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## PCAOB's Future In The Supreme Court's Hands

*Law360, New York (January 29, 2010)* -- The Supreme Court recently heard oral arguments in a case that will decide the future of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). While it is unlikely that a decision in the case, *Free Enterprise Fund v. PCAOB*,<sup>[1]</sup> will result in the PCAOB's dissolution, it could significantly change the Board's jurisdiction over public accounting firms and individual accountants and have a major impact on its regulatory role.

Since the enactment of its rules in 2004, the PCAOB has initiated 26 cases resulting in 26 settlements.<sup>[2]</sup> The PCAOB also performs inspections of accounting firms every year, often requiring the firms to make major changes to their audit approaches and documentation procedures.

While PCAOB investigations and informal inquiries are confidential, the PCAOB has an active and extensive docket of cases. If the Supreme Court requires Congress to alter the jurisdiction of the Board or otherwise change how the PCAOB is run, no one knows the effect such a decision could have on the PCAOB and the accounting firms under its jurisdiction.

Will the existing settlements be overturned? Will the accounting firms no longer have to make the changes PCAOB has mandated through the inspection process? Will the PCAOB have to turn over its docket to the U.S. Securities and Exchange Commission or some other regulatory body?

### The PCAOB's Formation and Role

Congress enacted the Sarbanes-Oxley Act of 2002 ("SOX")<sup>[3]</sup> in the wake of accounting scandals like Enron and WorldCom that highlighted "the critical need for a regular and comprehensive review, by an independent body of inspectors, of each audit firm's compliance with audit standards and procedures."<sup>[4]</sup>

Title I of SOX established the PCAOB as a private-sector, nonprofit corporation, to oversee the audits of public companies in an effort to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports ..."<sup>[5]</sup>

Pursuant to SOX, the SEC oversees the PCAOB and appoints the Board's five members after consultation with the Chairman of the Board of Governors of the Federal Reserve and the Secretary of the Treasury.<sup>[6]</sup> These Board members serve five-year, staggered terms and may only be removed by the SEC for "good cause shown."<sup>[7]</sup>

Through SOX, Congress bestowed numerous responsibilities upon the PCAOB. The Board can register public accounting firms,<sup>[8]</sup> adopt auditing, quality control and ethics standards,<sup>[9]</sup> conduct periodic inspections of registered firms,<sup>[10]</sup> and investigate and discipline registered public accounting firms and individual accountants.<sup>[11]</sup>

If a firm is not registered with the PCAOB, it cannot perform an audit of, or issue an audit report for, a publicly held company.[12] The sanctions the PCAOB may impose include: censure; additional training or education; temporary suspension or permanent revocation of registered status; temporary or permanent limitation on the activities performed by the sanctioned firm or accountant; and a number of monetary penalties.[13]

Although the Board's actions are subject to SEC oversight to a certain extent,[14] the sheer breadth of the PCAOB's powers has called into question not only its nominal status as a private corporation, but also whether its very existence is constitutional.

### **Free Enterprise Fund: A Threat to the PCAOB's Constitutionality**

The Supreme Court recently heard one such challenge to the PCAOB's constitutionality in Free Enterprise Fund, which has been touted as "the most important separation-of-powers case regarding the President's appointment and removal powers to reach the courts in the last 20 years." [15]

This case presents a facial challenge to the Board's constitutionality based on the Appointment Clause[16] and separation-of-powers principles.

The main issue before the court is whether SOX violates the Constitution's separation-of-powers principles by vesting Board members with broad executive powers without granting the President the authority to appoint or remove the them.

Beckstead and Watts LLP ("Beckstead"), a small Nevada-based accounting firm, along with the Free Enterprise Fund (the "Fund"), a public interest organization, initiated Free Enterprise Fund in 2006.

