

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

In the Matter of :
 :
KENNETH L. RUBIN, CPA and : INITIAL DECISION
MICHAEL W. LEWIS, CPA : September 8, 2005
 :

APPEARANCES: Jarett B. Decker and Carolann Gemski, for the Division of Enforcement and Office of the Chief Accountant, Securities and Exchange Commission.

Martin M. Green and Joe D. Jacobson of Green, Schaaf & Jacobson, P.C., for Kenneth L. Rubin, CPA, and Michael W. Lewis, CPA.

Thomas A. Litz of Thompson Coburn LLP for Kenneth L. Rubin, CPA, and Michael W. Lewis, CPA.

BEFORE: Robert G. Mahony, Administrative Law Judge.

I. INTRODUCTION

The Securities and Exchange Commission (Commission) issued an Order Instituting Proceedings (OIP) on November 29, 2004, against Kenneth L. Rubin (Rubin), and Michael W. Lewis (Lewis) (collectively, “Respondents”), pursuant to Rule 102(e) of the Commission’s Rules of Practice (Rule 102(e)). See 17 C.F.R. § 201.102(e).¹

The OIP alleges that Rubin and Lewis, as the engagement partner and manager, respectively, for the accounting firm of Rubin, Brown, Gornstein & Co., LLP (RBG), engaged in improper professional conduct during their audit of Eisner Securities, Inc. (ESI), for the year ended December 31, 2000 (2000 audit). The OIP alleges that ESI’s financial statements were not prepared in accordance with generally accepted accounting principles (GAAP), and the audit

¹ Rule 102(e)(1), as amended in 1998, was codified by the Sarbanes-Oxley Act of 2002. 15 U.S.C. § 78d-3.

report, signed by Rubin in his firm's name, was not prepared in conformance with generally accepted auditing standards (GAAS).² Specifically, the financial statements failed to include an accrual for a contingent liability that resulted from ESI's offer to settle potential claims of its customers who had funds misappropriated by a former registered representative, Joseph E. Erwin (Erwin). The OIP alleges that, under GAAP, an accrual was required pursuant to Statement of Financial Accounting Standards No. 5 (FAS 5).³ The failure to adhere to GAAP hid ESI's violation of Section 15(c)(3) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 15c3-1 promulgated thereunder, commonly known as the "net capital rule."

Further, the OIP alleges that Respondents failed to comply with GAAS, as they failed to obtain sufficient competent evidential matter, exercise due professional care, and maintain an attitude of professional skepticism. ESI management disclosed to Respondents, during the planning stages of the audit, that Erwin misappropriated approximately \$2 million from his customers' accounts. The OIP alleges that Respondents received an attorney confirmation letter from outside counsel that contradicted, rather than confirmed, management's assertion that no customer claims were probable of assertion under FAS 5. The OIP alleges that Respondents, despite the receipt of this letter, failed to conduct any follow-up procedures to obtain additional information regarding the claims of the customers whose funds were embezzled by Erwin. Accordingly, the OIP alleges that Respondents failed to render an accurate audit report.

The OIP alleges that on September 26, 2001, more than seven months after the audit report was issued, ESI reported to the Commission and the National Association of Securities Dealers (NASD) that it was in violation of the net capital rule. ESI was placed in liquidation proceedings on October 31, 2001, by the Securities Investor Protection Corporation and voluntarily withdrew its broker-dealer registration under Section 15 of the Exchange Act on December 2, 2001.

Due to the conduct described above, the OIP alleges that Respondents engaged in intentional or knowing conduct, including reckless conduct, that resulted in a violation of applicable professional standards, or in the alternative, negligent conduct consisting of a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which Respondents knew, or should have known, that heightened scrutiny was warranted. 17 C.F.R. § 201.102(e)(1)(iv)(A)-(B)(1).

² GAAP are guidelines, established by the Financial Accounting Standards Board (FASB) and other accounting industry authorities, used to measure economic activity and present them in the form of financial statements and related disclosures. See SEC v. Arthur Young & Co., 590 F.2d 785, 788-89 n.4 (9th Cir. 1979). GAAS are a set of standards that govern how auditors should perform an audit. Id. at 788 n.2. They differ in that GAAP involve the measurement, timing of recognition, disclosure, and presentation of financial information, while GAAS govern how auditors verify this information. Id. at 788-89 nn.2 & 4.

³ FAS 5 governs the accounting treatment of contingent liabilities and assets.

A hearing was held in St. Louis, Missouri, on April 4 and 5, 2005.⁴ The Division of Enforcement and the Office of the Chief Accountant (collectively, the “Division”) submitted fifteen exhibits and called Respondents and one expert witness.⁵ Respondents did not submit any exhibits and called Rubin and two expert witnesses.⁶ The parties submitted posthearing briefs and proposed findings of fact and conclusions of law.⁷

In their posthearing brief, Respondents argue that they did not violate any applicable professional standard, as their audit was performed in accordance with GAAS. They contend that their inquiries to ESI management were appropriate, as was their reliance on management’s representation that no accrual was necessary for Erwin’s theft of customer funds. Respondents also argue that they followed applicable GAAS procedures by requesting that ESI’s outside counsel confirm management’s position that no accrual was necessary for any pending litigation involving Erwin’s former customers. Since outside counsel’s letter failed to indicate any unasserted claims were probable of assertion and that ESI would vigorously defend the two asserted claims, Respondents argue that the attorney confirmation letter provided sufficient evidential matter to support management’s assertion that no accrual was necessary.

To the extent that management’s representations or outside counsel’s confirmation of those representations were false, Respondents argue that they were misled. Accordingly, Respondents concede that although the financial statements were not in conformance with GAAP, they still adequately performed the audit procedures required by GAAS. (Resp. Br. 22.) Had management or its outside counsel disclosed ESI’s settlement offers, Respondents contend, they would have insisted that a contingent liability accrual be included in the financial

⁴ In a joint motion and stipulation (Joint Stipulation), the parties notified this Office that the official transcript of the hearing contained numerous transcription errors. See Joint Stipulation (filed June 8, 2005). The parties jointly prepared a listing of errors and proposed corrections of the transcript (Errata Sheet), which they represent is their best efforts to correct the transcript with reasonable accuracy. See Joint Stipulation at Ex. B. The official transcript was ordered amended by the Errata Sheet pursuant to Rule 302(c) of the Commission’s Rules of Practice, 17 C.F.R. § 201.302(c). See Kenneth L. Rubin, Admin. Proc. 3-11748 (June 8, 2005) (unpublished). Thus, all citations to the transcript in this Initial Decision will refer to the official transcript as amended by the Errata Sheet.

⁵ The Division’s Exhibit 13 contains various American Institute of Certified Public Accountants (AICPA) auditing standards. Exhibit 13 is subdivided into 13 subsections, labeled as Exhibits 13A through 13M.

⁶ Respondents submitted two expert witness reports, which were entered into the record as the Division’s Exhibits 9 and 10.

⁷ Citations to the transcripts are noted as “(Tr. __.)” The Division’s exhibits are noted as “(Ex. __.)” The Division’s posthearing brief is noted as “(Div. Br. __.)” and Respondents’ posthearing brief is noted as “(Resp. Br. __.)”

statements. Thus, Respondents assert they committed no violation under Rule 102(e) and request this proceeding be dismissed. (Resp. Br. 11-27.)

II. FINDINGS OF FACT

The findings and conclusions herein are based on the record, my observation of the testifying witnesses, all arguments, proposals of facts, as well as the relevant statutes and regulations. Preponderance of evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91 (1981). All arguments, proposed findings, conclusions, and contentions set forth by the parties were considered and only those consistent with this Initial Decision are accepted.⁸

A. Background

Rubin, age 47, is a resident of St. Louis, Missouri. He graduated from the University of Illinois at Urbana-Champaign with a bachelor's degree in accountancy in 1979. (Tr. 197.) He is a licensed certified public accountant (CPA) authorized to practice in Missouri. Rubin joined RBG in 1979 and was promoted to manager in 1983. He became an audit partner in 1986. (Tr. 198.)

Lewis, age 35, is also a resident of St. Louis, Missouri. He graduated from Southeast Missouri State University in 1992 with a bachelor's degree in accounting. (Answer ¶ 2; Ex.10 at 3.) Like Rubin, he is a licensed CPA authorized to practice in Missouri. (Answer ¶ 2.) He joined RBG in 1992, was promoted to manager in 1998, and, subsequent to the 2000 audit, was promoted to audit partner on June 1, 2004. (Answer ¶ 2; Tr. 14-15.)

