



## Issue Analysis

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# **The Public Company Accounting Oversight Board:**

An Unconstitutional Assault on  
Government Accountability

By Hans Bader and John Berlau

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# **The Public Company Accounting Oversight Board: *An Unconstitutional Assault on Government Accountability***

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## **EXECUTIVE SUMMARY**

The Sarbanes-Oxley Act of 2002 created a powerful quasi-private agency to oversee the auditing of American business, the Public Company Accounting Oversight Board (PCAOB). The PCAOB is responsible for a mountain of red tape, and its broad interpretation of Sarbanes-Oxley's rules on what constitutes a company's "internal controls" is costing the U.S. economy billions of dollars every year.

But there is a different yet related reason that the PCAOB is problematic. The structure and method of appointing its members clearly violates the Appointments Clause of the U.S. Constitution. Disregarding the Constitution's bedrock principle of separation of powers, Congress gave the power to appoint the members of the PCAOB not to the President, but to the five members of the Securities and Exchange Commission. This method of appointment violates the Appointments Clause in numerous ways. The Appointments Clause gives only the President the power to appoint the nation's principal officers, and allows low-ranking officers to be picked only by the President, a court, or by a single head of a cabinet-level department. The five commissioners of the SEC, as a group, don't fall under any of these categories.

Recent Supreme Court decisions show that a consensus of both liberal and conservative justices takes Appointments Clause violations very seriously. The Court has ruled that disciplinary actions can be overturned solely because the government body in question was improperly appointed. Based on these precedents, courts can block enforcement of the PCAOB's rules interpreting portions of Sarbanes-Oxley, such as the onerous "internal control" provisions.

Above all, the authors conclude, the Appointments Clause violation creates a lack of accountability for rules that hurt businesses and don't help investors. They note that England's abuses with offices spawning more offices led the Constitution's Framers to take great care to ensure that the power to appoint was limited to the very top officials of the Executive Branch. "Sarbanes-Oxley violates time-honored principles of democracy and separation of powers by delegating the construction and enforcement of the securities laws to an unaccountable entity," The authors conclude. "The PCAOB is a violation of our Constitution and a threat to the rule of law."



## INTRODUCTION

“This board is going to have massive power, unchecked power, by design. . . We are setting up a board with massive power that is going to make decisions that affect all accountants and everybody they work for, which directly or indirectly is every breathing person in the country. They are going to have massive unchecked powers.”<sup>1</sup>

*This board is going to have massive, unchecked power, by design.*

With these words, U.S. Senator Phil Gramm (R-TX) summed up the vast powers of the Public Company Accounting Oversight Board (PCAOB), created by the Sarbanes-Oxley Act of 2002. The Act was intended to supervise the auditing of America’s public companies to prevent scandals like those at Enron and WorldCom. Sen. Gramm hastened to add that he was “not criticizing” this feature of the law, for which he voted, since his own proposal for the law would have also granted the PCAOB “massive unchecked power.”<sup>2</sup> Yet that is precisely the problem. Through this delegation, Congress ducked its responsibility for the messy and costly rules about to be created. And worse, the PCAOB’s unaccountable power violates the Appointments Clause of the Constitution and bedrock ideals of separation of powers.

The PCAOB, known not-so-affectionately in the business community as “Peekaboo,” has broad powers to impose regulations controlling the auditing of all public companies.<sup>3</sup> It supports itself with a tax, the accounting support fee that it levies on all public companies in the United States.<sup>4</sup> It also has the power to inspect, investigate, and punish accounting firms and accountants for violating its regulations, professional standards, or federal laws.<sup>5</sup> The PCAOB can fine an accountant up to \$100,000 or an accounting firm up to \$2 million for a single, inadvertent violation of its rules.<sup>6</sup>

Magnifying the PCAOB’s power is its authority to adopt rules greatly extending the reach of the law that created it.<sup>7</sup> Using its powers under Sarbanes-Oxley, it has given auditors the power to micromanage corporations’ internal controls, including matters only tangentially related to financial statements, such as what software the company uses and who has access to employee passwords.<sup>8</sup> These broad rules expand the reach of Sarbanes-Oxley’s Section 404, which contains only a vague requirement that company managers assess companies’ internal controls, and that auditors “attest” to the assessment.<sup>9</sup> The PCAOB interprets these undefined terms as requiring a full-blown audit and approval by auditors of a company’s internal operating procedures.<sup>10</sup>

In so doing, the PCAOB has imposed more than \$35 billion dollars in costs on the nation’s businesses in the first year alone, enriching the very accounting firms that were blamed for the Enron and WorldCom fiascos.<sup>11</sup> Moreover, such micromanagement of companies’ internal controls effectively requires every public company to pay auditors for a wide array of consulting services that Sarbanes-Oxley sought to separate

from auditing, by broadening the scope of auditing to reach beyond fair reporting of financial data to regulating the most intimate aspects of a corporation's daily activities.<sup>12</sup>

The PCAOB's regulations have greatly harmed competition in the accounting industry. The costs of its regulations have led many smaller firms to give up auditing public companies, reducing businesses' range of choices among accountants, and increasing concentration in the accounting industry.<sup>13</sup>

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These costs may grow even larger in the future, since the PCAOB has the power to outlaw entire categories of services performed by accountants. Sarbanes-Oxley seeks to prevent conflicts of interest by preventing auditors from consulting for a company at the same time they are scrutinizing its financial statements.<sup>14</sup> In addition to prohibiting accounting firms from engaging in eight designated forms of consulting with the companies that they audit, Congress also authorized the PCAOB, in sweeping language, to "prohibit any other service that the Board determines, by regulation, is impermissible."<sup>15</sup> This regulatory blank check gives the PCAOB plenty of opportunity to flex its muscles in the future.

