

PCAOB Survives Constitutional Challenge

By Steven R. Berger, JD

WASHINGTON—The recently released Treasury Advisory Committee on the Auditing Profession's final report recommends that the Public Company Accounting Oversight Board (PCAOB) take a greater oversight role of large CPA firms, but a recent lawsuit and a possible appeal to the Supreme Court could leave the board not only without the power to follow through on these recommendations but could also mean an end to the PCAOB itself.

A federal appeals court upheld, 2-1, the constitutionality of the PCAOB on Aug. 22, after a lawsuit challenged the board's legality to regulate and inspect public company accounting and auditing firms.

The suit was originally filed in 2006 by plaintiffs Free Enterprise Fund, a free market advocacy nonprofit organization in Washington D.C., and Beckstead and Watts LLP, a small, Nevada-based accounting firm.

The suit charged that creation and operation of the PCAOB under the Sarbanes-Oxley Act of 2002 (SOX) violated the appointments clause of the Constitution, the separation of powers principles and non-delegation principles, because it did not permit adequate control of the PCAOB by the U.S. president.

Ultimately, the United States Court of Appeals for the District of Columbia Circuit disagreed and found that the president possesses significant influence over the SEC, which, in turn, has comprehensive control over the PCAOB. That is sufficient to withstand the constitutional challenge that SOX violated the separation of powers principle.

The Free Enterprise and Beckstead in 2006 sought declaratory and injunctive relief, arguing that the provisions of SOX creating the PCAOB were unconstitutional, that the PCAOB should be prohibited from carrying out its powers delegated to it under SOX, and that, specifically, the PCAOB should be enjoined from taking any further investigative or enforcement action against Beckstead and Watts.

At the time of the original filing, the firm had been the focus of a PCAOB investigation.

Beckstead and Watts argued that it had been injured by the PCAOB's auditing standards, which the firm said substantially increased the time and expense of public company audits, thereby reducing its profits and client capacity. The firm also argued that the PCAOB's inspection report damaged its professional reputation.

Earlier Decision

In its March 2007 opinion, the Federal District Court in Washington D.C. rejected the PCAOB's motion to dismiss for lack of subject matter jurisdiction and for lack of standing of the plaintiffs, but granted the PCAOB's motion for a summary judgment stating that Free Enterprise and Beckstead had not demonstrated that the provisions of SOX are unduly severe in all circumstances and cannot be constitutionally applied. The plaintiffs appealed to the circuit court of appeals.

The United States government intervened in the case to defend the constitutionality of SOX, and in a 2-1 decision, the D.C. Circuit Court of Appeals upheld the lower court's findings. It determined that the courts did indeed have the jurisdiction necessary to hear the constitutional challenges posed by the plaintiffs and that the creation and organization of the PCAOB under SOX did not violate the separation of powers clauses under the Constitution.

Citing substantial Supreme Court precedents addressing constitutional challenges to previous executive appointments, the appeals court stated that the plaintiff's burden of proof was a heavy one in that they had to show that the provisions of SOX were unduly severe in all circumstances and could not be constitutionally applied.

"The Supreme Court precedent as we have it does not support appellants' singular focus on removal of powers as the be-all and end-all of Executive authority," wrote Judge Judith Rogers for the majority, "but rather compels a more nuanced approach that examines the myriad means of Executive control."

The Board

The PCAOB, created by SOX in response to the Enron and WorldCom scandals, is a non-profit corporation charged with overseeing auditors of public companies to protect the interests of investors. In the five years since its creation, the PCAOB has implemented registration requirements for accounting firms performing attest services for public company clients in the United States, issued new standards for auditors and reviewed the operations of all registered firms at least once.

The PCAOB is not without its critics, however. Some have argued that the inspection process is slow and has not produced significant changes in the way accounting firms perform, while others have criticized the PCAOB for being too intrusive on private industry.

The Appointments Clause Question

The appointments clause of the Constitution (Article II, Section 2) provides that the president shall nominate, and with the advice and consent of the U.S. Senate, shall appoint, ambassadors, public ministers and consuls, the justices of the Supreme Court and all other officers of the United States whose appointments are not otherwise specifically addressed. However, Congress may, by law, grant appointment powers of inferior officers of the U.S. government in entities or agencies other than the president.

The gist of the plaintiffs' argument was that the PCAOB was an independent agency appointed by another independent agency, with a structure that restricted the president's constitutional authority to remove executive officers. The suit alleged that the absence of daily supervision of the PCAOB by the SEC and the limitation on the SEC's ability to remove members of the PCAOB meant that the members of the PCAOB were not inferior officers and therefore were required to be appointed by the president.

The majority opinion rejected those arguments and found that the PCAOB did not have to be appointed directly by the president.

SOX does not encroach upon the appointment power because board members are subject to direction and supervision of the commission and therefore are inferior officers not required to be appointed by the president, Rogers wrote.