RBG is an accounting and business consulting firm based in St. Louis, Missouri. The firm has more than 250 employees, which places it among the fifty largest accounting firms in the country. (Ex. 10 at 1.)

ESI, formerly headquartered in St. Louis, Missouri, was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act on May 15, 1996. Since its establishment, ESI has retained RBG as its independent auditor. (Ex. 10 at 3.) Rubin served as RBG's engagement partner for the ESI account since 1996. (Ex. 10 at 3.) On November 21,

⁸ Respondents filed a Motion to Strike Proposed Findings of Fact Submitted by the Enforcement Division on August 2, 2005. Specifically, Respondents request striking paragraphs 4 through 9, 11, 12, 17, 19, 20, 25, and 97 of the Division's Proposed Findings of Fact and Conclusions of Law. These paragraphs cite either a Commission order, Charles A. Dairaghi, 84 SEC Docket 945 (Nov. 29, 2004), not entered into evidence or allegations in the OIP, some of which Respondents denied in their Answer. Respondents' motion to strike is GRANTED insofar as the Division's proposed findings of fact are based on the Dairaghi order or a denial in the Answer, absent proof of the allegations. The motion is DENIED insofar as the Answer admits some or all of the questioned paragraphs.

2000, Charles Dairaghi (Dairaghi),⁹ ESI's chief financial officer, signed an engagement letter for RBG to perform the 2000 audit. (Ex. 2 at RBG00119-22.) Rubin again served as the engagement partner for the 2000 audit with Lewis serving as the engagement manager. The 2000 audit was the first time Lewis worked on an engagement for ESI. (Tr. 20.) At the time, Lewis had only participated in two prior broker-dealer audits, but Rubin had extensive experience in auditing broker-dealer firms. (Tr. 19, 198-99.)

As the engagement partner, Rubin described his duties as having "overall responsibility of the engagement, overall review, consultation and overall client relationship." (Tr. at 199.) He described Lewis's duties, as the engagement manager, as having "the responsibility for overall supervision of the engagement, detailed review of the workpapers, detailed review of the staff accountant's workpapers, communicating progress all throughout the engagement to the engagement partner" (Tr. 199.)

Along with Dairaghi, RBG's other point of contact for the 2000 audit at ESI was Bruce D. Oakes (Oakes), ESI's chief operating officer since its inception in 1996. (Ex. 2 at RBG0091.) Oakes was also licensed as a financial and operations principal (FINOP) by the NASD. (Tr. 23.) During the 2000 audit, Oakes was the registered FINOP for ESI because Dairaghi had not yet received his FINOP license from the NASD. (Tr. 23-24.) Prior to the hiring of Dairaghi, Oakes was in charge of the finance and accounting functions at ESI, along with his duties as the chief operating officer. (Tr. 24-25.)

Joseph E. Erwin (Erwin) was a registered representative for ESI in its Columbus, Ohio, office. From 1997 through 2000, Erwin embezzled funds from at least eleven customer accounts. (Ex. 6.) Upon discovery of illegal activities in these accounts, ESI terminated Erwin in September 2000 and launched an internal investigation.¹⁰ As part of the investigation, ESI created a spreadsheet that listed the amount of funds misappropriated from each customer account. (Ex. 6.) ESI estimated that the amount misappropriated by Erwin totaled approximately \$2 million. (Tr. 36-37; Ex. 6.)

⁹ Dairaghi was a former auditor at RBG. According to Lewis, Dairaghi was the previous engagement manager for the ESI audit, a role he served for four to five years. (Tr. at 20-22.) Dairaghi was hired by ESI about six months before the 2000 audit commenced. (Tr. 21.) Lewis was a colleague of Dairaghi at RBG and considered him a personal friend. (Tr. 29.)

¹⁰ ESI also reported Erwin to the Federal Bureau of Investigation (FBI), the NASD, and the Ohio Division of Securities. (Exs. 7, 8.) Erwin was eventually convicted of mail and wire fraud, 18 U.S.C. §§ 1341, 1343, and was sentenced to ten years in prison. (Answer ¶ 8 (citing United States v. Erwin, No. CR-01-012 (S.D. Ohio Jan. 23, 2001).) He was also ordered to make restitution payments of \$2,013,404.15. Lewis assumed that Oakes represented ESI in discussions with the FBI, securities regulators, and outside counsel in its handling of the Erwin fraud. (Tr. 51-52, 65-66.)

After its internal investigation, ESI contacted customers defrauded by Erwin and attempted to resolve any potential claims. ESI sent at least one customer, Fred W. Laubie (Laubie), a letter dated November 20, 2000, updating him on the status of the Erwin situation. (Ex. 7.) The letter included a request to fill out an insurance claim form, but warned that the insurance company may take sixty to ninety days to process the claim. In the event the customer's claim was not resolved by March 31, 2001, ESI offered to handle the claim directly. (Ex. 7.)

ESI retained Mark A. Vander Laan (Vander Laan), an attorney with the Cincinnati, Ohio, law firm of Dinsmore & Shohl LLP (D&S), to represent it in potential litigation related to the Erwin embezzlement. On December 29, 2000, D&S mailed letters to ten of the affected customers, or their legal representatives. ESI promised that it would restore their losses as "promptly as possible." (Ex. 8.) Each letter specified the total dollar amount Erwin stole from their respective accounts. Each letter also proposed a settlement offer in which ESI would pay one-half of the amounts stolen from their accounts in cash immediately and issue a promissory note for the remaining balance. The promissory note would be paid by ESI over eighteen months with seven percent interest. ESI would accelerate the repayment of the note's principal balance if it was successful in recovering insurance proceeds or payments from any other source. (Ex. 8.)

B. The Audit

1. Planning and Preliminary Matters

In anticipation of the 2000 audit, Lewis contacted Dairaghi in December 2000 to discuss scheduling and inquire if anything unusual occurred that should cause RBG any concern. (Tr. 28-29; Ex. 2 at RBG0093.) Dairaghi informed Lewis about the Erwin embezzlement during this initial conversation. (Tr. 28-29, 36-37.) In the general procedures outline of the 2000 audit workpapers, along with a similarly worded paragraph in another part of the outline, Lewis memorialized this conversation as follows:

Management is aware of one case of fraud. Joe Erwin, an independent [emphasis in original] broker, who is alleged to have embezzled approximately 2 million dollars of customers money. RBG will examine attorney letters for further investigation.¹¹

¹¹ In addition, Lewis's notes by this paragraph state: "See [attorney] response for litigation issues." (Ex. 2 at 98A.) Additionally, his notes discuss the overall fraud risk for the 2000 audit. (Tr. 35-36; Ex. 2 at 98A.) Lewis believed that Erwin's independent broker status might be significant in terms of determining ESI's legal liability. (Tr. 87-88; Exs. 2 at 98A, 14.) Lewis, however, cannot recall if any audit procedures were performed to verify that Erwin was, in fact, an independent broker. (Tr. at 88.)

(Ex. 2 at 98A, RBG00104.) Dairaghi told Lewis that \$2 million was the approximate amount stolen from “several” of ESI’s customers. (Tr. 38.) This amount was derived by ESI from documentation left by Erwin. (Tr. 36-37.) Lewis, however, did not recall if he ever inquired specifically how the \$2 million figure was calculated, or how many customers were affected by the Erwin embezzlement. (Tr. 36-37, 42-47.) Further, Lewis did not follow up with Dairaghi after the planning stage of the audit to confirm if the \$2 million figure remained accurate. (Tr. 47.)

During the planning stage of the 2000 audit, Respondents increased the overall fraud risk from “low to moderate” to “moderate.” (Tr. 33-34, 60; Ex. 2 at 98A.) The audit workpapers indicate that RBG “[o]bserved no motivation for fraudulent financial reporting.” (Ex. 2 at RBG0095.) Lewis could not recall if he considered whether management would have been motivated to misstate the financial statements to avoid violating the net capital rule. (Tr. 55-57.) Also, Lewis did not recall considering whether avoiding a violation of the net capital rule would impair management’s judgment as to the proper accounting treatment of the Erwin embezzlement. (Tr. at 56-57.)

Respondents calculated the tolerable misstatement¹² for the 2000 audit to be \$97,000. (Ex. 2 at RBG00102-03.) RBG used this number to identify which significant items within a specific account to examine and to provide general guidance for materiality. (Tr. at 30-33; Ex. 2 at RBG00102-03.)