In addition to wielding broad investigative and rulemaking powers, the five PCAOB members effectively have the power to set their own salaries.<sup>16</sup> The PCAOB's Chairman was paid a princely \$556,000 in 2003, while other members were paid a whopping \$452,000.<sup>17</sup> Despite its vast authority and the far-reaching consequences of its actions, the PCAOB is not accountable to our elected representatives. Its members are not appointed by the President or any of his top lieutenants, nor are they confirmed by the Congress. Its Board members cannot be removed by the President or any other single administrator accountable to him.

Sarbanes-Oxley's construction of the PCAOB raises several constitutional questions, some of which were brought up during the legislative frenzy to pass it in response to the Enron and WorldCom scandals.<sup>18</sup> Scholars have questioned the constitutionality of its broad delegation of rulemaking powers.<sup>19</sup>

But the PCAOB's clearest and most important violation is in how its members are appointed. The Founders regarded the Appointments Clause as one of the Constitution's most crucial provisions. They may not have been able to envision anything like the PCAOB, but experience from England taught them all too well about abuses that could result from the government's unchecked power to create offices and appoint officers. Sarbanes-Oxley's structuring of the PCAOB is a clear violation of the Constitution's Appointments Clause, something made even clearer by recent Supreme Court rulings, as well as statements by the Constitution's framers.

## THE PCAOB VIOLATES THE APPOINTMENTS CLAUSE

Under Sarbanes-Oxley, the Securities and Exchange “Commission . . . shall appoint the chairperson and other initial members of the Board,” and fill any “vacancies on the Board,” and may remove the Board members “for good cause.”<sup>20</sup> That means that all the SEC Commissioners, not just the Chairman, get to decide who sits on the Board, and the Commission as a whole must agree that removal of a PCAOB member is necessary.<sup>21</sup> The appointment process is further diffused by the law’s requirements that the Secretary of the Treasury and the Chairman of the Federal Reserve must review PCAOB appointments.<sup>22</sup>

However, this method of selection plainly contradicts the Appointments Clause of the Constitution. This clause gives only the President the power to appoint the nation’s principal officers, and limits the power of agencies to appoint even “inferior officers.” When an agency is permitted to appoint an “inferior officer,” only the head of that agency can make the appointment.

The clause provides that the President “shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other Officers of the United States, whose Appointments are not herein provided for...but Congress may, by Law, vest the Appointment of such inferior officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.”<sup>23</sup> Thus, an officer of the United States must either be appointed by the President, or, if the officer is an “inferior officer,” by either (1) the President, (2) a Court, or (3) a Head of Department.

PCAOB members are clearly “officers” under Supreme Court precedent, since the powers they exercise more than fit the Court’s criteria of “significant authority.”<sup>24</sup> For example, under Section 105(c)(4)(D) of Sarbanes-Oxley, they can fine accounting firms up to \$2 million and individual accountants up to \$100,000 for violations—even non-intentional ones—of Board rules and the Sarbanes-Oxley Act. While their disciplinary actions are subject to plenary review by the SEC, under section 107(c) of Sarbanes-Oxley, the Supreme Court has found that the ability to impose substantial sanctions makes adjudicators officers of the United States even if “they lack authority to enter a final decision.”<sup>25</sup> And because the PCAOB’s members are officers, regardless of whether they are considered to be “principal” or “inferior” officers, the appointment method provided for them in Sarbanes-Oxley violates the Appointments Clause.

Under Supreme Court precedent, members of the PCAOB are probably principal rather than inferior officers, and thus only the president should be able to appoint them. The members have the “authority to formulate policy for the Government,” and their investigative authority covers an entire national industry, which they can investigate on their own initiative,

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rather than being limited to investigating a single case referred to them by a supervising body.<sup>26</sup> Moreover, their enormous pay—\$452,000 for PCAOB members, and \$556,000 for its Chairman—which is higher than the salary of the President or the Chairman of the SEC, also weighs in favor of their being principal officers.<sup>27</sup>

*The PCOAB's decision whether or not to initiate an investigation is unreviewable.*

It has been argued that the PCAOB members, despite their vast powers, are inferior officers, since “everything that the Board does is subject to the scrutiny of the Commission.”<sup>28</sup> Under Section 107(b)(2), “no rule of the Board shall become effective without prior approval of the Commission.” Similarly, under Sections 107(c)(2)(A) and 105(e), any disciplinary action by the Board is automatically stayed by an appeal to the SEC, until the SEC decides to end the stay.

Nevertheless, it is not true that *everything* that this body does is subject to the scrutiny of the SEC: Its decision whether or not to initiate an investigation is unreviewable.<sup>29</sup> That alone gives it enormous power, since a single inadvertent violation of PCAOB rules can subject an accountant to a fine of \$100,000 or his firm to a fine of \$2 million.<sup>30</sup> This is yet another reason for viewing the PCAOB members as principal officers.

It is true that the Supreme Court has stated that, “the line between ‘inferior’ and ‘principal’ officers is one that is far from clear.”<sup>31</sup> Nevertheless, there is an Appointments Clause violation regardless of which side the PCAOB members fall on.

