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PLAYING PEEKABOO WITH CONSTITUTIONAL LAW: THE PCAOB AND ITS PUBLIC/PRIVATE STATUS

*Donna M. Nagy**

This Article is the first to consider the constitutional status of the Public Company Accounting Oversight Board (PCAOB—pronounced by some as “peekaboo”). Congress created the PCAOB in 2002 to regulate the accounting profession in response to scandals at Enron, WorldCom, and other public companies. The Article argues that, notwithstanding the PCAOB’s congressional designation as a nonprofit corporation in the private sector, its governmental creation, governmental objectives, governmental powers, and governmentally appointed board members render it a public (or state) actor for purposes of constitutional law. The Article also analyzes the PCAOB from a policy perspective and argues that the public/private PCAOB stands in tension with democratic values such as accountability, transparency, and legitimacy, and that inefficiencies result from its ambiguous status. It concludes with a discussion of legislation pending in Congress that would establish a “Mutual Fund Oversight Board” and recommends that even if the PCAOB’s status remains unchanged, Congress should not create any other public/private regulators modeled after the PCAOB.

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INTRODUCTION

Congress created the Public Company Accounting Oversight Board (the PCAOB or the Board)¹ in direct response to the collapses of Enron and WorldCom, and the bevy of other accounting and corporate governance scandals capturing front page headlines in 2001 and 2002.² As the cornerstone of the Sarbanes-Oxley Act,³ its immediate mission was to restore public confidence in the securities markets by ensuring the integrity of the accounting firms that audit financial statements for publicly traded companies.⁴ To achieve this end, Congress vested the PCAOB with broad governmental powers and responsibilities,⁵ including the authority to register accounting firms that audit public companies;⁶ enact rules setting standards for auditing, quality control, ethics, and independence;⁷ inspect on a yearly basis the nation's largest accounting firms and inspect other firms at least once every three years;⁸ investigate accounting firms and their associated persons for possible violations of PCAOB rules or the federal securities laws;⁹ and impose discipline for established violations through a range of sanctions including censures, temporary suspensions, per-

1 15 U.S.C.A. §§ 7211–7219 (West Supp. 2004).

2 See *infra* Part I.B (discussing congressional hearings and legislative proposals prompted by the collapse of Enron); see also William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1033 (2003) (noting that Congress was “frightened of negative elective consequences stemming from the compounding of the Enron disaster by the WorldCom accounting scandal (and bankruptcy) of the summer of 2002”).

3 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

4 See Elliott J. Weiss, *Some Thoughts on an Agenda for the Public Company Accounting Oversight Board*, 53 DUKE L.J. 491, 492 (2003) (maintaining that “[t]he Board’s mission quite clearly is to develop regulations and implement regulatory procedures that will bolster—and may even restore—the public’s confidence in the integrity of public accounting firms and the credibility of the final reports they audit and certify”). On the Sarbanes-Oxley Act’s one-year anniversary, the Chairman of the Securities and Exchange Commission (SEC) expressed the view that “[t]he Board is absolutely vital to our markets going forward.” William H. Donaldson, Remarks to the National Press Club (July 30, 2003), available at <http://www.sec.gov/news/speech/spch073003whd.htm>.

5 See David M. Lawrence, *Private Exercise of Governmental Power*, 61 IND. L.J. 647, 648 (1986) (contending that “we do recognize certain powers as essentially governmental: rulemaking, adjudication of rights, seizure of person or property, licensing and taxation”).

6 15 U.S.C.A. § 7211(c)(1).

7 *Id.* § 7211(c)(2).

8 *Id.* § 7214(b)(1)(A)–(B).

9 *Id.* § 7211(c)(4).

manent bars, and substantial monetary fines.¹⁰ The PCAOB is now, without question, the congressionally designated auditor for auditors.

In creating the PCAOB, Congress provided the Board with a guaranteed source of funding,¹¹ the means for subpoenaing documents,¹² official immunity from civil liability,¹³ privileges from third-party discovery,¹⁴ and a comprehensive system of oversight by the Securities and Exchange Commission (the SEC or the Commission). Congress was specific in charging the SEC with a number of responsibilities: the SEC appoints the PCAOB's Chairperson and four other members¹⁵ (who may be removed by the SEC only for good cause),¹⁶ the SEC approves the PCAOB's annual budget¹⁷ (\$103 million in 2004),¹⁸ and the SEC approves the PCAOB's rules prior to their adoption.¹⁹ Moreover, any disciplinary sanctions imposed by the PCAOB are subject to SEC review.²⁰

Notwithstanding its governmental creation, its governmental objectives, its governmental powers and privileges, and its governmentally appointed board members, Congress established the PCAOB as a private, not-for-profit corporation. Congress's determination to situate the PCAOB in the private sector could not have been clearer. In a section entitled "status," the Sarbanes-Oxley Act provides that "[t]he Board shall not be an agency or establishment of the United States Government"²¹ and that "[n]o 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 by reason of such service."²² The PCAOB's public/private status renders its sardonic nickname "peekaboo"²³ more than a bit profound.

10 *Id.* § 7215(c)(4)(A)-(D).

11 *Id.* § 7219(d).

12 *Id.* § 7215(b)(2)(D).

13 *Id.* § 7215(b)(6).

14 *Id.* § 7215(b)(5).

15 *Id.* § 7211(e)(1), (4).

16 *Id.* § 7211(e)(6).

17 *Id.* § 7219(b).

18 *See infra* note 269 and accompanying text.

19 15 U.S.C.A. § 7217(b)(2).

20 *Id.* § 7217(c)(2).

21 *Id.* § 7211(b).

22 *Id.*

23 *See* Judith Burns, *Accounting Board Tackles Its Mission Amid Initial Laughs: PCAOB, Known as Peekaboo to Some, Has Oversight of a Troubled Industry*, WALL ST. J., Jan. 8, 2003, at C5 ("It is serious business. But the board's members have just discovered that the body's name is also a cause for chuckles. That is because the board, known as PCAOB, is called peekaboo by some.").

This Article is the first to analyze the PCAOB's ambiguous status. Indeed, in the two years since the passage of the Sarbanes-Oxley Act, legal scholars have had remarkably little to say about whether, despite Congress's characterization, the PCAOB should be regarded as an entity of the federal government.²⁴ The media has been similarly silent on this issue, with a notable exception in January 2003, when it was reported that the Chairperson of the PCAOB was to be paid a salary of \$560,000 and its four other members were to be paid \$452,000.²⁵ National newspapers such as the *Wall Street Journal* and *The New York Times* contrasted these salaries to the mere \$142,500 paid to Harvey Pitt, the then-SEC Chairman,²⁶ and highlighted criticism by a number of Senators, including Barbara Boxer (D-Cal.), Judd Gregg (R-N.H.), and Ernest Hollings (D-S.C.), who described the PCAOB salaries as "exorbitant" and "absurd."²⁷ Senator Boxer went so far as to sponsor legislation barring any federal salaries over the \$400,000 paid to President Bush, a cap she intended to make applicable to the Board.²⁸ The hullabaloo concerning PCAOB salaries was a missed opportunity for serious reflection on the public/private status of the Board.

24 A brief discussion of the PCAOB's public/private status can be found in DONNA M. NAGY ET AL., *SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS* 830-31 (2003), and in a seven page "white paper" prepared for the Federalist Society for Law and Public Policy Studies, ERIKA C. BIRG, *IS THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD CONSTITUTIONAL?* (2003), available at <http://www.fed-soc.org/Publications/Corpresp/ApptClauseFinal.pdf>.