On January 2, 2001, Trisha Massie (Massie), the RBG audit staff person who performed most of the audit testwork, wrote to Dairaghi and requested ESI provide certain information and documents prior to the start of fieldwork. (Tr. 19-20; Ex. 2 at RBG00114-17) The letter did not request any information or documents from ESI regarding the Erwin embezzlement. (Ex. 2 at RBG00114-17.)

2. Fieldwork

Fieldwork commenced on January 30, 2001, and lasted four days until February 2, 2001. Other than the comments from Dairaghi during the planning stage of the audit, the audit workpapers do not reflect any inquiries to management regarding the Erwin embezzlement. Lewis could not recall if he asked Dairaghi, or anyone else at ESI, which ESI employees were involved in investigating or resolving the Erwin embezzlement. (Tr. 50-51.) Lewis vaguely recalls a working lunch in a conference room at ESI, where he, Massie, Dairaghi, Neil Eisner

¹² This number is calculated by using a mathematical formula to approximate what the materiality threshold should be for a particular audit. (Tr. 30-32.) The audit workpapers refer to this type of quantitative materiality formula as the “rule of thumb” calculation. (Ex. 2 at RBG00103.)

(Eisner),¹³ and Oakes discussed the progress of the audit. (Tr. 52-53.) Lewis is certain the Erwin embezzlement was discussed during this lunch meeting, but he cannot recall making any specific inquiry. (Tr. 52-53.) The audit workpapers do not reference this conversation or any other communication with Oakes or Eisner in regard to the Erwin embezzlement. (Ex. 2.) Despite Lewis's belief that Oakes had detailed knowledge of the Erwin embezzlement, Lewis cannot recall speaking to Oakes individually regarding the fraud. (Tr. 53.)

Other than requesting attorney confirmation letters of potential claims arising out of litigation, no other substantive audit procedures were performed that related to the Erwin embezzlement. (Tr. 39-40, 62.) Lewis did not ask Dairaghi, or any other ESI personnel, for the number or identities of the defrauded customers, the amount each customer lost, whether any insurance claims were filed, or copies of documentation related to the Erwin embezzlement. (Tr. 38-50.)

3. ESI's Request for an Attorney Confirmation Letter

On January 22, 2001, about three weeks after Vander Laan sent settlement offers to Erwin's former customers, ESI mailed attorney confirmation request letters (request letters), signed by Oakes, to five of its outside law firms. (Ex. 2 at RBG00145-54; Ex. 3.) One of these request letters was addressed to Vander Laan. (Ex. 3.) The letter asked Vander Laan to provide a listing of all pending or threatened litigation, claims, and assessments that D&S handled on behalf of ESI. In addition, ESI requested D&S to describe the nature of the litigation, the progress of the case to date, how management intended to respond to the litigation, an evaluation of the likelihood of an unfavorable outcome, and a dollar estimate of any possible loss, if applicable. (Ex. 3.)

The request letter also asked D&S to consult with ESI if it formed a professional conclusion about whether ESI should disclose or consider disclosing any unasserted claims. If there were none, ESI requested that D&S represent to RBG that no unasserted claims are probable of assertion. ESI also requested that D&S "furnish our auditors any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated," and to identify any limitations in its response to RBG. (Ex. 3.)

The request letter, although on ESI letterhead and signed by Oakes, was actually drafted by RBG personnel. (Tr. 63.) The request letter is a routine letter that Lewis had used for other clients. (Tr. 61-63; Exs. 3, 9 at 13, 11 at 12.) Lewis testified that auditors have the option to tailor a request letter to include information about specific cases or pending litigation. (Tr. 71-72.) The request letter, however, makes no reference to the Erwin embezzlement, the \$2 million in customer losses, or any claim from Erwin's former customers. (Tr. 71; Ex. 3.) Lewis

¹³ Eisner founded ESI and owned fifty percent of its outstanding common stock. (Ex. 2 at RBG0091.) During the year ended December 31, 2000, he served as the chief executive officer and president of ESI.

acknowledged that he chose to leave out any references to the Erwin embezzlement in the request letter. (Tr. 71-72.)

4. D&S's Confirmation to the ESI Request Letter

RBG received D&S's confirmation letter (D&S letter), signed by Vander Laan, on February 23, 2001, approximately three weeks after fieldwork concluded. (Ex. 4.) Lewis talked to Dairaghi when he received the attorney confirmation letter and asked if there was anything in the letter to cause RBG any concern.¹⁴ Dairaghi, according to Lewis, replied "no." (Tr. 112-13.) Lewis did not ask Dairaghi any specific questions on any of the matters mentioned in the letter, nor was this conversation reflected in the audit workpapers. (Tr. 112-13; Ex. 2.) The letter stated, inter alia, that D&S represented ESI in arbitration proceedings pending before the NASD brought by two former clients of Erwin, Laubie and Roger S. Talmage (Talmage). Laubie's claim arose out of Erwin's \$2 million embezzlement, but Talmage's claim for \$350,530.62, based on unauthorized trading, was not listed on the ESI spreadsheet as part of the \$2 million figure. (Exs. 4, 6.)

Under the heading of "Unasserted Claims and Assessments," the D&S letter stated:

Approximately ten other customers of Joseph E. Erwin were affected by his misconduct. Dinsmore & Shohl has contacted each customer on behalf of Eisner and initiated discussions in order to resolve any matters pertaining to Mr. Erwin's acts.

(Ex. 4 at RBG00128.)

Lewis knew during the planning phase of the audit that Erwin embezzled \$2 million from his customers. (Tr. 36-37.) He, therefore, assumed that the Laubie and Talmage claims were part of Erwin's misappropriation, but he never sought confirmation from ESI or Vander Laan. (Tr. 42-45.) Lewis did not ask Vander Laan to explain what the words "initiated discussions" meant; rather he assumed that it did not include settlement offers. (Tr. at 99-100, 102-03.) By placing the potential customer claims under the "Unasserted Claims and Assessments" heading in the D&S letter, Lewis believed that this precluded the possibility of a settlement offer being made. (Tr. 99-100, 102-04.)

Lewis understood that if D&S disagreed with management's representations that no unasserted claims were probable of assertion, therefore not requiring accrual or disclosure under FAS 5, counsel would notify ESI of the disagreement.¹⁵ (Tr. 75-76.) Lewis believed that if

¹⁴ Rubin also reviewed the D&S letter upon its receipt by RBG. (Tr. 144-45.)

¹⁵ The D&S letter also contained language that D&S's disclosure was limited by paragraphs 5 and 6 of the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (ABA Statement). (Ex. 4 at RBG00129.) As described in the D&S letter, the ABA Statement provides that it is inappropriate for outside counsel to

D&S contacted ESI to advise it of the impropriety of non-disclosure, then D&S was obligated to notify RBG that such a communication occurred.¹⁶ (Tr. 76.) Lewis, however, was confident that the D&S letter was clear, and it confirmed that no unasserted claims were probable of assertion. (Tr. 100-101, 104).

A copy of the D&S letter in the audit workpapers contains a note written by Lewis stating: “Appropriate disclosures made on [financial statements regarding] arbitration proceedings . . . no accrual for potential claims appears necessary.” (Ex. 2 at RBG00127.) Lewis believed that his reliance on the D&S letter was sufficient testwork to establish that no accrual was necessary for the potential liability stemming from the Erwin fraud. (Tr. 40, 103, 106-08.) In hindsight, Lewis testified that he would have inquired further had he known the settlement offers had been made. (Tr. 103, 105-06.)

5. ESI’s Management Representation Letter

In accordance with accounting profession practice, ESI’s management representation letter to RBG was dated on the last day of fieldwork, February 2, 2001.¹⁷ (Tr. 147.) Both Oakes and Dairaghi signed the management representation letter, which stated that, “[t]here are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of the Financial Accounting Standard No. 5.” (Ex. 5.) Although the management representation letter is signed by ESI management and is printed on ESI letterhead, RBG actually drafted the letter. (Tr. 114.) The management representation letter makes no reference to the Erwin embezzlement or the settlement offers to his former customers. (Ex. 5.)

6. Rubin’s Supervision of the 2000 Audit

While Lewis and Massie performed all of the testwork for the 2000 audit, Rubin supervised them throughout the audit and met with Lewis periodically to discuss the status of the audit. (Tr. 20, 28-29, 140-41.) Rubin reviewed all the audit workpapers and was ultimately

respond to a general inquiry relating to the existence of a possible unasserted claim or assessment involving a client. According to the ABA Statement, outside counsel may only furnish information concerning specifically identified unasserted claims or assessments requested by the client company. (Ex. 13K at AU 337C ¶ 5.c.) If outside counsel believes that an unasserted claim or assessment requires financial statement disclosure, counsel must advise the client company of its obligations concerning financial disclosure and the applicable requirements of FAS 5.