If the PCAOB’s members are principal officers, then their appointment is plainly invalid given their failure to be nominated by the president and confirmed by the Senate. But even if the members are found to be “inferior officers,” their method of appointment is still unconstitutional. This is because Congress has vested the appointment power for the PCAOB very likely in an inappropriate agency and certainly with the wrong officials in that agency.

The Constitution provides that inferior officers can be appointed any of three ways: by the president, by a court, or by a head of a department. Plainly, they are not appointed by the president or a court, since the Commission is neither of these things. Nor, on closer inspection, are they appointed by a head of department, since the SEC is probably not a “department” under Supreme Court precedent, and even if it were, only the SEC Chairman, not its other Commissioners, qualifies as the agency’s head.

The SEC does not meet the Supreme Court’s test for what constitutes a “department” with the power to appoint. As the Supreme Court observed in 1991, the “Court for more than a century has held the term ‘Department’ refers only to ‘a part or division of the executive government, as the Department of State, or of the Treasury’ expressly ‘creat[ed]’ and ‘given the name of a department’ by Congress.” As the Court explained, “We cannot accept the... assumption that every part of the Executive Branch is a department, the head of which is eligible to receive the appointment power.”



Thus, the Justices ruled in favor of “confining the term ‘Heads of Department’ in the Appointments Clause to executive divisions like the Cabinet-level departments” because “(t)heir heads are subject to the exercise of political oversight and share the President’s accountability to the people.”<sup>32</sup>

Further bolstering the case that the SEC is not a “department” under the Appointments Clause is the fact that it never had this type of appointment power before the PCAOB. Since its creation in the 1930s the SEC has overseen several preexisting self-regulatory organizations, such as the New York Stock Exchange, and has involved itself in the creation of other ones, such as the National Association of Securities Dealers. But although the SEC had influence over the appointment process for those bodies, it never had the power to actually appoint members to the organizations. An exhaustive review by Congress’s General Accounting Office (now Government Accountability Office or GAO) found only one instance of the commission ever having appointment power. This was for a municipal bond supervisory board formed in the mid-1970s. And that appointment power was only temporary, unlike the permanent authority Congress mandates for the SEC with respect to the PCAOB.<sup>33</sup>

Even if the SEC were somehow found to be a “department,” Sarbanes-Oxley would still violate the Appointments Clause. This is because it vests the appointment power in the five Commissioners collectively, when only the Chairman is the SEC’s head. In addition to the fact that an entity can only have one head,<sup>34</sup> the SEC Chairman has substantial administrative authority that the other Commissioners lack. Moreover, it is the Chairman who appoints the SEC’s personnel, confirming that he is more than the Commission’s nominal leader.<sup>35</sup> Accordingly, the SEC’s “Head” is its Chairman, not the other Commissioners, and, under the Appointments Clause, only he (or the President or a court) can pick the PCAOB members.<sup>36</sup> Yet under Sarbanes-Oxley, the Commission as a whole picks the members of the PCAOB.<sup>37</sup> This unprecedented process is a violation of the Appointments Clause.<sup>38</sup>

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Congress may have attempted to sidestep the Appointments Clause issue by declaring in Section 101(b) of Sarbanes-Oxley that “the Board shall not be an agency or establishment of the United States Government,” and that “no member or person employed by, or agent for the Board shall be deemed to be an officer or employee of or agent for the Federal Government.” But labels accorded by Congress have no weight in determining whether an entity is a federal agency subject to the Constitution.<sup>39</sup> The fact that PCAOB members are appointed by the government, and that the PCAOB enforces federal law, makes it a federal entity subject to the Constitution no matter what Congress says.<sup>40</sup>

For example, the Supreme Court held that the Amtrak passenger rail monopoly is subject to the Constitution, even though its enabling statute, in language strikingly similar to Sarbanes-Oxley, declares that Amtrak is not a federal government agency.<sup>41</sup> Like Amtrak, the PCAOB was created by a federal law, has a board composed of federal appointees, and carries out federal policies. That alone makes it a federal agency.<sup>42</sup> Further, the PCAOB,



unlike Amtrak, is wholly funded through federal exactions<sup>43</sup> and enforces federal laws.<sup>44</sup>

The purpose of the Appointments Clause is to promote effective management in government by preventing lack of accountability in a multi-member body. Vesting appointments in the president or in a single agency head makes clear who is responsible for a given appointment, and makes it possible for the executive to demand good performance from the appointee.<sup>45</sup>

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That goal of effective management was undermined by Sarbanes-Oxley's unprecedented requirement that the SEC as a whole agree on the appointment of PCAOB members. Sarbanes-Oxley triggered a messy and divisive process for selecting the initial Board members. On Oct. 25, 2002, a majority of divided SEC commissioners voted in the five-member PCAOB. According to the GAO, "The selection process broke down in early October when the Commission was unable to agree on a consensus candidate for chairman." Different commissioners backed different candidates, and this "inability to choose a final slate of candidates until the eve of the Commission's vote resulted in the appointment of PCAOB members who had not been fully vetted." Retired judge William Webster, the first PCAOB Chairman, resigned shortly after he was appointed when his service on the audit board of U.S. Technologies, a company under SEC investigation for accounting problems, became public. The SEC's own Chairman, Harvey Pitt, was blamed for withholding this information from his fellow commissioners, and he ended up resigning as well. But the GAO found that no one, including Pitt, knew of this information before the vote, because no commissioner was really in charge of the selection. The SEC's Chief Accountant did not view this information as relevant and "did not inform the SEC chairman or other commissioners about certain matters concerning Judge Webster."<sup>46</sup>

To avoid these types of problems, Pitt's successor, William Donaldson, instituted a process by which new PCAOB members must have unanimous approval from all five Commissioners.<sup>47</sup> But this rule shields the PCAOB even further from accountability to the executive branch. As an independent agency, the SEC has two commissioners from the opposing party of the president, and this rule gives those two SEC commissioners veto power over executive appointees. This convoluted process can rule out many qualified candidates and even deter others from serving if approached.