Several scholars have critiqued the Sarbanes-Oxley Act and its impact on the accounting profession. See, e.g., George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325 (2003); Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 917 (2003); Stephen C. Gara & Craig J. Langstraat, *The Sarbanes-Oxley Act of 2002: A New Ballgame for Accountants*, 34 U. MEM. L. REV. 73 (2003); Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking The Federal Securities Laws*, 28 N.C. J. INT'L L. & COM. REG. 725 (2003); Perry E. Wallace, *Accounting, Auditing and Audit Committees After Enron, et al.: Governing Outside the Box Without Stepping Off the Edge in the Modern Economy*, 43 WASHBURN L.J. 91 (2003). However, none thus far have devoted significant attention to the PCAOB's nongovernmental status. A number of other scholars have focused on the PCAOB's responsibility for setting auditing and ethical standards and its potential impact on the reporting, disclosure, and governance practices of securities issuers. See, e.g., Bratton, *supra* note 2; James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301 (2003); Weiss, *supra* note 4.

25 Stephen Labaton, *Six Months Later, New Audit Board Holds First Talk*, N.Y. TIMES, Jan. 10, 2003, at A1; David Rogers, *Big Salaries for Oversight Panel Are Questioned on Capitol Hill*, WALL ST. J., Jan. 27, 2003, at A4.

26 See Labaton, *supra* note 25.

27 See Rogers, *supra* note 25.

28 *Id.*

Compensation aside, issues surrounding the PCAOB's public/private status are tremendously important ones and beg for thoughtful analysis. Indeed, Congress's creation of the PCAOB raises core constitutional questions about whether its actions constitute "state action" for purposes of the rights and protections secured by the U.S. Constitution. Such doctrinal questions are sure to arise in litigation as soon as the PCAOB begins to take disciplinary action against accounting firms and their personnel. There are also important normative questions raised by Congress's decision to create the PCAOB as an ostensibly private watchdog for the accounting industry. Chief among these are whether the PCAOB stands in tension with democratic values such as accountability, transparency, and legitimacy. The PCAOB's legislative history is replete with references to the benefits gained from the Board's "strength" and "independence."²⁹ But democratic values will be compromised if the PCAOB has the capacity to function too independently from the will of Congress, the President, and the general public.

Part I of this Article traces the history of the accounting profession's largely unsuccessful experience with self-regulation. It also examines the legislative history of the Sarbanes-Oxley Act, with particular focus on the competing proposals for a new oversight board that would restore the public's confidence in the accounting profession.

Part II highlights the PCAOB. It first analyzes the PCAOB's structure, powers, and responsibilities. It then compares the PCAOB to self-regulatory organizations (SROs) in the securities industry such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). It also compares the PCAOB to other private corporations created by Congress, such as the Securities Investor Protection Corporation (SIPC).³⁰ The comparisons reveal that, while the PCAOB is by no means the only private sector entity relied on by

29 See, e.g., S. REP. NO. 107-205, at 2 (2002) ("The bill creates a strong independent board to oversee the conduct of the auditors of public companies . . ."); 148 CONG. REC. S6773 (daily ed. July 15, 2002) (statement of Sen. Dodd) ("The bill . . . creates a new independent regulator for the accounting profession. The new body will act as a strong, independent, full-time board with significant authority to regulate auditors of public companies.").

30 The paucity of attention paid to the PCAOB's public/private status is somewhat predictable against a backdrop of constitutional and administrative law scholarship that includes relatively few critiques of government corporations, whether public or private. For a notable exception, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 ILL. L. REV. 543, 547 (maintaining that "[a]lthough federal corporations have been a part of the national life for 200 years, they remain obscure").

Congress to fulfill governmental objectives, its broad and sweeping authority for rulemaking, enforcement, and adjudication, when coupled with its governmental creation and governmentally appointed board, is indisputably unique.

Part III tackles the doctrinal issues raised by the PCAOB and argues that, notwithstanding its congressional designation, the PCAOB is a public (or state) actor for purposes of the Constitution. Although constitutional law scholars have described the Supreme Court's state action doctrine as incoherent³¹ and a "conceptual disaster area,"³² the PCAOB permits a fairly straightforward application of precedent. The key Supreme Court case is *Lebron v. National Railroad Passenger Corp.*,³³ which involved a First Amendment challenge to an Amtrak official's decision to remove a politically charged advertisement from a billboard in New York City's Penn Station. Like the PCAOB, Amtrak was created by Congress as a private corporation in legislation declaring that it "will not be an agency or establishment of the United States Government."³⁴ And like the PCAOB, Amtrak was established to serve governmental objectives with a board appointed entirely by gov-

There are, however, numerous critiques of so-called "private power" and the growing state, federal, and international tendencies to look to private sources for the provision of services typically performed by government—that is, privatization. See, e.g., MARTHA MINOW, PARTNERS, NOT RIVALS: PRIVATIZATION AND THE PUBLIC GOOD 4 (2002) (seeking "to identify the promise and dangers in the shifting roles of public and private . . . in providing schooling, welfare, healthcare, and legal services"); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 547 (2000) (noting that "[a] variety of nongovernmental actors, including corporations, public interest organizations, private standard setting bodies, professional organizations, and nonprofit groups, engage in 'public' decision making in myriad ways"); Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1369 (2003) (stating that "[p]rivate entities provide a vast array of social services for the government; administer core aspects of government programs; and perform tasks that appear quintessentially governmental, such as promulgating standards or regulating third-party activities"); *infra* notes 311–14 (citing additional books and articles). Recent law review symposia have also featured the subject of privatization. See *Annual Regulation of Business Focus: Privatization*, 52 ADMIN. L. REV. 813 (2000); Single Subject Issue, *Privatization and Outsourcing*, 30 PUB. CONT. L.J. 551 (2001); Symposium, *New Forms of Governance: Ceding Power to Private Actors*, 49 UCLA L. REV. 1687 (2002); Symposium, *Public Values in an Era of Privatization*, 116 HARV. L. REV. 1211 (2003); Symposium, *Redefining the Public Sector: Accountability and Democracy in the Era of Privatization*, 28 FORDHAM URB. L.J. 1304 (2001).

31 Erwin Chemerinsky, *Rethinking State Action*, 80 Nw. U. L. REV. 503, 505 (1985).

32 Charles L. Black, Jr., *The Supreme Court, 1966 Term—Foreword: "State Action," Equal Protection, and California's Proposition 13*, 81 HARV. L. REV. 69, 95 (1967).

33 513 U.S. 374 (1995).

34 *Id.* at 391 (quoting 45 U.S.C. § 541 (1964)).

ernment officials. Writing for an almost unanimous Supreme Court,³⁵ Justice Antonin Scalia held that it was for the Court—not Congress—to decide whether Amtrak's officials were subject to the Constitution.

In making the determination that Amtrak was a public entity for purposes of the Constitution, the Court found it “unnecessary to traverse th[e] difficult terrain” of traditional state action analysis,³⁶ which questions whether actions by a private entity can be fairly attributed to the state because of its “nexus,” “symbiotic relationship,” or “entwinement” with the government.³⁷ Instead, the Court embraced the petitioner's contention that, notwithstanding Congress's characterization, Amtrak was the “government itself” for purposes of the Constitution. In stark and unambiguous language, the Court concluded: “We hold that where, as here, the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment.”³⁸ Under the precedent in *Lebron*, the PCAOB must be considered a public entity—the “government itself”—for purposes of constitutional law.

But the conclusion that the PCAOB *is* the government for purposes of the Constitution spawns a host of other constitutional issues, implicating individual rights and liberties as well as structural protections secured by the Appointments Clause and the general doctrines of separation of powers and nondelegation. The second and third sections of Part III seek to frame these issues for future discussion and analysis.