¹⁶ The ABA Statement does not mention whether disclosure to outside auditors is required if a client refuses to meet the requirements of FAS 5, only that counsel should resign if its client refuses to follow counsel’s advice as to proper disclosure. (Ex. 13K at AU 337C ¶ 6.)

¹⁷ RBG actually received the management representation letter on February 26, 2001. (Ex. 5.)

responsible for the 2000 audit, since he was the engagement partner and signed the audit report. (Tr. 29, 118.) Rubin devoted about one hour for his review of the audit testwork performed by Lewis and Massie. (Tr. 122-23; Ex. 15.)

Although Lewis lacked experience with broker-dealer clients and audits with significant fraud issues, Rubin denied the 2000 audit required more of his supervision. (Tr. 119, 123-24.) He also denied that contacting outside counsel was necessary, as the attorney letter, along with management's representation, was sufficient evidential matter under GAAS. (Tr. 126-29.) As such, he believed the 2000 audit met the requirements of GAAS. (Tr. 123-24, 126-27, 134-35.)

Rubin denied he was misled by ESI management. He believed Dairaghi was unaware of the settlement offers and Oakes did not appreciate their significance. (Tr. 124, 201.) Rubin initially testified that the D&S letter was "not unfair," but could have been clearer. (Tr. 124-25, 133-34.) He later, however, testified it was inappropriate for an experienced attorney like Vander Laan to fail to disclose the existence of the settlement offers. (Tr. 201-03.)

When reminded of his obligation to follow up with the attorney and/or management when confronted by an unclear or ambiguous attorney letter, Rubin testified that there was "no uncertainty as what that meant." (Tr. 127.) Rubin explained he believed the D&S letter confirmed management's representations that no unasserted claims existed to require disclosure or an accrual on the financial statements. (Tr. 127-31.) He further testified that the letter did not cause any uncertainty for him; rather it confirmed what RBG already knew. (Tr. 128.)

According to Rubin, Dairaghi represented to Lewis that ESI believed it was not liable for Erwin's embezzlement.¹⁸ (Tr. 137, 144.) Rubin acknowledged, however, that Dairaghi did not have any legal training or background to evaluate ESI's legal defenses, but Rubin assumed Dairaghi relied on Oakes to make this determination. (Tr. 138.) Rubin believed Oakes possessed a law degree, but was uncertain if he was a licensed member of any bar during the 2000 audit. (Tr. 138-39.)

Rubin believed the phrase "initiated discussions in order to resolve any matters" in the D&S letter was clear and meant that ESI was determining the merits of the ten customers' potential claims, not submitting settlement offers to them. (Tr. 128-30, 135-36.) In addition, the placement of these potential claims under the "Unasserted Claims and Assessments" heading of the letter precluded any chance of their being a settlement offer. (Tr. 129.) Rubin also believed that if a settlement offer was made D&S would disclose this fact to RBG. (Tr. 133-34, 201.) He was, however, not surprised that ESI did not forward copies of the settlement offers to RBG. (Tr. 133-34, 201-03.) Rubin testified that if a client provided evidence of settlement offers, RBG would make further inquiries, but there is no specific requirement under GAAS to inquire of management if any settlement offers were made. (Tr. 128-29, 134-36.)

¹⁸ Lewis did not memorialize the conversation(s) in the audit workpapers. (Tr. 113; Ex. 2)

7. RBG's Audit Report & ESI's 2000 Financial Statements

RBG issued an unqualified audit report for ESI's 2000 financial statements. (Ex. 1 at RBG0049.) The financial statements included the following footnote describing ESI's potential litigation liabilities.

The Company has been named a co-defendant in a state court action and several arbitrations before the National Association of Securities Dealers, Inc. (NASD). The suits allege that the Company is liable for the actions of various independent contractors, [who are] registered representatives of the Company. Management believes, based on advice from legal counsel, that it has meritorious defenses and plans to vigorously defend these matters. The Company has accrued no liability for these matters.

The Company also has been named a co-defendant in an arbitration proceeding before the NASD alleging that the Company is liable for the actions of a former registered representative of the Company. Management believes, based on advice from legal counsel, that it has meritorious defenses and plans to vigorously defend this matter. The Company has accrued no liability for this matter.

(Ex. 1 at RBG0060) (Footnote 9.)

ESI's 2000 financial statements do not contain any contingent liability on the balance sheet, or related expenses on the income statement, to reflect the firm's exposure from litigation resulting from the Erwin embezzlement. (Ex. 1 at RBG0052-55.) Similarly, the accompanying footnotes to the 2000 financial statements fail to specifically mention the Erwin embezzlement or the settlement offers made to his former customers. (Ex. 1 at RBG0060.)

C. The Net Capital Rule

The net capital rule, Exchange Act Rule 15c3-1, is designed to protect customers from losses that result from a brokerage firm's insolvency. The net capital rule requires broker-dealers to maintain a certain level of net capital, essentially the amount of a firm's liquid assets less its liabilities.¹⁹ A brokerage firm may not conduct securities business while it is in contravention of the net capital rule or any other Commission financial responsibility requirement. 15 U.S.C. § 78o(c)(3). If a firm is in violation of the net capital rule, the Commission may revoke its registration. See 15 U.S.C. § 78o(b)(4); see also Touche Ross & Co. v. Redington, 442 U.S. 560, 570 & n.10 (1979).

¹⁹ Exchange Act Rule 15c3-1 provides detailed and complex procedures on how to calculate net capital, along with prescribing varying levels of net capital required to be maintained by broker-dealers.

ESI's net capital calculation was included in the 2000 financial statements as a supplemental statement. (Ex. 1 at RBG0062-64.) RBG issued an unqualified opinion as to the accuracy of the net capital calculation.²⁰ (Ex. 1 at RBG0061.) As of December 31, 2000, ESI reported it had \$356,168 in net capital, which exceeded its required net capital amount of \$63,844 by \$292,324. (Ex. 1 at RBG0062-64.)

The audit workpapers contain a reference to a prior net capital violation by ESI. Because of this, RBG considered ESI to be very conservative as to its compliance with the net capital rule. (Ex. 2 at RBG0095.) The audit workpapers also state that ESI had a strong net capital position at year end, but make no mention of the possible effect the Erwin embezzlement may have had on its net capital situation. (Ex. 2 at RBG0095-98, 98A.)

Lewis conceded that if a \$2 million contingent liability was required to be reflected in the 2000 financial statements, it would reduce ESI's net capital position to a deficit of more than \$1.4 million, which would cause the firm to be in substantial violation of the net capital rule. (Tr. at 55-56.) Lewis denied that being in violation of the net capital rule would necessarily cause ESI to be liquidated. He testified that if ESI was in violation of the net capital rule, the owners of the firm could contribute capital to stabilize ESI's net capital position. (Tr. 55-56.) Lewis acknowledged, however, that the failure to do so could cause an immediate shut down of ESI. (Tr. 55-56.)

D. Expert Witnesses

The Division called one expert witness, Edward B. Chez (Chez), and Respondents called two expert witnesses, Steven B. Rafferty (Rafferty) and James G. Castellano (Castellano).²¹

1. Edward B. Chez

The Division retained Chez as an expert witness to identify any material departures from GAAP in ESI's financial statements for the year ended December 31, 2000, and any material failures by Respondents to adhere to GAAS.²² Chez also was engaged, in the event departures

²⁰ Exchange Act Rule 17a-5 requires an auditor to opine on the accuracy of the financial statements and review the practices and procedures used to calculate net capital under Exchange Act Rule 15c3-1.

²¹ The Division objected to Respondents' expert witnesses' testimony during the hearing and filed a motion to strike their testimony. The Division based its objection and motion on both Rafferty's and Castellano's lack of experience and expertise in the audits of broker-dealer entities and Castellano's lack of impartiality as a partner at RBG. (Tr. 230-34, 281-83.) The Division's motion is DENIED. The lack of broker-dealer audit expertise and Castellano's potential conflict of interest will be factored into the weight accorded their testimony and reports.

²² Chez is a partner at Schultz and Chez, L.L.P., an accounting firm specializing in auditing and tax preparation for broker-dealer firms, commodities and options traders, and high net worth

from GAAS and GAAP were discovered, to opine whether Respondents' conduct violated Rule 102(e).