There is yet another way in which Sarbanes-Oxley may violate the Appointments Clause: Section 101(e)(2) requires that two of the PCAOB's five members must be accountants and that three must not be members of the accounting profession. As President Bush has argued in another context, this sort of limitation on the executive's ability to select officers violates the Appointments Clause.<sup>48</sup>

The Constitution's framers drafted the Appointments Clause as an essential check on overweening bureaucracy. As colonists of England, they had seen offices created by both the king and Parliament spawn more offices with no accountability, creating what the Declaration of Independence refers

to as a “multitude of new offices” and “swarms of officers to harass our people and eat out their substance.”<sup>49</sup> In its 1991 *Freytag* decision, the Supreme Court cited historian Gordon Wood, who wrote that “the power of appointment to offices” was considered by the American revolutionary generation to be “the most insidious and powerful weapon of eighteenth-century despotism.”<sup>50</sup> Thus, “The Clause reflects our Framers conclusion that widely distributed appointment power subverts democratic government.”

With the growth of the federal government and the rise of quasi-private bodies vested with governmental power and privileges, the Appointments Clause is just as essential today to ensure government accountability. As the Court observed in *Freytag*, “Given the inexorable presence of the administrative state, a holding that every organ in the executive branch is a department would multiply indefinitely the number of actors eligible to appoint.”<sup>51</sup> The same can be said for vesting the power to appoint to multiple officials in an agency rather than its head. Of course, even when operating under the constraints of the Appointments Clause, the bureaucracy can be large, intrusive, and unreasonable. But a governmental regulatory body unanswerable to the president or his top lieutenants is something even more repugnant: a throwback to the “swarms of officers” of the eighteenth century and a threat to democracy.

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## II.

### **THE PCAOB’S UNCONSTITUTIONAL APPOINTMENT CAN BE USED TO OVERTURN ITS DISCIPLINARY ACTIONS**

In *Freytag v. C.I.R.* (1991) and later in *Ryder v. United States* (1995), the Supreme Court affirmed that an individual or firm disciplined by a government agency can challenge that discipline if agency officials were improperly appointed. Such challenges are permitted to give citizens an incentive to question improper appointments, and thus ensure that agencies remain accountable and respectful of constitutional protections.<sup>52</sup>

An accountant subject to enforcement proceedings by the PCAOB clearly has standing to challenge its composition, as a defense to any disciplinary action against him, irrespective of his guilt or innocence.<sup>53</sup> A firm indirectly affected by the auditing rules of the PCAOB might also have standing to challenge policies such as the broad interpretation of Section 404, the assessment the PCAOB levies on public companies to support itself, or rules that expose an accounting firm to sanctions.<sup>54</sup> A challenger does not have to prove that, but for the improper composition of the Board, it would not have taken the action challenged.<sup>55</sup> Its illegal appointment itself renders its actions invalid.

Nor does the SEC’s ability to review the Board’s disciplinary decisions render its improper composition harmless. The PCAOB is not just the judge and jury, but also the rule maker and prosecutor, in its disciplinary

proceedings. It is totally in the PCAOB's discretion whether to even bring a disciplinary action in the first place, and that threshold decision is unreviewable by the SEC. Since the PCAOB can impose sanctions of \$100,000 on an accountant or \$2 million on an accountant's firm for a single, inadvertent violation, and accountants must comply with many pages of arcane PCAOB regulations, its discretion whether or not to prosecute gives it enormous power.

*Sarbanes-Oxley violates time-honored principles of democracy and separation of powers by delegating the construction and enforcement of the securities laws to an unaccountable entity, and giving it the power to act as prosecutor, judge, and jury, all without public scrutiny.*

III.

## CONCLUSION

Sarbanes-Oxley's unconstitutional appointment process for the Public Company Accounting Oversight Board reflects a deep-seated contempt for government accountability and openness that is manifested in other aspects of the Act. The law delegates the government's powers to tax, regulate, and judge citizens to a supposedly private entity, although giving a private entity government powers constitutes what the Supreme Court has called "legislative delegation in its most obnoxious form."<sup>56</sup>

Fortunately, the Appointments Clause cannot be evaded by mere labels. But by declaring the PCAOB private, the Congress has called into question whether a whole host of statutes that protect against arbitrary action by federal agencies even apply to it, since Congress has the power to create unprincipled exceptions to its own statutes.<sup>57</sup>

Observing that sunlight is the best disinfectant, the writers of the securities laws advocated full disclosure, so that investors could guard themselves against abuses of power by corporate managers.<sup>58</sup> But Congress has shielded the PCAOB from the public scrutiny necessary to foster accountability. As one observer commented, "Unlike federal agencies, which generally must produce materials when an investigation is no longer pending, PCAOB materials are to remain exempt from disclosure under the Freedom of Information Act or otherwise."<sup>59</sup> Moreover, Sarbanes-Oxley permits—and usually requires—the PCAOB to close its hearings to the public even when in dealing with issues for which the public would be entitled to attend SEC hearings.<sup>60</sup>

Sarbanes-Oxley violates time-honored principles of democracy and separation of powers by delegating the construction and enforcement of the securities laws to an unaccountable entity, and giving it the power to act as prosecutor, judge, and jury, all without public scrutiny. Thus, the PCAOB is a violation of our Constitution and a threat to the rule of law.