The fourth and final Part of this Article shifts from doctrine to policy and argues that an entity established by federal law with a combination of rulemaking, enforcement, and adjudicative power should be part of the federal government for all purposes, not merely for those which the Constitution has placed beyond Congress's purview. Such a public/private regulator, even one subject to official federal oversight, stands in great tension with democratic values such as accountability, transparency, and legitimacy. To be sure, almost every broad delegation by Congress raises concern about policymaking by

35 The lone dissenter, Justice Sandra Day O'Connor, argued that considering whether Amtrak is a government entity was “precluded because it was not presented in the petition for certiorari,” *id.* at 400 (O'Connor, J., dissenting), and that the conduct did not constitute state action under the traditional tests, *id.* (O'Connor, J., dissenting).

36 *Id.* at 378.

37 See *infra* Part III.A.1.

38 *Lebron*, 513 U.S. at 400.

unelected officials. But unlike most other congressionally created regulators, a public/private regulator generally is not subject to the political and statutory checks that curb regulatory discretion and foster rational and reflective decisionmaking. Moreover, broad delegations to centaur-like entities³⁹ make it alarmingly easy for Congress and the President to claim credit for the entities' achievements while avoiding the blame for their unpopular decisions or unwise policies. The result is a serious lessening of Congress's and the President's own accountability to the public. Finally, although Congress often creates public/private entities to further the goal of efficiency, a public/private regulator may actually result in a regulatory program that costs more than one administered by a regulator that is officially part of the federal government.

The Article concludes with a discussion of legislation pending in the Senate that would create an ostensibly private "Mutual Fund Oversight Board" in response to the current industry crisis. It argues that even if the legal fiction surrounding the PCAOB is retained, Congress should cease playing peekaboo with public/private regulators modeled after the PCAOB.

I. THE ACCOUNTING PROFESSION AND THE NEED FOR REFORM

A. *Accountants and Self-Regulation*

The accounting profession's system of self-regulation owes its origin to congressional and SEC decisions made in the 1930s and reaffirmed in the 1970s to allow accountants to establish their own standards of professional conduct and regulate their practices.⁴⁰ The

39 Credit for this mythological term goes to Justice Scalia, who used it in oral argument to describe Amtrak. See Oral Argument Transcript, *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995) (No. 93-1525), available at 1994 WL 759068.

40 In addition to self-regulation and the new PCAOB, accountants are subject to regulation from two additional sources. One source is state regulation: the licensing of certified public accountants (CPAs) is done at the state level and states may conduct a disciplinary proceeding and may suspend or revoke a license if a CPA is found to have violated state regulations governing the conduct of CPAs. See Benston, *supra* note 24, at 1345-46. The other source is direct regulation by the SEC. See *infra* notes 72-73 and accompanying text (discussing SEC rules regarding auditor independence). Accountants who violate SEC rules, or any provisions in the federal securities laws, may be subject to enforcement action. See NAGY ET AL., *supra* note 24, at 657-62 (outlining SEC civil remedies); *id.* at 833-35 (discussing possible penalties in criminal actions brought by the Department of Justice). Moreover, under Rule 102(e) of its Rules of Practice, the SEC has the power to censure or to prohibit from practicing before the Commission any professional who lacks the "requisite qualifications to represent others," is "lacking in character or integrity," has "engaged in unethical or

ineffectiveness of this system was a constant theme in the congressional hearings leading up to the PCAOB's creation. Dean Joel Seligman depicted it as a "positively Byzantine structure of accounting disciplinary bodies which generally lack adequate and assured financial support, clear and undivided responsibility for discipline, and an effective system of SEC oversight."⁴¹ Other witnesses described it as "a veritable alphabet soup of organizations provid[ing] governance"⁴² and "a bewildering array of monitoring groups."⁴³ The PCAOB replaces most of this self-regulatory system with a new system of "independent" regulation.

The analysis that follows examines the standard setting and oversight/disciplinary aspects of the accounting profession's self-regulatory system. It also discusses the SEC's role in this scheme.

1. Standard Setting

Although the federal securities laws authorize the SEC to regulate the accounting methods to be used in preparing and auditing the financial statements included in SEC reports,⁴⁴ as a fledgling agency,

improper professional conduct," or has "willfully violated, or willfully aided and abetted the violation of" the securities laws. 17 C.F.R. § 201.102(e)(i)-(iii) (2004). With respect to accountants, "improper professional conduct" includes "intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards" as well as a single instance of highly unreasonable conduct, or repeated instances of unreasonable conduct, "that results in a violation of applicable professional standards." *Id.* § 201.102(e)(iv). The Sarbanes-Oxley Act codified this rule as Section 4C of the Securities Exchange Act of 1934. 15 U.S.C.A. § 78d-3 (West Supp. 2004).

41 *Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 532 (2002) [hereinafter *Accounting Reform Hearing*] (testimony of Joel Seligman, Dean and Ethan A. H. Shepley Univ. Professor, Washington Univ. Sch. of Law).

42 *Id.* at 963 (prepared statement of Aulana Peters, Member, Public Oversight Bd.) (bemoaning the "alphabet soup" of governance); *Oversight Hearing on Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies Before the Senate Banking, Hous., and Urban Affairs Comm.*, 107th Cong. 723 (2002) [hereinafter *Oversight Hearing*] (prepared statement of Shaun O'Malley, Chairman, 2000 Public Oversight Bd. Panel on Audit Effectiveness). The "alphabet soup" metaphor surfaced several times in congressional testimony. *See, e.g., Accounting Reform Hearing, supra* note 41, at 245 (testimony and prepared statement of Lynn Turner, Chief Accountant, Sec. & Exch. Comm'n, 1998-2001) (stating that "the multitude of organizations often referred to in the press these days as 'alphabet soup' do not yield an efficient or effective quality control process").

43 *Accounting Reform Hearing, supra* note 41, at 376 (prepared statement of John Biggs, Chairman, President, and CEO, TIAA-CREF).

44 Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (2000); Securities Exchange Act of 1934 § 13(b), 15 U.S.C. § 78m(b) (2000).

the SEC was quick to delegate most of its standard-setting authority to the private sector.⁴⁵ Specifically, the SEC deferred to the accounting industry's principal trade association, the American Institute of Accountants (AIA), which later became known as the American Institute of Certified Public Accountants (AICPA).⁴⁶ The AICPA's initial standard-setting responsibilities included the formulation of both "generally accepted accounting principles" (GAAP)⁴⁷ as well as "generally accepted auditing standards" (GAAS).⁴⁸ As we shall see, the AICPA (and thus the SEC) later looked to an independent body—the Finan-

45 See DAVID R. HERWITZ & MATTHEW J. BARRETT, *ACCOUNTING FOR LAWYERS* 145 (3d ed. 2001); see also Administrative Policy on Financial Statements, SEC Accounting Series Release No. 4, 11 Fed. Reg. 10,913 (Sept. 27, 1946). In its entirety, the Release provided:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared *in accordance with accounting principles for which there is no substantial authoritative support*, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is *substantial authoritative support* for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.

Id. (emphasis added).

Commenting on the importance of this Release, Professor George Mundstock emphasizes that "[i]n two sentences, the SEC (i) gives the industry primary responsibility for accounting principles and (ii) blesses the notion that there can be many acceptable accountings for the same transaction." George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L L. & COM. REG. 813, 826 (2003).