In preparing for his testimony and his submitted written report, Chez reviewed the non-privileged portions of the Division's investigative file, including: audit workpapers prepared by RBS; depositions of Lewis, Rubin, Oakes, Dairaghi, Eisner, Beth Susan Oakes, Glenda Bone,²³ Christi Meyers, and Joseph Keaveny; and the Wells submissions for Rubin, Lewis, and Oakes. Chez also reviewed the OIP, Respondents' Answer, and portions of relevant authoritative accounting profession literature and Commission materials. (Tr. 150-86; Ex. 11.)

Chez opined that, pursuant to FAS 5, ESI was required to account for the unasserted claims that resulted from Erwin's misappropriations in its December 31, 2000, financial statements. (Tr. 165-67.) ESI's failure to do so meant its financial statements were not in conformity with GAAP. Chez opined that Respondents failed to exercise due professional care as required by GAAS in both planning and performing the 2000 audit. (Tr. 156, 161-62.) Chez also opined that Respondents failed to obtain sufficient competent evidential matter, as required by GAAS, regarding the claims of Erwin's former customers. (Tr. 162-65.) Accordingly, RBG issued an inaccurate audit report for the 2000 audit, as the financial statements did not conform to GAAP nor was the audit performed in accordance with GAAS. (Tr. 165-67.)

Under GAAS,²⁴ auditors must exercise due professional care in both planning and performing the audit. According to AU 230, "[d]ue professional care is to be exercised in the planning and performance of the audit" Due professional care requires the auditor to exercise professional skepticism, as to matters of integrity of management, errors and irregularities, and illegal acts. (Tr. 162.) AU 317 states when an auditor becomes aware of information concerning a possible illegal act, he or she should obtain an understanding of the nature of the act, the circumstances in which it occurred, and other information to evaluate the effect on the financial statements.

Chez opined that Respondents failed to exercise due professional care in planning the audit because they should have gone beyond merely increasing the audit risk for fraud. Despite

individuals. (Tr. 150-52; Ex. 11 at 19.) He is a licensed Illinois CPA with a bachelor's degree in economics and master's degree in accounting from the University of Pennsylvania. He is also a graduate of the Northwestern University School of Law. He is member of the Illinois CPA Society and the AICPA. He has approximately thirty years of accounting and auditing experience.

²³ Glenda Bone was ESI's senior compliance officer. (Ex. 7.)

²⁴ GAAS are comprised of Statements on Auditing Standards (SAS) issued by the AICPA. The AICPA compiled all of the SAS's in the Codification of Statements on Auditing Standards and organized them in sections labeled "AU." Various SAS's are located in Exhibit 13, but citations to individual sections are noted as "AU __."

increasing the fraud risk, Respondents failed to alter or expand the scope of their audit procedures regarding the Erwin fraud. (Ex. 11 at 11-12.) In particular, Chez believes they should have requested additional information from ESI management to provide them reasonable assurance that no accrual was necessary. (Tr. 158.) Respondents, however, chose to rely only on a management representation letter and an attorney confirmation letter.²⁵ (Tr. 159.) AU 337.23 encourages auditors to contact a client's attorney if they are uncertain of the meaning of the attorney's evaluation of a potential claim. (Tr. 171-72.) Given the nature of Erwin's misconduct, the large dollar amounts involved, and the unusual attorney confirmation letter received, Chez opined that Respondents should have conducted an in-depth inquiry with ESI and D&S. (Tr. 158, 162, 171-76.)

According to Chez, AU 326.01 requires that "sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statement audit." (Tr. 162; Ex. 11 at 12.) Chez opined that the D&S letter clearly was in conflict with ESI's management representation letter, in that ESI claimed there were "no unasserted claims whatsoever,"²⁶ while D&S mentioned that there were approximately ten such claims. (Tr. 168-75, 175-81.) Chez opined that Respondents should have obtained more information once this discrepancy was discovered. (Tr. 168-69, 173-84.) According to Chez, Respondents should have: obtained a detailed description and thorough evaluation of each possible litigation, claim, and assessment from ESI management; conducted a thorough examination of ESI's documentation related to potential customer claims; and reviewed minutes of the board of directors or any other documentation concerning the embezzlement. (Tr. 158-59, 161-62, 171-72.)

Finally, Chez opined that Respondents failed to take into account how the Erwin fraud might affect ESI's compliance with the net capital rule. Because an accrual for the \$2 million in losses would result in a violation of Exchange Act Rule 15c3-1 and would require an immediate suspension of broker-dealer activities, Respondents needed to apply heightened scrutiny to the Erwin embezzlement. (Tr. 161, 165-66.)

Due to the Respondents' lack of due professional care, failure to obtain sufficient competent evidential matter, and failure to render an accurate audit report, Chez concluded that their conduct was both highly unreasonable and reckless under Rule 102(e). (Tr. 166.)

²⁵ AU 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, provides that an auditor must inquire with management about potential litigation claims and its applicability to FAS 5. Upon obtaining management representations on FAS 5's applicability, an auditor's primary means of confirming this understanding is to obtain a letter from outside counsel that corroborates management's information concerning litigation, claims, and assessments. AU 337.

²⁶ The management representation letter actually stated that there were "no unasserted claims or assessments . . . probable of assertion" (Ex. 5.) (emphasis added); but see infra note 32.

2. Steven B. Rafferty

Rafferty's²⁷ engagement was limited to determining whether Respondents' conduct, as it relates to the contingent liability, constituted highly unreasonable conduct in violation of Rule 102(e)(1)(iv)(B)(1). (Ex. 9 at 3.) He submitted a written report and testified on Respondents' behalf. (Ex. 9.) In preparation for his testimony and report, Rafferty interviewed Respondents and reviewed the OIP, the Answer, the Division's investigative file, Respondents' Wells submission, Chez's report, and relevant professional authorities. (Ex. 9.)

Rafferty testified that although he has extensive experience as an auditor, he has never audited a broker-dealer. (Tr. 231.) Rafferty has never calculated broker-dealer net capital under Exchange Act Rule 15c3-1, nor is he familiar with the details of the net capital rule. (Tr. 231-32.) Further, Rafferty acknowledged that an auditor must have an understanding of a particular industry, along with its rules, regulations, and practices, to effectively audit a client. (Tr. 231-32.)

Rafferty opined that Respondents' failure to perform certain additional procedures, given their knowledge of the Erwin fraud, does not constitute highly unreasonable conduct within the meaning of Rule 102(e)(1)(iv)(B)(1). (Tr. 223-34.) Rafferty cited AU 337 in specifying that management is the primary source for information regarding contingent liabilities. (Tr. 219-20.) Under AU 337.08, GAAS require a letter of inquiry be sent to a client's attorney, as the primary means of obtaining corroboration of management's representations as to litigation, claims, and assessments. Rafferty opined that Respondents met their professional obligations under GAAS based on: their evaluation of the attorney confirmation letter and the management representation letter; Oakes's and Dairaghi's accounting experience; D&S's description of the Laubie and Talmage cases; the classification of the ten other cases as "unasserted" with no claims filed despite the five month lapse since the discovery of the misappropriation; Erwin's status as an independent contractor; and the lack of concern in the other attorney confirmation letters. (Tr. 218-20, 225-26, 245.)

Rafferty acknowledged that D&S's response to the unasserted claims is unusual, as most attorneys just confirm management's understanding. (Ex. 9 at 7.) Rafferty, however, opined that the phrase "initiated discussions in order to resolve any matters" related to unasserted claims is innocuous and not alarming on its face. (Ex. 9 at 8.) Given the low likelihood of accruing for unasserted claims in general, Rafferty opined that this statement is not sufficient to require

²⁷ Rafferty is a partner at BKD, LLP, a public accounting firm with twenty-seven offices in eleven states. (Ex. 9 at 21-23.) BKD, LLP, according to Rafferty, is among the 10 largest accounting and advisory firms in the United States. He is a licensed Missouri CPA with a bachelor's degree in accounting from the University of Missouri-Kansas City. He has more than twenty-six years of experience in accounting and auditing and currently is his firm's Professional Practices Partner. He is a member of both the Missouri Society of Certified Public Accountants and the AICPA. He also serves as the vice-chairman of the AICPA Center for Public Company Audit Firms' Executive Committee.

further investigation, nor would Respondents be required to contact D&S under AU 337.10 for clarification. (Tr. 226.)

