to the public.¹⁵²

A claim under Section 11(a) does not require a showing of either a “scheme” or of “scienter,” which, as we have seen, has limited to ability to hold members of audit committees accountable under other theories of recovery.¹⁵³ As such, Section 11(a) would appear to be a very promising avenue for doing so. However, Section 11(b)(3) provides several due diligence defenses for persons other than the issuer—including directors and independent auditors—facing liability under Section 11(a).¹⁵⁴ Any person considered to be an “expert” must demonstrate that, after a reasonable investigation, the defendant had reasonable grounds to believe—and did in fact believe—that such statements made by the expert were accurate.¹⁵⁵ For a non-expert, the burden is much lower. The reasonable investigation requirement falls away, and non-experts must only prove they had no reasonable ground to believe, and did not believe, that the expert-provided information was materially false or misleading.¹⁵⁶

The classic “experts” for these purposes are the issuer’s independent auditors.¹⁵⁷ Because audit committee members do not prepare or certify any reports included in registration statements, they are not “experts” under Rule 11(a)(3) and are not subject to the more rigorous due diligence standard applicable to experts. SOX encourages, though does not require, at least one member of a company’s audit committee to be a “financial expert.”¹⁵⁸

One would think the financial *expert* on an audit committee would be held to the expert standard under 11(b)(3). However, a safe harbor protects the financial expert from exposure to expert liability under Section 11(a) of the Securities Act.¹⁵⁹ Indeed, under Item 407(d)(5) of Regulation S-K, “a person who is determined to be an audit committee financial expert will not be deemed an *expert* for any purpose, including without limitation for the purposes of section 11.”¹⁶⁰ As such, even though a member of the audit committee is designated a “financial expert,” the member has no more liability for material

152. 15 U.S.C. § 77m.

153. *See* 15 U.S.C. § 77k(c) (discussing the standard for a reasonable investigation to ensure the statement was true is simply “that required of a prudent man in the management of his own property”).

154. *See* 15 U.S.C. § 77k(b)(3).

155. *Id.*

156. *Id.*

157. This status is imposed by 15 U.S.C. § 77k(a)(4) (stating that accounts are included because their “profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any report or valuation which is used in connection with the registration statement”). For more information, see *SEC 2300 - Experts Language*, PWC (Sep. 17, 2024), https://viewpoint.pwc.com/dt/us/en/pwc/pwc_sec_volume/pwc_sec_volume_US/2000_registration_un_US/sec_2300_expertizati_US.html#pwc-topic.dita_031c2887-99da-4419-99c0-3d092e84748 [https://perma.cc/35JW-YZAL].

158. *See* 17 C.F.R. § 229.407(d)(5)(i) (2025).

159. 17 C.F.R. § 229.407(d)(5)(iv).

160. *Id.* Regulation S-K is a Commission regulation that prescribes what and how issuers must disclose on registration statements, periodic reports, and any other filings.

misstatements or omissions in the issuer's audited financial statements than any other director.¹⁶¹

The committee that is statutorily mandated to investigate and recommend auditor work for accuracy is currently held to a due diligence standard that requires less than that of the auditors they oversee.¹⁶² Those with greater authority should have greater responsibility under the law, not less. Cases like *BFB* demonstrate that without holding audit committees to a higher standard, financial reporting is not adequately supervised.¹⁶³ For this reason, the language contained in Item 407(d)(5)(iv) should be amended, and audit committee members should be held to the expert standard under private actions arising out of 11(a). By upping the due diligence standard of audit committee members, the committee will operate at a higher standard of due diligence, one that exactly aligns with the intentions behind creating their oversight role in SOX.¹⁶⁴

As with 102(e), modifying the safe harbor contained in 407 does not change the obligation of the committee.¹⁶⁵ Under SOX, an audit Committee must submit a report stating that, based on review of the audit and discussion with the auditors, they recommend to the Board of Directors that the audited financial statements be included in Annual Reports or Form 10-K.¹⁶⁶ The expert standard under Section 11(a)(3) requires proof of a reasonable investigation into the accuracy of statements made and of reasonable grounds to believe and actual belief that the information in the registration statement contained no material false statements or omissions.¹⁶⁷ These are highly analogous if not substantially the same requirement. Therefore, modifying 407 would not increase audit committee liability, but instead would directly fulfill the objectives of SOX.

The Commission acknowledged in its amendment of Rule 102(e) that it lacks the resources and time to verify every detail of financial statements for accuracy.¹⁶⁸ Because of these limitations, audit committees play a critical role in ensuring accuracy and compliance. Since the Commission cannot review each financial statement, they must provide investors with enforcement mechanisms to ensure this legally required duty is properly fulfilled. The modification of Item 407 provides such a mechanism. By aligning Item 407 with the objective of SOX, this modification ensures that audit committees remain diligent in their oversight and enhances the reliability of financial disclosures.