46 Since 1887, AICPA and its predecessors have been the principal trade group for the accounting profession. See Am. Inst. of Certified Public Accountants, *Summary of AICPA Operations*, at <http://www.aicpa.org/about/summary.htm> (last visited Jan. 8, 2005). The AICPA currently has over 128,000 public accounting members in the United States. See Am. Inst. of Certified Public Accountants, *AICPA Membership Figures and Breakdown*, at <http://www.aicpa.org/members/memstats.htm> (last visited Jan. 8, 2005).

47 The broad term "accounting principles" encompasses "those guidelines, rules or procedures which enterprises use to prepare financial statements." HERWITZ & BARRETT, *supra* note 45, at 144. Thus, GAAP "reflects a consensus of what the accounting profession and financial community consider good accounting practices." *Id.*

48 The broad term "auditing standards" encompasses the standards and procedures that independent accountants must follow when they examine an enterprise's financial statements for the purpose of expressing "an opinion regarding whether the

cial Accounting Standards Board (FASB)—to formulate GAAP; but the AICPA retained responsibility for GAAS until Congress established the PCAOB.

a. Accounting Principles

The AICPA's initial role in the formulation of formal accounting principles was an important one. Its first efforts to develop such principles occurred in 1939 when it organized a Committee on Accounting Procedure (CAP) and a Committee on Accounting Terminology (CAT), whose accounting pronouncements took the form of Accounting Research Bulletins (ARBs).⁴⁹ In response to SEC criticism about the slow pace of their pronouncements,⁵⁰ as well as criticism by business groups as to their closed processes,⁵¹ the AICPA replaced CAP and CAT in 1959 with the Accounting Principles Board (APB), whose pronouncements took the form of APB Opinions.⁵²

In 1972, the AICPA disbanded the APB and designated the Financial Accounting Standards Board (FASB) as the entity that would establish accounting principles governing the profession. The change was made after an AICPA committee chaired by former SEC Commissioner Francis M. Wheat recommended the establishment of an independent standard-setting entity with broad-based public participation.⁵³ The FASB was part of the newly created Financial Accounting Foundation (FAF), a nonprofit organization that is responsible for "selecting the [seven] members of the FASB and its advisory council, ensuring adequate funding of their activities, and exercising general oversight with the exception of the FASB's resolution of technical issues."⁵⁴

financial statements fairly present, in all material respects, the enterprise's financial position, results of operations and cash flows in conformity with GAAP." *Id.* at 180.

49 *See id.* at 152.

50 *See* Benston, *supra* note 24, at 1333.

51 *See* Mundstock, *supra* note 45, at 828–29.

52 *See* HERWITZ & BARRETT, *supra* note 45, at 153. The APB's membership included AICPA members, with representatives from each of the "Big Eight" accounting firms, *see infra* note 69, as well as a few representatives from smaller firms and academia. *See* HERWITZ & BARRETT, *supra* note 45, at 153.

53 Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 385 (2003).

54 *See* FIN. ACCOUNTING STANDARDS BD., FACTS ABOUT FASB, at 2 (2003), available at http://www.fasb.org/facts/facts.about_fasb.pdf. The nonprofit FAF has a Board of Trustees composed of members from its eight constituent organizations: the American Accounting Association; the AICPA; the Association for Investment Management and Research; Financial Executives International; the Government Finance Officers Association; the Institute of Management Accountants; the National Association of

From its inception, the FASB commanded more respect than any of its standard-setting predecessors. Its heightened reputation was due in part to its "large budget, professional staff, and a mandate to reduce the scope of choice among alternative accounting practices."⁵⁵ But the SEC greatly contributed to the new organization's authority and reputation when it issued a Release in 1973 expressing its "intent[ion] to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB."⁵⁶ After reaffirming the 1938 Release that first articulated its policy of private-sector delegation,⁵⁷ the SEC stated unequivocally that the "principles, standards, and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."⁵⁸ Scholars have since debated whether the SEC abdicated an essential regulatory function by delegating the formulation of accounting principles to the FASB⁵⁹ and, without success, accounting firms have challenged the constitutionality of this delegation.⁶⁰

Although its budget was substantially larger than its standard-setting predecessors, until recently the FASB's funding was never very

State Auditors, Comptrollers and Treasurers; and the Securities Industry Association. *Id.* at 3.

55 Benston, *supra* note 24, at 1334.

56 Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, SEC Accounting Series Release No. 150, 39 Fed. Reg. 1260 (Jan. 7, 1974).

57 See *supra* note 45.

58 See Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, 39 Fed. Reg. at 1260.

59 See HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 153 (1979) (maintaining that "[t]he determination of what accounting should mean is the SEC's most important job—too important to be left to others"); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 *BROOK. L. REV.* 763, 883 (1995) (arguing that "there is something to be said for Kripke's (and many others') arguments that disclosure accounting should be governed by the SEC" and emphasizing that "[t]he accounting profession is only one party in interest in the debate about accounting standards, and accounting standards that are unduly responsive to the interests of the accounting profession in the sale of accounting services, rather than the interests of all the affected parties, are probably not socially beneficial"). *But see* Cunningham, *supra* note 24, at 981 (observing that "[t]ruly sweeping reform would abolish the FASB" but that "[g]iving the SEC sole direct power could further politicize the standard-setting process").

60 See *Arthur Andersen & Co. v. SEC*, Fed. Sec. L. Rep. (CCH) ¶ 95,720 (N.D. Ill. Sept. 3, 1976); see also *infra* notes 456–59 and accompanying text (discussing the so-called private nondelegation doctrine).

secure. The FASB received its funding from the FAF, which derived more than two-thirds of its monies from subscriptions and sales of FASB publications and about one-third from voluntary contributions.⁶¹ This funding mechanism drew sharp criticism from congressional witnesses during the Enron hearings, who testified that it caused FASB to be “less than optimally independent or objective” because “it constantly place[d] FASB and FAF in the role of a hat-in-hand supplicant soliciting the industry for charity.”⁶²

The Sarbanes-Oxley Act responds to this criticism by providing the FASB with the same source of guaranteed funding it accorded to the PCAOB: public companies are required to pay “annual account-

61 GEN. ACCOUNTING OFFICE, GAO-02-601T, PROTECTING THE PUBLIC'S INTEREST: CONSIDERATIONS FOR ADDRESSING SELECTED REGULATORY OVERSIGHT, AUDITING, CORPORATE GOVERNANCE, AND FINANCIAL REPORTING ISSUES 17 (2002) (testimony of David Walker, Comptroller General, U.S. General Accounting Office). In 2001, “FASB received net contributions of \$5,113,000 and subscription and publication sales of \$14,818,000; its direct costs of sales was \$1,586,000.” See Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, Securities Act Release No. 8109, Exchange Act Release No. 46,120, 67 Fed. Reg. 44,964, 44,979 n.92 (July 5, 2002).