Rafferty opined that it was unnecessary for Respondents to make additional inquiries with management regarding the Erwin fraud or the need for an accrual, because the management representation letter clearly indicates that Oakes and Dairaghi intended to convey to Respondents that no offers of settlement were made. (Tr. 226-28.) Accordingly, Rafferty assumed that Oakes and Dairaghi may have intentionally withheld the existence of the settlement offers from Respondents. (Ex. 9 at 11-12.) Thus, Rafferty opined that additional inquiries to management would have proved futile.

Rafferty also opined that it was unnecessary for Respondents to make additional inquiries of Vander Laan after RBG received the D&S letter. (Tr. 220-22.) Rafferty believes that Vander Laan mischaracterized the ten defrauded customers of Erwin as unasserted claims. (Tr. 228; Ex. 9 at 14-15.) Because ESI made settlement offers to the ten customers, by definition, the claims could not have been unasserted. (Ex. 9 at 14-15.) According to Rafferty, D&S should have characterized the “discussions in order to resolve any matters” as “pending or threatened litigation, claims or assessments,” not as unasserted claims. (Ex. 9 at 14-15.) Rafferty believes D&S’s characterization of the ten customers’ claims as being unasserted to be misleading. (Tr. 228.) Although AU 337.10 encourages auditors to contact outside counsel when the attorney confirmation letter is not responsive, unclear, or in other limited circumstances, Rafferty noted that professional literature does not recommend contacting legal counsel to challenge the accuracy or forthrightness of their response. (Tr. 220-23.) That in doing so, it is unlikely an auditor would receive additional useful information. Thus, Rafferty opined that if Respondents contacted D&S, they would, in effect, have challenged D&S’s statements and conclusions, which is beyond what is required by GAAS. (Ex. 9 at 16-17.)

Finally, Rafferty opined that had Respondents known of the settlement offers, it is likely that they would have requested ESI management to book an appropriate accrual. Otherwise, Respondents would have modified their audit report if management refused. Rafferty concluded that Respondents’ actions failed to rise to the level of highly unreasonable conduct under Rule 102(e)(1)(iv)(B)(1). (Tr. 223-24; Ex. 9 at 20.)

3. James G. Castellano

Castellano, currently the chairman of RBG, has known both Respondents for most, if not all, of their careers at the firm. (Tr. 280.) Castellano was a partner at RBG when Respondents’ alleged misconduct occurred and is currently a partner, along with Respondents, at the firm. (Tr. 302-03.) Despite this relationship, Respondents retained Castellano as an unpaid expert witness to opine whether their conduct violated accounting industry standards.²⁸ (Tr. 280.)

²⁸ Castellano has bachelor’s degree in business administration, with a concentration in accounting, from Rockhurst College located in Kansas City, Missouri. (Ex. 10 at 2.) He joined RBG in 1973 and has more than thirty-two years of experience in the accounting profession. He was managing partner at RBG from 1989 to 2004 and has been chairman of the firm since June

In preparing for his testimony and report, Castellano reviewed the OIP, Respondents' Wells submission, Respondents' Answer, Chez's report, the NASD's letter of caution dated April 20, 2001, FAS 5, excerpts from GAAS and GAAP, and an online dictionary. (Tr. 285; Ex. 10 at Exh. 1.) Castellano opined that the procedures performed by Respondents in their determination of possible contingent liabilities under FAS 5 were in conformity with GAAS. (Tr. 300-01.) Further, he opined that Respondents gathered persuasive evidential matter and exercised due professional care during the ESI audit to meet the requirements of GAAS. (Tr. 287-89.)

Specifically, through inquiries of ESI management during the planning stages of the audit, Respondents became aware of Erwin's embezzlement. Based on this information, Castellano opined that Respondents appropriately increased the audit risk from "low to moderate" to "moderate" in the planning stage of the audit by taking into account the following mitigating factors: Respondents' assessment of ESI management's integrity, a lack of motivation for financial reporting fraud, RBG's history with ESI and its management, and the experience and expertise of ESI's management. (Tr. 293-94, 297-99.)

Based on the above analysis, the only evidential matter required by GAAS, according to Castellano, was obtaining a management representation letter addressing contingent liabilities, or the lack thereof, and a confirmation letter from outside counsel. RBG obtained both of these during the course of the audit. (Tr. 289-92.) Castellano disputes that the letter contradicted, rather than confirmed, ESI's representation that there were no unasserted claims that required an accrual under FAS 5. (Tr. 294.) Castellano opined that the disclosure of the unasserted claims and initial discussions with ten customers were insufficient to conclude, without more, that they were probable of assertion, requiring disclosure or an accrual. (Tr. 293-94.) Further, because the Laubie and Talmage claims were being vigorously defended, Castellano opined that it was reasonable for Respondents to assume ESI would have similar defenses for the unasserted claims mentioned by Vander Laan. (Ex. 10 at 15.) Since the existence of the settlement offers were withheld from RBG, it was appropriate, in Castellano's opinion, for RBG to rely on Vander Laan's representations that the unasserted claims were not probable of assertion. (Tr. 293-94.)

Castellano opined that Respondents did, in fact, exercise due professional care during the 2000 audit. (Tr. 299.) Citing AU 230.10, Castellano noted that absolute assurance is not attainable during an audit. Also, under AU 230.12, GAAS acknowledge that collusion between a third party and client personnel makes it difficult to detect intentional misstatements. (Tr. 296, 299-300.) Thus, despite this collusion, Respondents acted appropriately by following proper planning procedures, using their professional judgment to assess management's integrity, and

1, 2004. He is a member of the AICPA, where he served on the board of directors for six years. He served as chairman of the AICPA's board of directors from October 2001 to October 2002. He has also served as a member of the FASB Task Force on Financial Reporting by Small Public Companies, the FASB Small Business Advisory Group, and the AICPA's Technical Issues Committee, where he also served as its chairman.

confirming management's representations with outside counsel. (Tr. 297-99.) Castellano mentions a letter from the NASD dated April 20, 2001, noting ESI had certain deficiencies but found general compliance with the rules and regulations reviewed, as further evidence that RBG exercised due care during the 2000 audit.²⁹ (Ex. 10 at 16-17.)

Finally, Castellano concluded that Respondents' conduct failed to rise to the level of recklessness or highly unreasonable conduct based on the dictionary definition of "reckless," "highly," and "unreasonable." (Tr. 301; Ex. 10 at 18-19.)

III. CONCLUSIONS OF LAW

A. RULE 102(e)

Rule 102(e)(1)(ii) permits the Commission to censure or deny, permanently or temporarily, the privilege of appearing or practicing before it any person found to have engaged in improper professional conduct. With respect to accountants, "improper professional conduct" includes:

- (A) [i]ntentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
- (B) . . . negligent conduct [consisting of]:
 - (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

Rule 102(e)(1)(iv), 17 C.F.R. § 201.102(e)(1)(iv).

Rule 102(e), along with its predecessors, was promulgated by the Commission to ensure that professionals, upon whom it relies, perform their duties diligently and with reasonable competence. Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979). Accountants play a particularly important role in the Commission's processes, as the investing public relies heavily on the independent certification of the accuracy of the financial statements for their investment decisions. Marrie v. SEC, 374 F.3d 1196, 1200-01 (D.C. Cir. 2004). Rule 102(e) protects the integrity of the Commission's processes, "as well as the confidence of the investing public in the integrity of the financial reporting process." Id. at 1200.

²⁹ The NASD letter referred to by Castellano was not offered into evidence.

B. Recklessness

The Commission defines recklessness under Rule 102(e) the same as the antifraud provisions of the federal securities laws. Russell Ponce, 54 S.E.C. 804, 823 n.52 (Aug. 31, 2000), aff'd, 345 F.3d 722 (9th Cir. 2003); Albert Glenn Yesner, 54 S.E.C. 414, 416-17 (Oct. 19, 1999). Recklessness is an “extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it.” Amendments to Rule 102(e), 68 SEC Docket 707, 710 (Oct. 26, 1998) (also at 63 Fed. Reg. 57164, 51167); see also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); McCurdy v. SEC, 396 F.3d 1258, 1263 (D.C. Cir. 2005); SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992).