Beckstead was the subject of a 2004 PCAOB inspection, which caused the firm to shut down its auditing practices due to the time and money expended to comply with the Board's requirements.[17]

In response, the Fund and Beckstead brought an action in the District of Columbia seeking declaratory and injunctive relief "declaring unconstitutional the provisions of [SOX] creating and empowering the Board ... [and] enjoining the Board and its Members from carrying out any of the powers delegated to them by [SOX]." [18]

While both the D.C. District Court and Circuit Court of Appeals upheld the PCAOB's constitutionality, the Supreme Court granted certiorari in May 2009.[19]

On Dec. 7, 2009, Beckstead and the Fund argued their case before the Supreme Court. Certain Justices showed some skepticism about the PCAOB's constitutionality.[20] For those Justices who seemingly oppose the PCAOB, their main concern is the way SOX insulates the PCAOB from presidential control.[21]

Chief Justice Roberts questioned whether SOX's two layers of insulation, or "for-cause squared," [22] violates the President's removal powers and asked if there is "any reason Congress couldn't have achieved [the] same objectives by establishing the PCAOB as a division within the SEC?" [23]

Similarly, Justice Alito referred to the removal issue, asking whether "the more layers of for-cause removal you add, the less control the President has?" [24] Conversely, Justices Ginsburg, Breyer and Sotomayor appeared sympathetic to the Board's case.[25]

While it is likely that the Court will not return a decision for a few months, the strong arguments against the PCAOB's, and by extension SOX's, [26] constitutionality have caused many to question what the future holds for the PCAOB and the accounting profession.[27]

## The Future of the PCAOB

Assuming that the Supreme Court deems the PCAOB unconstitutional, Congress will be forced to rework SOX.

As Judge Kavanaugh in his dissenting opinion in the court of appeals noted, “the constitutional flaws here could be easily and quickly corrected,” and SOX’s deficiencies remedied in two ways: 1) amend SOX and authorize the President to appoint and remove Board members; or 2) make the PCAOB part of the SEC.[28]

Additionally, a “simple but, perhaps, inappropriate approach would be to transfer all the [PCAOB’s] functions to the SEC,”[29] thereby eliminating the PCAOB entirely.

Regardless of the ease with which Congress can remedy the situation, the question remains what effect such a reformation would have on accounting firms and individual accountants registered with the PCAOB.

### *PCAOB Settlements and Subject Matter Jurisdiction*

As a result of the Board’s 26 disciplinary proceedings, 19 accounting firms and 30 accountants have been sanctioned.[30] Each case was resolved through the entry of consent orders, in which firms and accountants acknowledged the Board’s personal and subject matter jurisdiction and agreed to the imposition of sanctions.[31]

Most commonly, the PCAOB revoked the firms’ registrations and/or barred individual accountants from further association with any registered public accounting firm.[32] However, four accountants were suspended for one year, three of which remain in effect.[33]

If the PCAOB is unconstitutional, what happens to these settlements?

The simplest answer would be for disciplined parties to enter new consent orders with whatever organization takes over the PCAOB’s role, i.e. the SEC or a reworked version of the PCAOB.

The new order would mirror that currently in effect thereby carrying out the sanction imposed. Moreover, if SOX is amended to afford the president appointment and removal power, there will likely be no need to enter new orders.

Assuming that a disciplined accountant or firm does not enter a new consent order, would the existing settlements remain in effect?

Supreme Court precedent suggests that a party disciplined by a government agency can challenge that discipline if the agency’s officials were improperly appointed.[34] However, it is possible that a decision against the Board could render the settlements void even without such a challenge.

An analogy can be drawn between consent orders in PCAOB proceedings and consent orders in court proceedings. To adjudicate a case, a court must have jurisdiction over the subject matter of the case conferred upon it by statute.[35]

Absent subject matter jurisdiction, any order or judgment the court enters may be set aside as void[36] and treated as if it never existed.[37] Similarly, if Title I of SOX is unconstitutional, the PCAOB loses its only source of jurisdiction.

If the PCAOB lacked subject matter jurisdiction at the time the consent orders were entered, the orders should be voided. The issue then becomes whether a finding of unconstitutionality would retroactively strip the PCAOB of jurisdiction and invalidate consent orders previously entered.

It is well established that a finding of unconstitutionality renders a law void ab initio: “[a]n unconstitutional act is not a law; it confers no rights; it imposes no duties; it affords no protection; it creates no office; it is, in legal contemplation, as inoperative as though it had never been passed.”[38]

Furthermore, questions of constitutionality should generally be given retroactive effect.[39] Therefore, a decision in *Free Enterprise Fund* that Title I of SOX is facially unconstitutional would render Title I void ab initio. Such a determination should retroactively strip the PCAOB of jurisdiction and invalidate existing consent orders.[40]

Even if the settlements are voided, it is likely in the disciplined parties’ best interests to consent to new orders with the SEC or the reestablished PCAOB.