62 *The Financial Accounting Standards Board Act: Hearing Before the House Subcomm. on Commerce, Trade and Consumer Protection of the House Energy & Commerce Comm.*, 107th Cong. 52 (2002) [hereinafter *FASB Act Hearing*] (prepared statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Univ. Law Sch.); see also *The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearing on H.R. 3763 Before the House Comm. on Fin. Servs.*, 107th Cong. 496 (2002) (statement of Damon A. Silvers, Assoc. Gen. Counsel, AFL-CIO) (stating that “[a]nyone familiar with the political pressures brought to bear on FASB around accounting for executive stock options in the mid-1990’s, not to mention the decade long paralysis on SPE [Special Purpose Entities] accounting knows that FASB is too open to pressures from issuers and those beholden to issuers”); *Accounting Reform Hearing*, *supra* note 41, at 205 (testimony of Michael Sutton, Chief Accountant, Sec. & Exch. Comm’n, 1995–1998) (“Take control of the money away from those who want to manipulate the system [and] . . . have a truly independent governance process. If you do that, I think we would have a chance of getting better and more timely answers from the FASB.”); *The Fall of Enron: How Could It Have Happened?: Hearing Before Senate Comm. on Governmental Affairs*, 107th Cong. 37 (2002) (testimony of Arthur Levitt, Former Chairman, Sec. & Exch. Comm’n) (“The fact that the board is funded by the very firms for whom they set standards, who often come back to them and say, ‘If you are going to set this standard, we are going to cut off your funding.’ That is wrong. We have got to change their funding.”). *But see FASB Act Hearing*, *supra* at 32 (statement of Edmund L. Jenkins, Chairman, Fin. Accounting Standards Bd.) (stating “[i]n my five years as Chairman of the FASB, no contribution to the FAF, or threat of withholding a contribution, if any occurred, had any impact, in any way, on any of the decisions of the Board” but acknowledging that “a secure and adequate non-discretionary funding source for the FAF that might serve to strengthen the appearance of independence of the FASB”).

ing support fees” to fund both boards’ operations.⁶³ Congress further strengthened the FASB by confirming its authority to establish GAAP, provided the FASB satisfies new criteria designed to separate it from the accounting profession.⁶⁴

b. Auditing Standards

Although the SEC from time to time encouraged the formation of an “independent” FASB-like entity to promulgate auditing standards, that responsibility fell initially to the AICPA and remained with it for decades. The AICPA’s first formal auditing standards were issued in 1939 by a newly created Committee on Auditing Procedure (CAC), which promulgated the broad auditing standards that continue to form the core of GAAS.⁶⁵ Over time, the CAC was reorganized and became the Auditing Standards Board (ASB).⁶⁶ The ASB is primarily responsible for interpreting GAAS, and its interpretations are published in the AICPA’s Statements on Auditing Standards (SAS).⁶⁷ For a brief time in 2001, the ASB was overseen by the Public

63 See *infra* notes 264–68 and accompanying text.

64 See 15 U.S.C.A. § 77s(b)(1) (West Supp. 2004) (as amended by Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108(a), 116 Stat. 745, 768):

[T]he Commission may recognize as “generally accepted” for purposes of the securities laws any accounting principles established by a standard setting body . . . that—(i) is organized as a private entity; (ii) has . . . a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their term of service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm; (iii) is funded as provided in section 7219 of this title; (iv) has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and (v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors.

Id. The Senate Report makes clear that the standard-setting body referred to above is the FASB. See S. REP. NO. 107-205, at 13 (2002) (stating that “[t]he bill seeks to formalize the SEC’s reliance on the FASB”). For a discussion of the new criteria for standard-setting bodies, see *infra* note 262.

65 See Am. Inst. of Certified Public Accountants, *The Enron Crisis: The AICPA, The Profession & The Public Interest: A Brief History of Self-Regulation* (2002), at .

66 The name of the CAC was changed in 1972 to the Auditing Standard Executive Committee (AudSEC), “in recognition of its role as the AICPA’s senior technical committee charged with interpreting generally accepted auditing standards (GAAS).” *Id.* The Auditing Standards Board (ASB) was formed in 1978 as AudSEC’s successor. *Id.*

67 *Id.*

Oversight Board (POB), which was independent from, but funded by, the AICPA.⁶⁸

The self-interest endemic to the ASB's structure drew particularly harsh criticism during the Enron congressional hearings. Indeed, the fifteen members who volunteer their time to sit on the ASB are predominantly practicing accountants, many of whom are partners with what are now the Big Four accounting firms.⁶⁹ As Lynn Turner, former Chief Accountant at the SEC, testified:

They actually draft the standards.

One of the problems with that part of the system today is, when they go through that drafting process, since it is all being done by the firms themselves, in fact, their legal counsels get involved in editing those very standards themselves, those standards tend to be written to protect the accounting firms in case they get in trouble on an audit, sometimes probably which is deserved, and quite frankly, sometimes which is not deserved. . . .

It is not drafted with the public interest in mind "As long as you leave that standards setting process in the hands of the firms and of the firm's legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public."⁷⁰

Most witnesses believed that the SEC's role as the ASB's ultimate "overseer" did little to mitigate the standard-setting conflicts.⁷¹ An ar-

68 See *infra* notes 89–96 and accompanying text.

69 *Accounting Reform Hearing, supra* note 41, at 217 (testimony and prepared statement of Lynn Turner, Chief Accountant, Sec. & Exch. Comm'n). For many years, eight national firms dominated the accounting industry. But in 1989, with the mergers of Ernst & Whitney and Arthur Young into Ernst & Young and Touche Ross and Deloitte Haskins & Sells into Deloitte & Touche, the "Big Eight" was reduced to six members. When Price Waterhouse merged with Coopers Lybrand in 1998, the "Big Six" became the "Big Five." After Arthur Andersen's Enron-related demise in 2002, the "Big Five" dwindled to what is now the "Big Four" (also referred to sometimes as the "Final Four"): PriceWaterhouseCoopers LLP, Deloitte & Touche LLP, Ernst & Young LLP, and KPMG LLP.

70 *Id.* at 217 (testimony and prepared statement of Lynn Turner, Chief Accountant, Sec. & Exch. Comm'n) (quoting Sandy Burton, former Chief Accountant).

71 See S. REP. NO. 107-205, at 5–6 (2002); see also *The Enron Collapse: Impact on Investors and Financial Markets: Joint Hearing Before the House Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. and the House Subcomm. on Oversight and Investigation of the House Comm. on Fin. Serus.*, 107th Cong. 95 (2001) (statement of Robert Herdman, Chief Accountant, Sec. & Exch. Comm'n). Herdman described the SEC's monitoring role as follows: "[T]he SEC staff attends many of the ASB's public meetings, reviews exposure drafts of proposed auditing standards and selected comment letters responding to those exposure drafts, and periodically meets with representatives of the ASB to discuss current and future projects and other matters of mutual concern." *Id.*

guable exception might be the requirements for auditor independence because, only a few years before, the SEC had enhanced its own rules in that area.⁷² Yet even these requirements drew much criticism in congressional hearings.⁷³ Congress eventually interceded in Title II of the Sarbanes-Oxley Act, which amends the Exchange Act to make it unlawful for any accounting firm to provide contemporaneously with an audit for a public company any one of eight types of non-audit services.⁷⁴

In the wake of Sarbanes-Oxley, it is an open question as to whether the AICPA will play a significant role in standard setting for auditors. To be sure, Congress had the AICPA in mind when it authorized the PCAOB to “cooperate on an ongoing basis” with professional and advisory groups⁷⁵ and to “adopt as its rules . . . any portion of any statement of auditing standards . . . by [a] professional group[]

72 In the late 1990s, the SEC, at the urging of its Chairman, Arthur Levitt, sought to increase the independence of auditors by restricting an accounting firm’s ability to provide both audit services and consulting services to the same client. Although the SEC’s initial proposals would have resulted in substantial change, these proposals were scaled back substantially under heavy pressure from members of Congress (who were being lobbied strongly by the Big Five accounting firms). See Michael Schroeder, *SEC May Back Down on Key Consulting Issue*, WALL ST. J., Oct. 25, 2000, at C1 (reporting that both the House and the Senate had drafted provisions to bills that would undo any SEC rules prohibiting auditors from providing consulting services to their audit clients). The SEC’s final rules, Revision of the Commission’s Auditor Independence Requirements, Securities Act Release No. 7919, Exchange Act Release No. 43,602, 65 Fed. Reg. 76,008, 76,013 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240 (2004)), bore a faint resemblance to Chairman Levitt’s original plan for reform. See ARTHUR LEVITT, TAKE ON THE STREET 132–33 (2002) (describing the initiatives in the 1990s to increase auditor independence and stating that “[n]ever before had the SEC faced such a threat” to its own independence).