Proof of actual intent to defraud or assist in a fraud, or that the audited financial statements were materially misleading, is not necessary to establish recklessness under Rule 102(e)(1)(ii)(A). Marrie, 374 F.3d at 1200. The inquiry is not to determine whether an accountant recklessly participated or aided a client in committing fraud, but whether an accountant recklessly violated relevant professional standards such as GAAS. Id. This non-fraud standard of recklessness is based on the Commission’s “heavy reliance that it and the public place[s] on accountants ‘to assure disclosure of accurate and reliable financial information as required by the federal securities laws.’” Marrie, 374 F.3d at 1204 (citing Michael J. Marrie, 80 SEC Docket 2694, 2705 (July 29, 2003)).

1. Professional Standards

The “applicable professional standards” of care for accountants practicing before the Commission are GAAP, GAAS, and any other accounting industry authority. Amendments to Rule 102(e), 68 SEC Docket at 709. GAAS is the primary authority governing an accountant’s conduct during a financial statement audit. Id. GAAS consists of ten auditing standards, including three General Standards, three Standards of Fieldwork, and four Standards of Reporting. (Ex. 13A.) The auditing standards provide a measure of audit quality and objectives to be achieved during an audit. In addition to the auditing standards, GAAS prescribes various auditing procedures used by auditors to comply with the auditing standards.

GAAS require accountants to exercise reasonable diligence and due care while both planning and reviewing the financial statements. AU 230. During fieldwork, an auditor must obtain sufficient competent evidential matter to provide a reasonable basis to render an audit opinion. AU 326. To gather this evidence, an auditor must use his professional judgment, guided by sound auditing principles and professional skepticism. AU 326.22. Although it is not possible to scrutinize every transaction, GAAS recognize certain factors arouse suspicion and require a more focused investigation. Howard v. SEC, 376 F.3d 1136, 1149 (D.C. Cir. 2004) (certain transactions are “red flags” for which auditors are trained to remain alert). For example, large and unusual transactions require testing and special scrutiny under AU 316.20. Also, contingent liabilities that arise from litigation, or potential litigation, require auditors to confirm the reasonableness of the disclosure or accrual, or the lack thereof, with outside counsel. AU 337.

Under GAAP hierarchy, FAS 5 is the authoritative standard in determining whether a contingent liability (or asset) requires an accrual in the current period. See AU 337.05. FAS 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. FAS 5 defines three different levels of probability as to whether future events will confirm the existence of a loss:

1. Probable—The future event or events are likely to occur.
2. Reasonable possibility—The chance of the future event or events occurring is more than remote but less than likely.
3. Remote—The chance of the future event or events occurring is slight.

According to FAS 5, a loss must be accrued if both of the following conditions are met: (1) it is probable that . . . a liability has been incurred at the date of the financial statements; and (2) the amount of loss can be reasonably estimated. (Ex. 12.)

Because ESI made settlement offers and knew the amount of loss in each of Erwin's former customers' accounts, its liability was both probable and estimable. Thus, Respondents concede, due to the subsequent disclosure of the settlement offers, ESI's financial statements did not comply with either FAS 5 or GAAP. (Resp. Br. 22.)

2. Professional Due Care During Planning Phase of the Audit

Lewis was notified of the Erwin embezzlement by Dairaghi during the planning stages of the 2000 audit. A potential liability for \$2 million would have had devastating consequences for ESI, as this amount greatly exceeded both its GAAP shareholders' equity and its regulatory net capital.³⁰ As an experienced auditor in the broker-dealer industry, Rubin knew that a contingent liability accrual would require the firm to report a net capital violation to both the NASD and the Commission, which could result in the revocation of ESI's broker-dealer registration and/or in the firm's liquidation. Lewis, although not experienced in managing broker-dealer audits, also acknowledged that the sufficiency of a firm's net capital reserves should have been a primary concern of a broker-dealer audit. While litigation concerning disputes with customers may be common in the broker-dealer industry, the theft of funds by a registered representative of an audit client in an amount that greatly exceeds a firm's net capital is not. According to Chez, whose testimony I fully credit, the Erwin embezzlement was an obvious red flag. It required heightened scrutiny and should have been the most important item for the auditors to investigate and examine.

³⁰ The \$2 million embezzled by Erwin was more than twenty times the tolerable misstatement used by RBG for guidance on materiality. This amount was also more than thirty-one times the minimum net capital amount of \$63,844 ESI was required to maintain.

In evaluating ESI management's integrity during the planning stages of the audit, Respondents did not consider the Erwin embezzlement. I find ESI did not disclose or accrue for the Erwin liability in order to avoid the negative effect on its net capital calculation. I further find that Rubin and Lewis improperly relied on RBG's long-term relationship with ESI and Dairaghi to assess ESI's management integrity as strong. Although Dairaghi was a former colleague of Respondents for more than eight years at RBG, I find it was inappropriate for them to assume a high level of management integrity without analyzing the effect of the embezzlement on the issue of ESI's integrity. This is particularly troubling, as the audit workpapers acknowledge that ESI had previously violated the net capital rule. Professional skepticism under AU 230.07 requires a "questioning mind and a critical assessment of audit evidence," which Respondents failed to demonstrate. Thus, I find Respondents lacked professional skepticism while performing their evaluation of management integrity and the risk therein.

Although Respondents slightly increased the risk for fraud in the planning workpapers, they did not expand the scope of or alter their testing procedures. According to Chez, at a minimum, Respondents should have planned for a more thorough investigation into the Erwin embezzlement and its potential to require a contingent liability under FAS 5. Thus, I credit Chez's opinion and conclude that Respondents failed to exercise professional due care during the planning phase of the 2000 audit.

3. Sufficient Competent Evidential Matter

According to GAAS, an auditor acquires sufficient competent evidential matter through inspection, observation, inquiry, and confirmation. AU 326. The sufficiency of competent evidential matter is determined by an auditor's professional judgment after careful study of the circumstances of a particular case. AU 326.22. Respondents "careful study," however, was based solely on a cursory inquiry of management and through a confirmation letter from D&S.

a. Respondents' Lack of Inquiry with D&S

Under AU 337, the primary means of testing for contingent liabilities arising out of litigation is by obtaining a confirmation letter from outside counsel. Although the Erwin embezzlement should have received heightened scrutiny, RBG only drafted a routine request letter for ESI that did not specifically address Erwin or any of the firm's purported defenses. The request letter, therefore, allowed D&S wide discretion in how to respond to the claims, or potential claims, of Erwin's former customers.

Despite receiving a routine letter asking confirmation that no unasserted claims were probable of assertion, D&S replied that it had initiated discussions with at least ten customers for possible resolution. The letter did not mention the status of any of these discussions, or clearly define what the phrase "initiated discussions in order to resolve any matters" might entail. The D&S letter mentions the Laubie and Talmage claims and that ESI would vigorously defend them. However, the letter does not mention the \$2 million figure or if any defense exists as to the unasserted claims, nor did it ever explicitly confirm that no unasserted claims were probable of assertion. Other red flags in the letter include the identification of twelve defrauded

customers, in comparison to the “several” mentioned by Dairaghi, and the first mention of Erwin being accused of “unauthorized trading.” Despite these inconsistencies and omissions in the D&S letter, Respondents failed to investigate further, other than asking Dairaghi if there was anything in the letter that should cause RBG concern.

Both Chez and Rafferty opined that it was unusual for D&S to mention that it entered into initial discussions with ten of Erwin’s former customers. Chez testified that attorney confirmation letters usually state that there are no unasserted claims probable of assertion without further comment. Rubin and Lewis assumed “initial discussions” only referred to preliminary discussions and that it would be inappropriate to require an accrual or disclosure at this early stage. Respondents, however, never contacted either Vander Laan or ESI management to confirm these assumptions. Respondents also never inquired with ESI management or Vander Laan about any potential liability from Erwin’s former customers.

Although Rafferty opined that the D&S letter was misleading because it did not acknowledge the settlement offers, he believed requesting additional information from Vander Laan would have proved futile. Ordinarily, an auditor would not contact outside counsel without cause, but GAAS explicitly encourages an auditor to do so when the letter is vague. AU 337.23. Given the severe consequences of the unasserted claims mentioned in the letter, along with the unusual admission by D&S that discussions were taking place, Respondents should have, at a minimum, sought further information from D&S. If rebuffed by Vander Laan, Respondents should have sought additional information from ESI.

Respondents claim there was no uncertainty as to the meaning of the D&S letter. This contention is not credible. They, along with their experts, opined that the mere placement of the ten claims under the “Unasserted Claims and Assessments” heading of the D&S letter removed any need for Rubin and Lewis to make further inquiries of D&S or ESI management. I disagree.³¹ The phrase “initiated discussions in order to resolve any matters pertaining to Mr. Erwin’s acts” in the D&S letter is vague. Further, the placement of this language under the heading “Unasserted Claims and Assessments” is not dispositive. There are several possible interpretations of the “initiated discussions” language, from finding that no unasserted claims were probable of assertion to settlement offers were being made. I find that, without adequate support or justification, Respondents chose the interpretation that allowed ESI to conceal a liability that impaired its net capital.