### **About the Authors**

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John Berlau is the 2004-2005 Warren T. Brookes Journalism Fellow at CEI. He has written for many publications, recently serving as an investigative writer on the staff of *Insight* magazine. The National Press Club awarded him its 2002 Sandy Hume Memorial Award for Excellence in Political Journalism for his series of stories in *Insight* about the conflicts of interest of now-former IRS commissioner Charles Rossotti. He is a former Washington correspondent for *Investor's Business Daily*. He has also written for *Reader's Digest*, *USA TODAY*, the *Wall Street Journal*, *New York Post*, *Reason*, *The New Republic*, *National Review*, *The Weekly Standard*, and *RAZOR*. He graduated from the University of Missouri in 1994, with a double-major in journalism and economics. He was a media fellow at the Hoover Institution at Stanford University.

## Notes

<sup>1</sup> Professor Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status (Symposium: The SEC at 70)*, 80 Notre Dame L. Rev. 975, 1003 (March 2005), quoting 148 Cong. Rec. S6334 (daily ed. July 8, 2002) (statement of Sen. Gramm).

<sup>2</sup> *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1003, quoting 148 Cong. Rec. S6334 (Sen. Gramm) (“I would have to say the Board that Senator Enzi and I set up in our bill has massive unchecked power as well. I am not criticizing Senator Sarbanes. I am just reminding people that there are two edges to this sword”); 148 Cong. Rec. S7365 (July 25, 2002) (Sen. Gramm voted for Sarbanes-Oxley).

<sup>3</sup> Sarbanes-Oxley Act, § 103, 15 U.S.C. § 7213. The PCAOB is the focus of Title I of the Sarbanes-Oxley Act, see Pub. L. No. 107-204, §§ 101-109, 116 Stat. 745, 750-771 (July 30, 2002), which is encodified at 15 U.S.C. §§ 7211-19.

<sup>4</sup> Sarbanes-Oxley Act, § 109(c)-(d), 15 U.S.C. § 7219(c)-(d).

<sup>5</sup> Sarbanes-Oxley Act, § 104 (inspection), § 105 (investigation and discipline), 15 U.S.C. §§ 7214-15

<sup>6</sup> Sarbanes-Oxley Act, § 105(c)(4)(D)(i), 15 U.S.C. § 7215(c)(4)(D)(i).

<sup>7</sup> Sarbanes-Oxley Act, § 101(c)(2), 15 U.S.C. § 7211(c)(2) (PCAOB can establish standards governing not only “auditing” but also “quality control, ethics, independence, and other standards”).

<sup>8</sup> Brian Moran, *Accountants Setting IT Policy?*, SQL Server Magazine, InstantDoc # 43825 (Sept. 2, 2004) ([http://www.windowsitpro.com/SQLServer/Article/ArticleID/43825/SQLServer\\_43825.html](http://www.windowsitpro.com/SQLServer/Article/ArticleID/43825/SQLServer_43825.html)); PCAOB Audit Standard No. 2 ([http://pacoabus.org/Rules\\_of\\_the\\_Board/Documents/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://pacoabus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Auditing_Standard_2.pdf)).

<sup>9</sup> Sarbanes-Oxley, § 404, 15 U.S.C. § 7262.

<sup>10</sup> PCAOB Audit Standard No. 2 ([http://pacoabus.org/Rules\\_of\\_the\\_Board/Documents/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://pacoabus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Auditing_Standard_2.pdf)); John Berlau, *A Tremendously Costly Law*, National Review, April 11, 2005, at 39, 40.

<sup>11</sup> John Berlau, *A Tremendously Costly Law*, National Review, April 11, 2005, at 39 (“despite the media and legislative clamor to ‘get’ the big accounting firms after Enron imploded, it’s the Big Four accounting firms that have turned out to be the big winners from Sarbanes-Oxley”); Robert Novak, *Threat of the Auditors*, Washington Post, April 7, 2005 (available at <http://www.cnn.com/2005/POLITICS/04/07/threat.auditors>) (costs upwards of \$35 billion); American Electronics Association, *Sarbanes-Oxley Section 404: The ‘Section’ of Unintended Consequences and Its Impact on Small Businesses*, February 2005 (calculates \$35 billion cost figure) (<http://www.aeanet.org/governmentaffairs/AeASOXPaperFinal021005.asp>)



<sup>12</sup> Compare Sarbanes-Oxley, § 201(a) (auditors cannot provide “non-audit service” including “financial information systems design and implementation” except ), encoded as 15 U.S.C. § 78j-1(g)(2) with John Berlau, *A Tremendously Costly Law*, National Review, April 11, 2005, at 39-40 (discussing audit-related micromanagement of financial information systems under Sarbanes-Oxley).

<sup>13</sup> Diya Gullapalli, *Firms’ Audit Choices Dwindle*, The Wall Street Journal, June 21, 2005, at C1, C3.