161. *Id.*

162. *See id.* Compare this to 15 U.S.C. § 77k(a)(4) to see the discrepancy in liability.

163. SEC, *supra* note 11.

164. *See* 17 C.F.R. § 229.407(d) (requiring proof of reasonable investigation into the audit directly aligns with the requirements of Item 407, which requires reviewing and discussing the audited financial statements and independent status of the auditors before recommending to the board of directors that the audited financial statements be included in the company's annual reports).

165. *Id.*

166. *Id.*

167. 15 U.S.C. § 77k(b).

168. Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164 (Oct. 26, 1998) (codified at 17 C.F.R. pt. 201).

V. POLICY CONSIDERATIONS

SOX was implemented to address widespread corporate fraud and restore trust in financial markets.¹⁶⁹ However, despite its successes, gaps in enforcement oversight remain, particularly regarding audit committees. This part examines two key policy considerations related to the implementation of SOX, focusing on the critical role audit committees play in accomplishing the law's objectives. Strengthening protections against audit committee oversight failures is essential to preventing financial fraud and improving audit quality, demonstrating the need for new regulations to better align the federal securities framework with these policy considerations.

A. Protect the Public from Financial Fraud & Misconduct

SOX came at a time where desperate change was needed to restore confidence in the American marketplace. It instituted several laws designed to protect stockholders from fraud, deceit, and deception within the market. As Securities and Exchange Commissioner Paul Atkins said in February 2003, seven months after the implementation of SOX,

Sarbanes-Oxley strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest The role of directors is to monitor and oversee that situation on behalf of stockholders Since some of the recent problems concerned corporate managers using the corporation as a personal "piggy bank" or other theft by management of corporate assets, the Act's emphasis on a board's oversight function is certainly a step in the right direction.¹⁷⁰

While the act was a step in the right direction, cases like *BFB* illustrate the work that needs to be done to finish the goal of SOX. The audit committee serves as the initial gatekeeper for stockholders, providing a layer of oversight to the work of independent auditors. When the committee fails in that role, fraud can occur and investors face losses. Thus, to truly realize what SOX set out to accomplish over twenty years ago, a clear path for enforcement of those in oversight roles is long overdue.

B. Increase Audit Quality

A primary goal of SOX was to improve audit quality and reduce fraud—

169. Coates, *supra* note 4, at 91.

170. Paul S. Atkins, Comm'r, SEC, The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation (Feb. 5, 2003), <https://www.sec.gov/news/speech/spch020503psa.htm> [<https://perma.cc/MD9C-Y9FC>].

and the legislation has been relatively successful at doing so.¹⁷¹ It created new incentives for firms to invest in internal controls, policies, and oversight of the financial reporting process beyond any previous measures.¹⁷² However, the audit committee does play a critical role in mitigating fraud risk. The committee works with management and independent auditors to oversee antifraud controls and is tasked with taking appropriate actions when fraud is detected.¹⁷³ By establishing a clear consequence for failure to take these steps, committees will be more motivated to truly fulfill their responsibilities, therefore increasing audit qualities for their respective companies.

CONCLUSION

When Congress enacted SOX, investor protection was the main objective. The legislation created a complex statutory framework to protect stockholders. However, as illustrated by *BFB*, a significant gap currently exists in the regulations, threatening the safety of investors from fraud within public company financial reports with no way to hold the guilty party liable for their oversight failures.

This Note examined the current state of federal securities law and illustrated how the current antifraud provisions and Commission penalties fail to properly apply to audit committee members who egregiously fail in their oversight duties. In response, this Note argued that a new regulation is necessary to fill this gap. This Note contained two proposed changes to federal securities law. First, the Commission must implement a regulation which allows for a clear path of enforcement against audit committee members who fail to uphold their statutorily mandated oversight duties. With Rule 102(e) serving as a guide, a regulation similar in scope, but applicable to audit committees, allows for the most efficient and effective enforcement scheme. By avoiding civil penalties and instead relying on a bar sanction, the Commission avoids the *Jarkesy* federal court requirement and may bring these cases before an administrative law judge. Second, this Note urged for the modification of Item 407's safe harbor, specifying that audit committee members be held to the "expert" standard in Section 11(b)(3) in the case of material misrepresentations or omissions in securities' offerings. By treating audit committee members as experts, we are, in fact, not adding to the job of audit committees. Investors expect audit committees to partake in statutorily mandated due diligence. These new regulations will result in increased investor protection, more confidence in the marketplace, and an increase in audit quality for publicly traded companies. By enacting these changes, the original goals and promises of Sarbanes-Oxley will finally be accomplished, over twenty years after its inception.

171. Coates, *supra* note 4, at 97.

172. *Id.* at 92.

173. *See generally* DELOITTE, *supra* note 26.