³¹ I further find Respondents’ expert witnesses, Rafferty and Castellano, lacked credibility and were unpersuasive in opining that Respondents’ audit procedures complied with GAAS. Both Rafferty and Castellano failed to adequately distinguish Respondents’ procedures for the 2000 audit, an audit that had serious fraud issues and possible net capital rule implications, with those that would be performed during an ordinary audit. Further, Rafferty and Castellano, due to their inexperience with broker-dealer audit clients, failed to grasp the importance of the net capital rule on the survival of ESI and its effect on the 2000 audit.

b. Respondents' Lack of Inquiry with ESI Management

Respondents never requested any documentation regarding the Erwin embezzlement or how the \$2 million figure was calculated, despite Dairaghi notifying Lewis that a documentation trail was left by Erwin. In fact, other than an undocumented status meeting of which Lewis could not remember any details, neither Rubin nor Lewis questioned or discussed the fraud with Oakes, the ESI person most directly involved with the resolution of the Erwin embezzlement.

In addition to D&S's response letter, Respondents relied on the management representation letter stating there were no unasserted claims probable of assertion.³² According to AU 337.05, management is the primary source of information about litigation, claims, and assessments. While a management representation letter is one method of obtaining this information, it is not the sole method. AU 337.05(b), (d). Other than obtaining the management representation letter, Respondents failed to make any probing inquiries of ESI regarding the Erwin embezzlement. Obtaining a boilerplate management representation letter is not a replacement for an auditor performing the necessary inquiries required by GAAS, especially since Respondents knew of the Erwin embezzlement at the start of the audit. Misconduct constituting recklessness, which is an extreme departure from professional due care, occurs when an auditor either skips procedures designed to discover material misstatements or "looks the other way despite suspicions." *Marrie*, 374 F.3d at 1204. By not inquiring further with Vander Laan or making probing inquiries with ESI management, I find that Respondents, in fact, lacked professional skepticism throughout the audit.

Respondents showed no concern about the adverse affect the Erwin fraud could have on the firm's ability to survive. They avoided obvious inquiries that could have discovered the existence of the settlement offers and the need to accrue for them. Instead, Respondents inappropriately relied on their relationship with Dairaghi and a standard representation latter. Therefore, I conclude that Respondents failed to obtain sufficient competent evidential matter as required by GAAS.

4. Rubin's and Lewis's Credibility

Respondents' argue that ESI management and Vander Laan intentionally misled them by failing to disclose the existence of the settlement offers in either the management representation letter or the D&S letter. This is not supported by the record. Rubin testified that Dairaghi and Oakes did not mislead him. On direct examination, Rubin testified the D&S letter was not unfair, but he later changed his testimony that he believed Vander Laan acted inappropriately. I find Rubin's testimony to be inconsistent and not credible to explain why he believed he was deceived.

³² The D&S letter mentions unasserted claims, but does not explicitly characterize them as probable of assertion. Thus, Respondents' argue management's representation that there were no unasserted claims probable of assertion was consistent with the D&S letter. But without further investigation by Respondents, they could not determine if this was, in fact, true.

The pro forma letters exchanged between D&S, ESI, and RBG never mentioned the embezzlement or settlement offers. The inference I draw from these exchanges is that it enabled ESI to not disclose the settlement offers to Respondents with the understanding that Rubin and Lewis would not ask about them. Rubin was an experienced auditor for this client and Dairaghi, now ESI's chief financial officer, had previously been RBG's engagement manager for ESI. I infer from these relationships that this "pro forma" approach to conducting the audit was done intentionally, or at least recklessly, to avoid disclosing a net capital violation in order to give ESI an unqualified audit opinion and prevent its failure. As such, Rubin and Lewis were not credible witnesses in explaining why RBG issued an unqualified audit opinion, or why they failed to perform sufficient audit procedures that could have disclosed ESI's need to accrue for a contingent liability.

5. Respondents Issued an Inaccurate Audit Report

Under GAAS standards of reporting, an audit report must state whether the financial statements were presented in conformity with GAAP and whether the audit was conducted in accordance with GAAS. AU 410, 508. The audit report falsely represented both requirements were met. Accordingly, I conclude Respondents were reckless by failing to exercise professional due care and obtain sufficient competent evidential matter in their conduct of the 2000 audit. As a result of this reckless conduct, Respondents violated GAAS by issuing a materially false audit report. Thus, I further conclude that Respondents engaged in improper professional conduct that violated Rule of 102(e)(1)(ii)(A).

IV. SANCTIONS

The Division requests that Respondents be barred from appearing or practicing before the Commission as accountants, with the right to apply for readmission within three years. (Div. Br. at 10.) The Commission may impose a censure or deny a person the privilege to practice before it in any way, temporarily or permanently. 17 C.F.R. § 201.102(e)(1), (3). Sanctions under Rule 102(e) may be imposed for remedial purposes only. McCurdy, 396 F.3d at 1264; Johnson v. SEC, 87 F.3d 484, 490 (D.C. Cir. 1996). The purpose of Rule 102 sanctions is not to punish, but to protect the public from future reckless or negligent conduct by professionals who practice before the Commission. 17 C.F.R. § 201.102(e)(1)(iv); McCurdy, 396 F.3d at 1264. Sanctions under Rule 102(e), as applied to accountants, encourage a more rigorous compliance with GAAS in future audits. McCurdy, 396 F.3d at 1265.

The severity of sanctions depends on the facts of each case and the value of the sanctions in preventing a recurrence of the violative conduct. See Berko v. SEC, 316 F.2d 137, 141 (2d Cir. 1963). Sanctions should demonstrate to the particular respondent, the industry, and the public in general that egregious conduct elicits a harsh response. See Arthur Lipper Corp. v. SEC, 547 F.2d 171, 184 (2d Cir. 1976).

A. Kenneth L. Rubin

At the time of the 2000 audit, Rubin had more than twenty years of auditing experience, which includes approximately fifty broker-dealer audits. Given Rubin's lengthy audit and broker-dealer industry experience, his conduct and lack of professional due care during the 2000 audit is particularly troubling. Even more troubling is Rubin's testimony that he did not believe he committed any substantial errors during the 2000 audit, and if he could, he would not alter how the audit was performed.

Rubin is a licensed Missouri CPA and currently is an audit partner at RBG, so it is assumed he will continue to conduct audits of broker-dealers in the future. Other than this proceeding, Rubin has never been sanctioned by any regulatory or professional authority. (Tr. 200.) In this proceeding, however, I conclude that he acted at least recklessly, though there is a strong inference from the record that he also intentionally violated GAAS. His prior unblemished record fails to overcome his egregious conduct in supervising the 2000 audit.

Due to Rubin's reckless conduct and his belief that he did no wrong, I find there is a substantial risk that Rubin will commit future violations of GAAS. Thus, I find it necessary to deny him the privilege of appearing or practicing before the Commission for three years.

B. Michael W. Lewis

Lewis is a licensed CPA in Missouri. Prior to this proceeding, he has never been sanctioned by any regulatory or professional authority. Lewis was the manager of the 2000 audit and, in that role, performed or directly supervised the audit testwork that failed to conduct basic inquiries of the Erwin embezzlement and its effect on the financial statements. I conclude that he acted at least recklessly in his conduct as the manager for the 2000 audit. Since Lewis is currently an audit partner at RBG, it is assumed that he will continue to audit public companies and practice before the Commission. There is, therefore, a substantial risk Lewis will commit future violations of GAAS. Thus, I find it necessary to deny him the privilege of appearing or practicing before the Commission for three years.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Commission's Office of the Secretary on May 26, 2005.

VI. ORDER

Based upon the findings and conclusions set forth above:

IT IS ORDERED, pursuant to Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e), that Kenneth L. Rubin, CPA, be temporarily denied the privilege of appearing or practicing before the Commission as an accountant for three years; and

IT IS FURTHER ORDERED, pursuant to Rule 102(e) of the Commission's Rules of Practice, that Michael W. Lewis, CPA, be temporarily denied the privilege of appearing or practicing before the Commission as an accountant for three years.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact, or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Robert G. Mahony
Administrative Law Judge