73 See S. REP. NO. 107-205, at 17–18 (maintaining that “‘the AICPA and the SEC have failed to update their independence standards in a timely fashion and that past updates have not adequately protected the public’s interest’”) (quoting a statement by Comptroller General David Walker).

74 Exchange Act, § 10A(g)(1)–(8), 15 U.S.C.A. § 78j-1(g)(1)–(8) (West Supp. 2004); see also S. REP. NO. 107-205, at 18 (stating that “[t]he approach adopted by the bill reflects the Committee’s belief that the issue of auditor independence is so fundamental to the problems currently being experienced in our financial markets that statutory standards are needed to assure the independence of the auditor from the audit client”). As we shall see, Congress vested the PCAOB with significant power to both add to and subtract from this list of prohibited non-audit services. See *infra* notes 193–96 and accompanying text. The similarities between Title II’s requirements and the restrictions on auditors that were initially proposed by the SEC in the late 1990s, see *supra* note 72, have been noted by many. See, e.g., NAGY ET AL., *supra* note 24, at 832.

75 15 U.S.C.A. § 7213(c)(1).

of accountants” that is determined to be in the public interest.⁷⁶ But Congress clearly put the PCAOB in the driver’s seat with respect to the formulation of auditing standards,⁷⁷ and regarding professional group standards, stated explicitly that the PCAOB “shall retain full authority to modify, supplement, revise, or subsequently amend, modify, or repeal, in whole or in part, any portion of any statement” included in such standards.⁷⁸ At a public meeting in April 2003, the PCAOB announced that it would be developing its own standards for the audits of public companies and that the AICPA’s existing standards would be applicable only in the interim.⁷⁹

2. Oversight and Discipline

Unlike standard setting, which was clearly on the minds of SEC officials and members of Congress in the 1930s, significant concerns about the accounting profession’s oversight and discipline (or its lack thereof) did not arise until the 1970s, when investors lost staggering sums of money due to financial scandals and subsequent bankruptcies at companies including Penn Central Railway, Equity Funding, and Continental Vending.⁸⁰ In addition, congressional hearings prompted by the Watergate break-in and its subsequent cover-up revealed undisclosed slush funds, bank accounts, and other devices used

76 *Id.* § 7213(a)(3)(A)(i).

77 *See* Cunningham, *supra* note 24, at 919 (noting that the Sarbanes-Oxley Act stripped the AICPA of its power to make authoritative decisions).

78 15 U.S.C.A. § 7213(a)(3)(A)(ii).

79 *See Audit Standards: PCAOB to Adopt own Audit Standards, Agrees to Existing Rules as Interim Step*, 35 Sec. Reg. & L. Rep. (BNA) 671, 671–72 (2003) (reporting PCAOB member Kayla Gillan’s statements that she was “‘reluctantly supporting’ the adoption of interim standards and she ‘would have loved to have new [PCAOB] standards’ . . . [by the Sarbanes-Oxley Act’s deadline], but she understood that was not possible”); *see also Oversight of the Public Company Accounting Board: Hearing Before the Subcomm. on Capital Mkts., Ins. and Gov’t Sponsored Enters. of the Comm. on Fin. Serus.*, 108th Cong. 6 (2004) [hereinafter *PCAOB Hearing*] (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd. Chairman), *available at* <http://financialservices.house.gov/media/pdf/108-98.pdf> (emphasizing that the PCAOB intends to review the “interim standards and would determine, standard by standard, whether they should be modified, repealed, or made permanent”).

80 *See* Lynn Turner, SEC Chief Accountant, *Shifting Paradigms in Self-Regulation: Address at the 27th Anniversary Securities Regulation Institute* (Jan. 27, 2000), *available at* <http://www.sec.gov/news/speech/spch340.htm>; *see also Accounting Reform Hearing*, *supra* note 41, at 896 (testimony and prepared statement of Charles Bowsher, Chairman, Public Oversight Bd. and former Comptroller General of the United States) (noting that after its enactment of the Securities Act and the Exchange Act, “Congress did not look really again at the accounting profession until the 1970’s”).

by major corporations to hide illegal bribes and kickbacks.⁸¹ These revelations prompted the cry, “Where were the auditors?”⁸²

With Congress’s attention now focused on the accounting profession, the relative merits of federal regulation over self-regulation were examined and debated. Although a self-regulatory system was the one ultimately favored, members of Congress concluded that “the SEC’s reliance on the private accounting profession alone . . . ha[d] been insufficient to protect public investors and accomplish the objectives of the Federal securities laws,”⁸³ and that reforms were “needed to restore public confidence in the accuracy and reliability of financial and other information reported by publicly-owned corporations.”⁸⁴

In 1977, in response to congressional demands, “and as an alternative to federal legislation, the . . . [AICPA], in consultation with the SEC,” created a new self-regulatory framework with peer review at its center.⁸⁵ Specifically, the AICPA established the SEC Practice Section (SECPS) and the Quality Control Inquiry Committee (QCIC).⁸⁶ The SECPS handled the peer review of auditing firms while the QCIC investigated allegations of audit failure.⁸⁷ AICPA member firms performing audits for public companies were required to join the SECPS, meet its standards, and submit to its periodic peer reviews.⁸⁸ The AICPA also established the Public Oversight Board (POB) in the same 1977 Council Resolution that created the SECPS.⁸⁹ This resolution required the POB to

81 Turner, *supra* note 80.

82 *Id.*

83 STAFF OF SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 94TH CONG., REPORT ON FEDERAL REGULATION AND REGULATORY REFORM 38 (Subcomm. Print 1976) (also known as the “Moss Report”).

84 STAFF OF SUBCOMM. ON REPORTS, ACCOUNTING, AND MGMT. OF THE SENATE COMM. ON GOVERNMENTAL OPERATIONS, 95TH CONG., REPORT ON THE ACCOUNTING ESTABLISHMENT: A STAFF STUDY 20 (Subcomm. Print 1977).

85 See *Accounting Reform Hearing*, *supra* note 41, at 940 (testimony and prepared statement of Charles Bowsher, Chairman, Public Oversight Bd. and former Comptroller General of the United States).

86 See Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, Securities Act Release No. 8109, Exchange Act Release No. 46,120, 67 Fed. Reg. 44,964, 45,010 app. A (July 5, 2002); see also U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM 7 (2002).

87 Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, 67 Fed. Reg. at app. A.

88 *Id.*

89 *Id.*

(a) Monitor and evaluate [the regulatory and sanction] activities of the Peer Review and [SECPS] Executive Committees to assure their effectiveness, (b) Determine that the Peer Review Committee is ascertaining that firms are taking appropriate action as a result of peer reviews, (c) Conduct continuing oversight of all other activities of the Section.⁹⁰

The POB's story is, by now, a familiar one. Although its system of peer review resulted in some improvement, the POB's funding mechanism and lack of sanctioning authority ultimately doomed its ability to meet its objectives. As the SEC recounted:

While intended to be autonomous (the POB could set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff), the POB relied for its funding on voluntary dues paid by AICPA firms that audited public companies and belonged to [the] SECPS. In addition, the POB lacked the ability to organize and implement its own quality control reviews. And, the POB was not given any authority to sanction auditors for deficiencies or incompetence noted during quality control reviews.⁹¹

Peer review, the two-decade-old cornerstone of the self-regulatory system, drew particularly harsh criticism,⁹² eventually prompting the SEC in 1999 to remove its "endorsement" of the process from its Annual Reports to Congress.⁹³ The bubbling tension grew to a boil the following year after the AICPA cut off the POB's funding when it ac-

90 *Id.* (quoting DIV. FOR CPA FIRMS, SEC. & EXCH. COMM'N, SECPS REFERENCE MANUAL, § 100.23).