<sup>14</sup> See 15 U.S.C. § 78g (as amended by Sarbanes-Oxley Act, § 201(a)).

<sup>15</sup> 15 U.S.C. § 78j-1(g)(9) (as amended by Sarbanes-Oxley Act, § 201(a). See also Sarbanes-Oxley, § 201(b), 15 U.S.C. § 7231 (allowing PCAOB to create *ad hoc* exceptions to this prohibition for selected accounting firms).

<sup>16</sup> Sarbanes-Oxley Act, § 109(b), 15 U.S.C. § 7219(b) (PCAOB sets its own budget, subject to approval only by the SEC, not by Congress); Peter J. Wallison, *Rein in the Public Company Accounting Oversight Board*, at pp. 3-4 (Feb. 2005) (because the SEC does not set its own budget, and the PCAOB can perform functions on behalf of the SEC, the SEC has a built-in incentive to approve burgeoning PCAOB budgets to free up the use of its own budget, and it has in fact approved PCAOB budgets that are much more generous than the SEC’s own on a per capita basis) ([http://regulators.itgo.com/Reports/PCAOB/PCAOB\\_2Feb05.pdf](http://regulators.itgo.com/Reports/PCAOB/PCAOB_2Feb05.pdf)).

<sup>17</sup> Rebecca Byrne, *Accountants Board Tin Ear Now Golden*, The Street, Jan. 13, 2003 (<http://www.thestreet.com/markets/rebeccabyrne/10062297.html>).

<sup>18</sup> Pamela Barnett, *House GOP Opposition to Senate’s Accounting Bill Vanishes*, Congress Daily, July 18, 2002 (quoting Rep. Michael Oxley, R-Ohio, who would later become Sarbanes-Oxley’s coauthor, as saying that the “governmental powers” to be given the PCAOB would be “extraordinary and maybe even beyond constitutional”); Jill Zuckerman, *House GOP Leaders Threaten to Kill Senate’s Corporate Reform Bill*, Chicago Tribune, July 18, 2002, 2002 WLNR 11948307 (Both House Ways and Means Chairman Bill Thomas and Speaker Hastert’s office argued it violated the Origination Clause).

<sup>19</sup> *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1057-61.

<sup>20</sup> Sarbanes-Oxley Act, § 101(e), 15 U.S.C. § 7211(e).

<sup>21</sup> Erika C. Birg, *Is the Public Company Accounting Oversight Board Constitutional?*, at pg. 6 (“Board members . . . are appointed by the SEC as a whole”) (Federalist Society for Law and Public Policy Studies, Corporate Responsibility Practice Group, 2003) (<http://www.fed-soc.org/Publications/Corpresp/ApptClauseFinal.pdf>).

<sup>22</sup> Sarbanes-Oxley Act, § 101(e)(4)(A), 15 U.S.C. § 7211(e)(4)(A) (“the Commission after consultation with the chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, shall appoint”).

<sup>23</sup> U.S. Const. Art. II, § 2, clause 2

<sup>24</sup> *Buckley v. Valeo*, 424 U.S. 1, 126 (1976) (government employees with “significant authority” are officers of the United States); *Edmond v. United States*, 520 U.S. 651, 662 (1997).

<sup>25</sup> *Freytag v. C.I.R.*, 501 U.S. 868, 881 (1991) (special trial judges supervised by tax court judges are officers of the United States).

<sup>26</sup> See *Morrison v. Olson*, 487 U.S. 654, 671-72 (1988) (Independent Counsels are only inferior officers, because their “grant of authority does not include any authority to formulate policy for the Government,” they are “appointed essentially to accomplish a single task,” namely prosecuting a case referred to them by a court in response to a request from the Attorney General, and their jurisdiction is limited “to that specified by the appointing court”); see also Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 Notre Dame L. Rev. 975, 1053 (March 2005) (given the sheer scope of their power, and their fixed five-year terms, there is a “strong argument” that PCAOB members are principal officers); Peter J. Wallison, *Rein in the Public Company Accounting Oversight Board*, at pg. 2 (Feb. 2005) (the “President alone” must pick PCAOB members under the Appointments Clause) ([http://regulators.itgo.com/Reports/PCAOB/PCAOB\\_2Feb05.pdf](http://regulators.itgo.com/Reports/PCAOB/PCAOB_2Feb05.pdf)).

<sup>27</sup> See *United States v. Germaine*, 99 U.S. 508, 511 (1879) (officer’s “emoluments” are relevant to whether he is a principal or inferior officer).

<sup>28</sup> Birg, *Is the Public Company Accounting Oversight Board Constitutional?*, at pg. 6.

<sup>29</sup> Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1053 (“with respect to its investigative and prosecutorial functions, the PCAOB’s discretion is substantial, and the potential for SEC ‘supervision’ comes only at the very late stage of adjudicatory review”).

<sup>30</sup> Sarbanes-Oxley Act, § 105(c)(4)(D)(i), 15 U.S.C. § 7215(c)(4)(D)(i).

<sup>31</sup> *Morrison v. Olson*, 487 U.S. 654, 672 (1988).

<sup>32</sup> *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868, 886-87 (1991). quoting *United States v. Germaine*, 99 U.S. 508, 510-11. In a footnote, the Court left open the possibility that a list of “principal agencies,” including the SEC, might conceivably qualify as “Department” for purposes of the Appointments Clause despite their lack of cabinet-level status. See *id.* at 887 n.4. But as we explain below, even if the SEC qualified as a Department, no one at the SEC could make appointments other than its “Head,” the Chairman. That is not how PCAOB members have been selected.