She added that the "for-cause limitations on the Commission's power to remove Board members and the President's power to remove Commissioners do not strip the president of sufficient power to influence the Board and thus do not contravene separation of powers, as that principle embraces independent agencies like the Commission and their exercise of broad authority over subordinates."

There can be little argument that the power and authority of the PCAOB are subject to the supervision of the SEC, as Section 107(a) of SOX specifically states that the SEC "shall have oversight and enforcement authority over the [Board]" and that the [Board] shall be subject to the provisions of the Securities Exchange Act of 1934 as if the [Board] were a "registered securities association." In fact, SOX requires that all actions of the PCAOB require the approval of the SEC.

For example:

- the SEC must review and approve all rules promulgated by the PCAOB;
- the SEC has the authority to amend the PCAOB's rules as if the PCAOB were a registered securities association;
- the SEC must review any proposed disciplinary action by the PCAOB;
- the SEC may, by rule, consistent with the purposes of SOX, relieve the PCAOB of any responsibility to enforce provisions of SOX or the Federal securities laws, or impose limitations on the activities, functions or operations of the PCAOB; and
- the SEC may remove from office or censure any member of the PCAOB if the SEC finds, on the record after notice and hearing, that such member has willfully violated any provision of SOX, the rules of the PCAOB or Federal securities laws, or has willfully

(Continues on page 5)

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PCAOB Survives Constitutional Challenge

(Continued from page 4)

abused the authority of the office, or without reasonable justification or excuse, has failed to enforce against any registered public accounting firm or associated person, such firm's or person's compliance with any provision or rule under SOX, the Federal securities laws or the PCAOB, or compliance with any professional accounting standard.

While the PCAOB has a broad range of duties, its ability to fulfill such duties is subject to the check of the SEC at each significant step. Because the PCAOB members are accountable to the SEC and may be removed by the SEC, the court found that the members of the PCAOB are "inferior officers" within the scope of the appointments clause. The court also held that the SEC was equivalent to a "department" because it has rulemaking, investigative and adjudicatory authority.

SEC commissioners are appointed with the advice and consent of the Senate and are removable by the president. Relying on the structure that the SEC commissioners are principal officers appointed by the president and the members of the PCAOB are inferior officers accountable to the SEC, the circuit court ruled that the PCAOB did not violate the appointments clause.

The court stated that the control of the PCAOB by the SEC, and the control of the SEC by the president, did not amount to an unconstitutional restriction on presidential powers. The circuit court affirmed the grant

of summary judgment in favor of the PCAOB and the United States, ruling that the reality of the president's authority under SOX, whether exercised directly or through principal officers of departments, was sufficient to withstand the constitutional challenge by the appellants.

The circuit court decision was not unanimous, and it engendered a comprehensive, and fairly strident, dissenting opinion.

The Dissent

In his opinion, dissenting Judge Brett Kavanaugh stated that the PCAOB is not accountable to the president, and that such detachment under SOX was intentional by Congress.

"The two constitutional flaws in the PCAOB statute are not matters of mere etiquette or protocol," Kavanaugh wrote. "By restricting the President's authority over the Board, the Act renders this Executive Branch agency unaccountable and divorced from Presidential control to a degree not previously countenanced in our constitutional structure."

Not wanting to invalidate the PCAOB, the Kavanaugh suggested that the constitutional failing of SOX could easily be amended through the adoption by Congress of an amendment to SOX requiring that the members of the PCAOB be appointed by the president, with the advice and consent of the Senate, as set forth in the appoint-

(Continues on page 6)

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PCAOB Survives Constitutional Challenge

(Continued from page 4)

ments clause.

Congress could also make the PCAOB part of the SEC, Kavanaugh wrote, directed, supervised and removable at will by the commission.

"In the meantime, however, the Board's structure violates the Constitution of the United States," he wrote.

Legislative history clearly shows that Congress rejected making the PCAOB a

PCAOB issued a statement that it was gratified by the circuit court's decision.

The PCAOB had been supported in its case through amicus briefs submitted by Teachers Insurance and Annuity Association—College Retirement Equities Fund, the AFL-CIO and several public employee pension funds. The SEC issued a statement that the circuit court's ruling was "welcome news" for investors and the U.S.

"In the meantime, however, the Board's structure violates the Constitution of the United States."
—Judge Brett Kavanaugh, U.S. Court of Appeals for the District of Columbia Circuit

part of the SEC but opted to create it as an independent entity. The dissenting opinion also argued that the SEC does not have the power to supervise the PCAOB's critical functions of inspections, investigations and enforcement, and accordingly, the SEC did not have sufficient supervisory powers over the PCAOB. The dissenting opinion concluded that the PCAOB structure violates the appointments clause of the Constitution because it unduly restricts the president's appointment and removal powers.

What does this mean going forward? The

capital markets.

Appellants are most likely to request an en banc hearing in front of the full D. C. circuit court or to appeal to the Supreme Court. Until then, it is business as usual for the PCAOB.

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