In SOX’s current form, the SEC can “regulate the accounting profession ... set standards for accounting or auditing practices ... or take ... legal, administrative, or disciplinary action against any registered public accounting firm or any associated person thereof.”[41]

Assuming any prior disciplinary action is considered a nullity, what is to stop the SEC from initiating a second proceeding?[42] The drain on both financial resources and time that re-defending a case would entail will likely be too costly for many firms and individuals. Therefore, firms and accountants may be better off consenting to the continuation of their existing sanctions.

#### *Open PCAOB Investigations*

The fate of the unknown number of individuals and firms currently under investigation[43] will not likely be significantly affected by a declaration that the PCAOB is unconstitutional.

If Title I of SOX is struck down, investigated parties will presumably have their cases transferred to the SEC or to another organization. Alternatively, Congress could amend SOX to make it comport with the Constitution, and the cases would remain with the PCAOB.

Either a transfer of regulatory agency or a revision of Title I could lead to a change in investigatory procedures. Furthermore, a ruling against the PCAOB will likely halt pending investigations.

Whether the PCAOB is entirely disbanded or Congress amends SOX, the PCAOB, or whatever agency takes over its role, should be enjoined from carrying out its investigations until the transfer of cases is complete or the law is rewritten.[44]

As with those already disciplined, the time and money necessary to challenge any procedural change is likely too great. Additionally, firms that have altered their practices due to PCAOB recommendations,[45] in all probability, will continue to comply with those recommendations rather than return to their old practices.

Therefore, firms and accountants may be forced to endure a longer investigation if *Beckstead* and the *Fund* prevail, but there is no indication that the outcome of such investigations will differ if the Court deems the PCAOB unconstitutional.

#### **Whatever the Result in *Free Enterprise Fund*, There Likely Will Be No Certainty How the New PCAOB Will Interact With SEC**

There is little doubt that a decision against the PCAOB in *Free Enterprise Fund* will have a substantial impact on the accounting profession. However, the effect such a decision will have on the PCAOB's relationship with the SEC remains to be seen. Even today, it is unclear how exactly the SEC and the PCAOB interact.

This confusion is evidenced by the debate over the degree of control the SEC maintains over the Board, which is at the forefront of the parties' Appointment Clause arguments in *Free Enterprise Fund*.<sup>[46]</sup>

If Beckstead and the Fund prevail, will the PCAOB become a part of the SEC? Will the PCAOB cease to exist and the SEC take over its role? Or will SOX simply be amended and the SEC remain in the supervisory position it is today?

These questions have remained unanswered since the formation of the PCAOB. Indeed, the SEC's recent announcement regarding its initiative to encourage cooperation does not mention the PCAOB or how the initiative may apply to the PCAOB.<sup>[47]</sup>

In sum, the Supreme Court's decision in *Free Enterprise Fund* will resolve, at least for now, the legitimacy of the PCAOB. The role the agency will play in regulating accountants and accounting firms is yet to be determined.

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*The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*

[1] 537 F.3d 667 (D.C. Cir. 2008), cert. granted, 129 S. Ct. 2378 (U.S. argued Dec. 7, 2009) (No. 08-861).

[2] PCAOB Disciplinary Proceedings, [www.pcaobus.org/Enforcement/Disciplinary\\_Proceedings/index.aspx](http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/index.aspx) (last visited Jan. 26, 2010).

[3] Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[4] S. Rep. No. 107-205, at 8 (2002).

[5] 15 U.S.C. § 7211(a) (2002).

[6] *Id.* §§ 7211(e)(1), (e)(4)(A).

[7] *Id.* §§ 7211(e)(5)(A)(i), (e)(6). "Good cause" exists when a Board member "willfully violate[s] any provision of [SOX], the rules of the Board, or the securities laws ... willfully abuse[s] [his or her] authority ... [or] ... fail[s] to enforce compliance with any such provision or rule, or any professional standard." *Id.* § 7217(d)(3).

[8] *Id.* § 7211(c)(1). As of Nov. 15, 2009, there were 2,236 foreign and domestic accounting firms registered with the PCAOB. PCAOB Strategic Plan 2009-2013, at 12 n. 5, [www.pcaobus.org/About\\_the\\_PCAOB/Strategic\\_Plan.pdf](http://www.pcaobus.org/About_the_PCAOB/Strategic_Plan.pdf).