<sup>33</sup> *GAO Report No. GAO-03-339, Securities and Exchange Commission: Actions Needed to Improve Public Company Accounting Oversight Board Selection Process*, December 2003, at 3 (“SEC had not played such a role since 1975”) ([www.gao.gov/htext/d033339.html](http://www.gao.gov/htext/d033339.html)).

<sup>34</sup> There is one case, not from the Supreme Court, in which a multi-member board was deemed a Head of Department. But that board selected its manager, whom it could fire, giving it ultimate authority. The case involved the appointment of the Postmaster by the nine presidentially-appointed Governors of the Postal Service. The court deemed that valid because he was subject to their dismissal at will, making them collectively the head of their Department, and those Governors were co-equals who shared equally in the running of the Postal Service. The case was decided by a divided court, and its opinion was answered with a strong dissent. See *Silver v. U.S. Postal Service*, 951 F.2d 1033, 1040 (9<sup>th</sup> Cir. 1991). The Supreme Court has never suggested that a Department could have more than one head. And as discussed above, the SEC is structured very differently from the Postal Service, and authority is clearly vested in its Chairman.

<sup>35</sup> See *Samuels, Kramer & Co. v. C.I.R.*, 930 F.2d 975, 992 (2d Cir. 1991) (while 15 U.S.C. 78d(b) vests power to select personnel in the “Commission,” Reorganization Plan No. 10, 64 Stat. 1265, “plac[es] the power to appoint in the Chairman” of the SEC); accord *GAO Report No. GAO-03-339, Securities and Exchange Commission: Actions Needed to Improve Public Company Accounting Oversight Board Selection Process*, fn. 2 (2003) (“Under Reorganization Plan No. 10, most of the commission’s executive and administrative functions were transferred to the SEC Chairman, including the appointment and supervision of commission personnel”) (<http://www.gao.gov/htext/d033339.html>); [www.sec.gov](http://www.sec.gov) (Chairman’s office picked hundreds of new employees, and the Chairman picks the Inspector General); *Birg, Is the Public Company Accounting Oversight Board Constitutional?*, at pg. 6 (The SEC “is governed by the Chairman, who by even the SEC’s own web site, is the ‘SEC’s top executive’”); cf. *Freytag v. C.I.R.*, 501 U.S. 868, 887 n. 4 (1991) (referring to appointments by “the head of one of the principal agencies such as . . . the Securities and Exchange Commission”) (emphasis added).

<sup>36</sup> *Birg, Is the Public Company Accounting Oversight Board Constitutional?*, at 6.

<sup>37</sup> Sarbanes-Oxley, § 101(e)(4)(A), 15 U.S.C. § 7211(e)(4)9A).

<sup>38</sup> See *Birg, Is the Public Company Accounting Oversight Board Constitutional?*; Wallison, *Rein In the Public Company Accounting Oversight Board; PCAOB Constitutionality Questioned*, Corporate Financing Week, May 12, 2003, Volume 29, Issue 19, 2003 WLNR 6489089 (quoting “Thomas Riesenber, associate general counsel at Ernst & Young’s Washington office” as saying that “The members of the board are not [properly] appointed under the appointment clause of the U.S. Constitution”); see also Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 Notre Dam L. Rev. 975, 1049-53 (March 2005) (noting that the PCAOB may violate the Appointments Clause and the constitutional separation of powers).

<sup>39</sup> *Mistretta v. United States*, 488 U.S. 361, 393 (1989) (“Separation of powers analysis does not turn on the labeling of an activity”); *Birg, Is the Public Company Accounting Oversight Board Constitutional?*, at pg. 4 (“Congress cannot, by its simple declaration, render the Board a non-governmental entity”); Wallison, *Rein In the Public Company Accounting Oversight Board*, at pg. 2 (“it seems highly unlikely that Congress can avoid the appointments clause simply with a form of words”).

<sup>40</sup> Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. 975, 975, 1044; *Metropolitan Washington Airport Authority v. Noise Abatement Citizens*, 501 U.S. 252, 266 (1991) (fact that state laws created an entity did not exempt it from federal separation of powers restrictions where it enforced federal law and its members were federally chosen).

<sup>41</sup> *Lebron v. National Railroad Passenger Corp.*, 513 U.S. 374, 392-93 (1995) (“it is not for Congress to make the final determination of Amtrak’s status as a Government entity for



purposes of determining the constitutional rights of citizens affected by its actions”); 49 U.S.C. § 24301(a)(3) (declaring that Amtrak “is not a department, agency, or instrumentality of the United States Government”).

<sup>42</sup> *Lebron*, 513 U.S. at 399 (“a corporation is an agency of the government for purposes of the constitutional obligations of the government . . . when the State has specifically created that corporation for the furtherance of governmental objectives and . . . controls the operation of the corporation through its appointees”); *Pennsylvania v. Bd. of Directors of City Trusts of Philadelphia*, 353 U.S. 235 (1957) (per curiam) (College built and maintained pursuant to private trust was state actor because it was operated and controlled by a board of state appointees); Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1040-43 (it suffices to show that a corporation is the government if “the government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself the permanent authority to appoint a majority of the directors of that corporation,” although there are also other means of showing it is the government), quoting *Lebron*, 513 U.S. at 400.

<sup>43</sup> Sarbanes-Oxley, Section 109, 15 U.S.C. § 7219 (imposing a federal accounting-support fee on all public companies to support the PCAOB).