91 *Id.* at 44,970.

92 *See, e.g., Accounting Reform Hearing, supra* note 41, at 76 (prepared statement of Harold M. Williams, Former Chairman, Sec. & Exch. Comm'n) ("To my knowledge, there has never been a negative review of a major firm. . . . Particularly as the Big 8 has become only the Big 5, peer review, in its present form becomes too incestuous."); *id.* at 1116 (prepared statement of Harvey L. Pitt, Chairman, Sec. & Exch. Comm'n) ("[I]t appears that the current system of firm-on-firm peer reviews, overseen by [the POB] . . . has not produced a credible result."); *id.* at 1035 (prepared statement of Howard M. Metzenbaum, Chairman, Consumer Fed'n of Am. and former U.S. Senator) ("The POB . . . is notable for having never sanctioned a major accounting firm in its 25 years of existence, even when peer reviews have uncovered serious shortcomings in a firm's audit procedures."); *id.* at 533 (testimony of Joel Seligman, Dean and Ethan A. H. Shepley Univ. Professor, Washington Univ. Sch. of Law) ("Peer review has been to some degree unfairly maligned. But even at its best, it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one.").

93 *Id.* at 247 (testimony and prepared statement of Lynn Turner, Chief Accountant, Sec. & Exch. Comm'n, 1998–2001); *see also* Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, 67 Fed. Reg. at 44,968.

ceded to the SEC's request to examine the Big Five accounting firms' compliance with the then-applicable standards for auditor independence.⁹⁴ Although the POB and the SEC agreed to organizational changes in 2001,⁹⁵ the structural weaknesses remained. In January 2002, the members of the POB voted unanimously to disband after the SEC announced its intention to create an auditor oversight body with more independence from the accounting profession.⁹⁶

B. *The Enron Scandal and Congress's Response*

Despite the concerns raised in the 1980s and 1990s about the accounting profession's system of self-regulation, change was very slow to occur. Impediments came from a variety of sources, including an SEC that lacked the budget to avail itself more fully of its own regulatory authority⁹⁷ and elected officials who were mindful that the Big

For many years, we had stated in our Annual Report that the peer review and QCIC processes resulted in accounting firms "focusing on and achieving the important goal of maintaining and improving effective quality control systems." Because of our growing concerns, however, we intentionally did not include that statement in our 1999, 2000, and 2001 Annual Reports.

Id.

94 See *Accounting Reform Hearing*, *supra* note 41, at 941 (testimony and prepared statement of Charles Bowsher, Chairman, Public Oversight Bd. and former Comptroller General of the United States) (stating that "[t]he decision of the SECPS to deny funding to the POB was a serious blow to the notion of independent oversight of the accounting profession").

95 Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, 67 Fed. Reg. at 44,971. Among other changes, the new charter provided for POB oversight of the Accounting Standards Board. *Id.*

96 *Accounting Reform Hearing*, *supra* note 41, at 941 (testimony and prepared statement of Charles Bowsher, Chairman, Public Oversight Bd. and former Comptroller General of the United States) (contending that the "precipitating event" of the POB's decision to disband was a plan "worked out in private talks between the SEC and the AICPA and the Big 5 accounting firms with no input from the POB, which had repeatedly been assured that it would be consulted" and that "[t]he new proposal effectively rendered the POB a 'lame duck'"). The SEC proposal provided for the creation of one or more Public Accountability Boards (PABs). Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, 67 Fed. Reg. at 44,971. Members of a PAB were to be drawn from the accounting profession as well as the public, though the public members were to have predominated. *Id.* And PABs were to be overseen by the SEC. *Id.* The SEC's proposal for PABs, of course, was preempted by Congress's decision to establish the PCAOB.

97 See, e.g., *Accounting Reform Hearing*, *supra* note 41, at 18 (testimony of Richard C. Breeden, Former Chairman, Sec. & Exch. Comm'n).

Attrition among the staff of the SEC is the friend of everyone who hopes to commit an undetected fraud. . . . The SEC also does not have enough resources in the accounting area in particular. For many years we did not have

Five accounting firms and other major campaign contributors were staunchly opposed to increased government regulation (such as in the area of auditor independence).⁹⁸ But Congress and the SEC were propelled into action by the Enron debacle at the end of 2001. The growing number of accounting and corporate governance scandals had sounded an alarm,⁹⁹ which was made all the more deafening by the staggering sums of money lost by shareholders, employees, and retirees of the companies involved.¹⁰⁰ As one corporate law scholar observed, after Enron, “Congress possessed that rare political and institutional capacity to address deep causes and systemic dysfunction.”¹⁰¹ Indeed, within a six-month period, the scandal-driven momentum resulted in dozens of congressional hearings, more than thirty proposed bills, and landmark legislation passed by a virtually unanimous Congress and signed into law by the President.

1. Congressional Hearings

In the period of time between January and April 2002, committees in both the Senate and the House of Representatives held hear-

enough staff to look at both IPOs and 34 Act filings. That is not good enough.

Id.

98 See *supra* note 72. For discussions on the powerful force of the accounting lobby, see Bratton, *supra* note 2, at 1033 (contending that “[t]he accounting profession has become famously aggressive at protecting its own interests and those of its clients in the corridors of power in Washington”); Cox, *supra* note 24, at 316 (noting that “the industry spent \$41 million on lobbying activities between 1997 and 2001” and that of the “248 Senate and House members who sat on congressional committees involved in the numerous investigations prompted by the financial scandals of 2002, 212 of them had received contributions from one or more [of] the Big Five accounting firms”); see also LEVITT, *supra* note 72, app. (publishing letters received from members of Congress regarding the SEC’s proposed auditor independence rules).

99 In the winter of 2002, a list of significant accounting and corporate governance scandals would have included Adelphia Communications Corp., Qwest Communications, Rite Aid Corp., Global Crossing, Tyco International, and Xerox Corp. But in June 2002, a new company was added to the top of the list: WorldCom, whose fraud was initially estimated at \$3.8 billion, but was later revealed to be more than eleven billion dollars. See Robert Frank et al., *Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1; see also *infra* note 147 and accompanying text (contending that the WorldCom scandal fueled the momentum for the Sarbanes-Oxley Act).

100 Cunningham, *supra* note 24, at 979 (stating that Congress and the President “knew that constituents wanted action, eyeing [Enron and WorldCom] after the value of their investment funds—built for dreams concerning first-home purchases, educating children, enjoying retirement, and taking trips around the world—shrank from Dow 12,000 to Dow 8,000 (and less)”).

101 *Id.* at 917.

ings on the accounting and investor protection issues raised by Enron and the notorious scandals at other public companies. In the Senate, the Committee on Banking, Housing and Urban Affairs, chaired by Senator Paul Sarbanes (D-Md.), held ten days of hearings involving a total of thirty-six witnesses.¹⁰² A total of nineteen witnesses testified in hearings held by the House Committee on Financial Services, chaired by Representative Michael Oxley (R-Ohio).¹⁰³ To be sure, much of the congressional testimony related to issues of corporate governance, insider abuses, completeness of disclosure in SEC filings, conflicts of interest among securities analysts, and the inadequacy of the resources available to the SEC.¹⁰⁴ But issues concerning standards and oversight for accountants and auditors predominated.