[9] *Id.* § 7211(c)(2).

[10] Id. § 7211(c)(3). Audit firms that conduct more than 100 audits per year of publicly held companies are inspected annually, while firms auditing fewer than 100 companies are inspected every three years. Id. §§ 7214(b)(1)(A)-(B).

[11] Id. § 7211(c)(4).

[12] Id. § 7212(a).

[13] Id. §§ 7215(c)(4)(A)-(F). For intentional, knowing or repeatedly negligent conduct, civil monetary penalties may reach as high as \$15 million for a firm and \$750,000 for an individual. 15 U.S.C. § 7215(c)(4)(D)(ii).

[14] See id. § 7217(a) (“The Commission shall have oversight and enforcement authority over the Board”). Aside from general oversight, the SEC has the power to “enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board.” Id. § 7217(c)(3).

[15] *Free Enter. Fund*, 537 F.3d at 685 (Kavanaugh, J., dissenting).

[16] U.S. Const. art. II, § 2, cl. 2. The Appointment Clause requires that the President appoint and the Senate confirm “Officers of the United States.” Whereas, Congress may vest the power to appoint “inferior officers” in the President, Courts of Law, or “Heads of Departments.” Id. In *Free Enterprise Fund*, the petitioners argue: 1) Board members are not “inferior officers” and must be appointed by the President; and, 2) even if Board members are “inferior officers,” the SEC cannot validly appoint Board members as the SEC is neither a “Department,” nor are its Commissioners “Heads of Departments.” *Free Enter. Fund*, 537 F.3d at 672.

[17] See Complaint, at ¶¶ 72-80, *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 2007 WL 891675 (D.D.C. Mar. 21, 2007) (No. 06-0217), 2006 WL 316852 (D.D.C. Feb. 7, 2006).

[18] See id. at Prayer for Relief ¶¶ 1-2.

[19] The Court may have based its decision to grant certiorari on issues raised in Judge Kavanaugh’s dissent in the court of appeals. Finding that Title I of SOX violated the Appointment Clause, Judge Kavanaugh argued that Board members were principal officers, as they were neither directed and supervised nor removable at will by the SEC. Id. at 687 (Kavanaugh, J., dissenting). As principal officers, Board members must be appointed by the President and confirmed by the Senate, so the SEC’s appointment of PCAOB members is unconstitutional. Id.

Additionally, Judge Kavanaugh found the PCAOB ran afoul of separation-of-powers principles, as Board members are only removable for cause by SEC Commissioners who in turn are only removable for cause by the President. This renders the President’s power over the PCAOB “two levels of for-cause removal away ... [which] effectively eliminates any Presidential power to control the PCAOB ...” Id. at 686 (Kavanaugh, J., dissenting).

[20] See Transcript of Oral Argument at 67, *Free Enter. Fund*, 129 S. Ct. 2378 (U.S. argued on Dec. 7, 2009) (No. 08-861) (Chief Justice Roberts references Judge Kavanaugh’s dissent in a question to petitioners’ counsel).

[21] This concern stems from the so-called “unitary executive” theory under which the President controls the entire executive branch as the unitary executive, and Congress should not be permitted to insulate agencies that execute laws from the President’s control. Adam Liptak, *Court Spars Over Oversight of Agencies*, N.Y. Times, Dec. 7, 2009, available at [www.nytimes.com/2009/12/08/business/08bizcourt.html?\\_r=1](http://www.nytimes.com/2009/12/08/business/08bizcourt.html?_r=1) (last visited Jan. 26, 2010).

[22] Id.

[23] Transcript of Oral Argument, *supra* note 20, at 35.

[24] *Id.* at 48.

[25] See generally *id.*

[26] It is noteworthy that SOX does not include a severability clause to prevent the entire statute from being unconstitutional if any portion of it is struck down. See Harold S. Bloomenthal, *Constitutionality of PCAOB Under Attack*, 31 No. 10 Sec. and Fed. Corp. L. Rep. 1 (2009). Without a severability clause, some question whether a declaration that Title I of SOX, which establishes the PCAOB, is unconstitutional would render all of SOX invalid, while others note that the Fund and Beckstead were “careful ... to attack only the constitutionality of the PCAOB” rather than SOX as a whole. Bloomenthal, *supra* note 26.