<sup>44</sup> Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 102; compare *United States v. City of Spokane*, 918 F.2d 84, 88 (9<sup>th</sup> Cir. 1990) (Red Cross is federal entity immune from state taxes even though, unlike PCAOB, only a minority of its board is appointed by the federal government, and even though it receives no congressional appropriations, since it does use federal buildings and have some federally-appointed members, including its head).

<sup>45</sup> *Freytag v. C.I.R.*, 501 U.S. 868, 904-05 (Scalia, J., concurring) (citing founder James Wilson’s belief that its purpose was aimed at “lack of accountability in a multimember body”).

<sup>46</sup> GAO Report No. GAO-03-339, *Securities and Exchange Commission: Actions Needed to Improve Public Company Accounting Oversight Board Selection Process*, at “Highlights” (unnumbered), 3 ([www.gao.gov/htext/d03339.html](http://www.gao.gov/htext/d03339.html)).

<sup>47</sup> Justin Schack, *Getting down to Business: Veteran Wall Streeter Bill Donaldson is determined to revitalize a damaged Securities and Exchange Commission at a critical juncture in its—and the U.S. capital markets’—history*, Institutional Investor, Aug. 1, 2003 (“Anyone who might engender strong opposition from a single commissioner was eliminated”).

<sup>48</sup> *Statement on Signing the Vision 100 – Century of Aviation Reauthorization Act* (Dec. 12, 2003) (limiting qualifications of those who may be appointed to the Air Traffic Services Committee is invalid and will be treated as advisory only), Weekly Compilation of Presidential Documents, Volume 39, Issue 51, pg. 1795, 2003 WLNR 10051454 (Dec. 22, 2003).

<sup>49</sup> United States Declaration of Independence, para.12.

<sup>50</sup> *Freytag v. C.I.R.*, 501 U.S. 868, 883, quoting Gordon Wood, *The Creation of The American Republic, 1776-1787* (1969) at pp. 79, 143.

<sup>51</sup> *Freytag*, 501 U.S. at 885.

<sup>52</sup> *Ryder v. United States*, 515 U.S. 177, 182-83 (1995).

<sup>53</sup> *E.g., Ryder v. United States*, 515 U.S. 177, 182-83 (1995) (since “one who makes a timely challenge to the constitutional validity of an officer who adjudicates his case” can use the invalid appointment to obtain “whatever relief may be appropriate,” the defendant could challenge the composition of the Coast Guard Court of Military Review, which violated the Appointments Clause, and use it to overturn his conviction); *Freytag v. C.I.R.*, 501 U.S. 868, 879 (1991) (Supreme Court entertained a challenge to a disciplinary proceeding of the U.S. Tax Court even though the defendant had not raised an Appointments Clause challenge at trial); *FEC v. NRA Political Victory Fund*, 6 F.3d 821 (D.C. Cir. 1993) (since “appellants [can] raise the constitutional challenge as a defense to an enforcement action,” and “we are aware of no theory that would permit us to declare the Commission’s structure unconstitutional without providing relief to the appellants in this case,” the court overturned the trial court’s injunction against the NRA for violations of the campaign-finance laws and order that it pay the FEC’s costs of investigation, without deciding whether the NRA violated those laws); *Williams v. Phelps*, 482 F.2d 669, 671 n.3 (D.C. Cir. 1973) (standing of labor union to bring action challenging appointment of head of agency not nominated by president and confirmed by Senate as required by Appointments Clause “rests on firm ground” because that agency head carried out policies that “directly affected” the jobs of government employees who belonged to the union).

<sup>54</sup> *Williams v. Phelps*, 482 F.2d 669, 671 n.3 (D.C. Cir. 1973) (labor union could sue to challenge policies harming government employees carried out by improperly appointed

agency head).

<sup>55</sup> *FEC v. NRA Political Victory Fund*, 6 F.3d 821, 824 (D.C. Cir. 1993) (NRA could challenge presence of non-voting Congressional officials on executive branch agency, even if they had no vote in its decision to prosecute the NRA and were silent; “A litigant is not required to show that he has received less favorable treatment than he would have if the agency were lawfully constituted and otherwise authorized to discharge its functions’ . . . Instead, litigants need only demonstrate that they have been ‘directly subject to the authority of the agency’”); *see also Glidden Co. v. Zdanok*, 370 U.S. 530, 533 (1962) (“The claim advanced by the petitioners, that they were denied the protection of [Article III] judges ... has nothing to do with the manner in which either of these judges conducted himself in these proceedings”).

<sup>56</sup> *Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936) (invalidating delegation to coal producers and unions of the power to set wages and prices in their industry).

<sup>57</sup> *See Lebron*, 513 U.S. at 392.

<sup>58</sup> *S.E.C. v. Mutual Benefits Corp.*, 323 F. Supp. 1337 (S.D. Fla. 2004) (quoting Justice Brandeis, *Other People’s Money*, ch. 5 (1914); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 564 (E.D. N.Y. 1971).

<sup>59</sup> Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1015, *citing* 15 U.S.C. § 7215(b)(5)(A).

<sup>60</sup> Compare 15 U.S.C. § 7215 (c)(2) (PCAOB) with 17 C.F.R. § 201.102 (2003) (SEC); *see* Nagy, *Playing Peekaboo with Constitutional Law*, 80 Notre Dame L. Rev. at 1015-16.

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