[27] See, e.g., *id.*

[28] *Free Enter. Fund*, 537 F.3d at 687 (Kavanaugh, J., dissenting). Chief Justice Roberts mimicked Judge Kavanaugh during oral argument. See Transcript of Oral Argument, *supra* note 20, at 67.

[29] Bloomenthal, *supra* note 26.

[30] See PCAOB Disciplinary Proceedings, *supra* note 2.

[31] *Id.*

[32] See *id.* Since the PCAOB’s inception, it has revoked 14 firms’ registrations and barred 25 accountants from being further associated with any registered public accounting firm. *Id.*

[33] *Id.* The most recent suspension is set to end June 16, 2010.

[34] See *Ryder v. United States*, 515 U.S. 177 (1995) (holding that it was improper to validate decision of military panel where panel’s composition violated the Appointment Clause).

[35] See, e.g., 28 U.S.C. §§ 1331-32 (granting district courts subject matter jurisdiction).

[36] See Fed. R. Civ. P. 60(b)(4); 11 Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, *Federal Practice & Procedure* § 2862 (2d ed. 1995) (under Rule 60(b)(4), a judgment is void “if the court that rendered it lacked jurisdiction of the subject matter”).

[37] See *Kalb v. Feuerstein*, 308 U.S. 433, 438-39 (1940) (finding state court order involving subject matter exclusively in bankruptcy court’s jurisdiction void and a “nullity”). For purposes of relief from void judgments, consent orders are treated the same as other orders. *McCray v. Dawson*, 953 F. Supp. 1476 (M.D. Ala 1996); *Feeling v. Kelly*, 152 F.R.D. 670 (D.D.C. 1996).

[38] *Norton v. Shelby County*, 118 U.S. 425, 442 (1886).

[39] See *Harper v. Virginia Dep’t of Taxation*, 509 U.S. 86, 97 (1993) (noting that absent the Court’s explicit declaration, “an opinion announcing a rule of federal law ... must be read to hold ... that its rule should apply retroactively”).

[40] This assumes that the Supreme Court does not specifically address the retroactive application of its decision.

[41] 15 U.S.C. §§ 7202(c)(1)-(3).

[42] Indeed, the former chair of the panel on Audit Effectiveness, warned that the “coordination” between the SEC and PCAOB presents a type of “double jeopardy wherein a firm or individual agrees to a finding, sanction or settlement with the Board only to have the SEC set aside that agreement or settlement and begin the process all over.” Letter from Shaun F. O’Malley to Office of the Secretary, PCAOB (Aug. 13, 2003), available at [www.pcaobus.org/Rules/Docket\\_005/Comments/All.pdf](http://www.pcaobus.org/Rules/Docket_005/Comments/All.pdf).

[43] PCAOB inspections and investigations are confidential. See PCAOB Rule 5108(a).

[44] See Complaint, *supra* note 17, at Prayer for Relief ¶¶ 1-2.

[45] See PCAOB Rule 4009(a) (if the Board’s inspection report criticizes a firm’s quality control systems, the firm “may submit evidence or otherwise demonstrate ... that it has improved such systems ...”).

[46] Compare Brief of Petitioners at 48, *Free Enter. Fund v. PCAOB*, 537 F.3d 667 (D.C. Cir. 2008), cert. granted, 129 S. Ct. 2378 (July 27, 2009) (No. 08-861), 2009 WL 2247130 (arguing that Board members are principal officers, and noting the SEC has “no extant mechanism for reviewing the Board’s failures to investigate and cannot remove Board members for such mistakes in judgment”), with Brief for Respondents at 15-16, *Free Enter. Fund v. PCAOB*, 537 F.3d 667 (D.C. Cir. 2008), cert. granted, 129 S. Ct. 2378 (Oct. 13, 2009) (No. 08-861), 2009 WL 3327230 (arguing that Board members are inferior officers as they are “directed and supervised by the Presidentially appointed Commissioners of the SEC ... [and] [t]he SEC ... wields a vast degree of control at every significant step”).

[47] See Press Release, Securities and Exchange Commission, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), [sec.gov/news/press/2010/2010-6.htm](http://sec.gov/news/press/2010/2010-6.htm) (last visited Jan. 28, 2010).