For the reasons discussed in the previous section, virtually all of those testifying shared the view that the accounting profession's system of self-regulation was in need of a serious overhaul.¹⁰⁵ Most witnesses supported the creation of a new, independent entity to provide more effective auditor oversight.¹⁰⁶ And most agreed that the new entity should not be dependent for funding on the accounting profession.¹⁰⁷ But opinions diverged as to whether this newly created entity should be private or public. Some witnesses urged the establishment of a private sector entity modeled after SROs in the securities industry such as NYSE or the NASD.¹⁰⁸ It was argued that a private, independent entity with the SEC as its overseer would allow Congress to attain

102 S. REP. NO. 107-205, at 2-4 (2002) (listing hearings and names of witnesses).

103 H.R. REP. NO. 107-414, at 19 (2002). Prior to the enactment of the Sarbanes-Oxley Act, at least nine other congressional committees held hearings in response to the Enron scandal. See JOHN T. BOSTELMAN, *THE SARBANES-OXLEY DESKBOOK* § 2:4.3, app. K (2004) (listing committees and dates of hearings).

104 S. REP. NO. 107-205, at 2.

105 See *supra* notes 42, 61-62, 69-71 and accompanying text; see also S. REP. NO. 107-205, at 5-7.

106 See S. REP. NO. 107-205, at 5.

107 *Id.* at 13.

108 See *Accounting Reform Hearing*, *supra* note 41, at 583 (prepared statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Univ.) ("Legislation is necessary to create a body that would have at least the same powers, duties and obligations as the NASD."); *id.* at 532 (testimony of Joel Seligman, Dean and Ethan A. H. Shepley Univ. Professor, Washington Univ. Sch. of Law) ("[I]t is time for a new auditing self-regulatory organization to be created [with] . . . clear and undivided responsibility for discipline, and an effective system of SEC oversight."); *id.* at 194 (testimony of Michael Sutton, Chief Accountant, Sec. & Exch. Comm'n, 1995-1998) ("In my view, those goals can be best accomplished through an independent statutory regulatory organization operating in the private sector under the oversight of the Securities and Exchange Commission.").

“the best of both worlds.”¹⁰⁹ Other witnesses expressed concern with an NYSE/NASD model, with one witness warning that private sector companies with governmental powers constituted the “worst of both worlds rather than the best.”¹¹⁰

David Walker, the Comptroller General of the United States, provided the most extensive analysis on the choice between creating a new entity in the private or public sector. In his April 9, 2002, testimony to the House Committee on Financial Services, Comptroller Walker recommended that Congress “create an independent statutory federal government body to oversee financial audits of public companies.”¹¹¹ He also advised that “the new body would have independent decisionmaking authority from the SEC,”¹¹² that it “should be given appropriate flexibility . . . to provide compensation that is competitive to attract highly competent board members and supporting staff,”¹¹³ and that “members of the board should be appointed by the President and confirmed by the U.S. Senate.”¹¹⁴ The Comptroller provided a

109 *Id.* at 529 (prepared statement of Robert R. Glauber, Chairman and CEO, Nat'l Ass'n of Sec. Dealers)

It is my judgment that if properly designed, a new private sector regulator can make a major contribution by tapping industry resources and insights not available to the Government. To get the best of both worlds, however, these advantages should be matched with tough SEC oversight under the watchful eye of Congress.

Id.

110 *Id.* at 1027–28 (testimony of Sarah Teslik, Executive Director, Council of Institutional Investors).

They are not accountable to anyone. We don't elect them. They do not disclose anything. Do you know what Dick Grasso makes? We know what you make. We do not know what CEOs make. . . . And our ability to either police them, oversee them, or even give them input, tends to be less than the government entities that we deal with. . . . By and large, we get better responses, more quickly in the sunshine, with better regulation from government bodies.

Id. Teslik's critique foreshadowed the NYSE's surprising announcement that its Chairman and CEO, Richard Grasso, “will collect \$139.5 million in deferred retirement benefits and a pay package of at least \$2.4 million this year.” Kate Kelly, *NYSE Chief Will Collect \$139.5 Million*, WALL ST. J., Aug. 28, 2003, at C1.

111 GEN. ACCOUNTING OFFICE, *supra* note 61, at 5.

112 *Id.* at 7.

113 *Id.*

114 *Id.* Comptroller Walker further suggested that candidates for board membership “could be identified through a nominating committee that could include the Chairman of the Federal Reserve, Chairman of the SEC, the Secretary of the Treasury, and the Comptroller General of the United States.” *Id.*

more nuanced opinion to the Senate Banking Committee,¹¹⁵ and advised that there were “several alternative structures” that the Congress could choose from in establishing the new body, including creating: “(1) a new unit within the SEC, (2) an independent government entity within the SEC, (3) an independent government agency outside the SEC, or (4) a non-governmental private-sector entity overseen by the SEC.”¹¹⁶ Although he recognized that all four alternatives had various pros and cons, he believed that alternatives one and four had a lesser likelihood of success. He specifically noted that “under alternatives one and four, the new body would have less direct accountability to the Congress and the public than a body with board members who are PASs [President appointed confirmed by the Senate].”¹¹⁷ He also expressed concern that alternatives one and four would increase the SEC’s responsibility as well as its workload.¹¹⁸

Of the remaining alternatives, Comptroller Walker favored number two:

[W]e favor alternative two as having a greater likelihood of success because the new body would be housed within the SEC and, therefore, could receive administrative support from the SEC, including human resources, payroll, and other administrative support. More importantly, this alternative should better facilitate communication and provide for maximum coordination with the SEC, while also allowing the new body the independence to design its own policies and procedures as it deemed appropriate. In addition, alternative two would not require Congress to create a separate federal entity. Alternative two would also facilitate a consolidation of the new entity under the SEC in future years if such a consolidation was deemed to be both desirable and appropriate. Therefore, we be-

115 Letter from David M. Walker, Comptroller General, Gen. Accounting Office, to Senator Paul S. Sarbanes (May 3, 2002), *reprinted in* U. S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6 (2002), *available at* <http://www.gao.gov/new.items/d02411.pdf>.

116 *Id.* at 5, *reprinted in* U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6, at 79 (2002), *available at* <http://www.gao.gov/new.items/d02411.pdf>.

117 *Id.*, *reprinted in* U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6, at 79 (2002), *available at* <http://www.gao.gov/new.items/d02411.pdf>.

118 *Id.*, *reprinted in* U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6, at 79 (2002), *available at* <http://www.gao.gov/new.items/d02411.pdf>.

lieve that alternative two has the greatest likelihood of success in terms of potential effectiveness, efficiency, and accountability of the new body.¹¹⁹

But with that said, Comptroller Walker reiterated the view that “each of the alternative structures has merit and can potentially work if properly designed and implemented.”¹²⁰

Several witnesses agreed with the assessment that change to the status quo was necessary, but disagreed with the recommendation that Congress create a new regulatory body (whether public or private). A number of witnesses, including former SEC Chairman Richard Breeden,¹²¹ advocated direct regulation of the accounting profession by the SEC, provided it was infused with additional funding.¹²² Others suggested that the POB’s structure could be improved to correct its past weaknesses.¹²³

119 *Id.* at 6, reprinted in U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6, at 80 (2002), available at <http://www.gao.gov/new.items/d02411.pdf>.

120 *Id.*, reprinted in U.S. GEN. ACCOUNTING OFFICE, GAO-02-411, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM app. 6, at 80 (2002), available at <http://www.gao.gov/new.items/d02411.pdf>.

121 *Accounting Reform Hearing*, *supra* note 41, at 37 (testimony of Richard C. Breeden, Former Chairman, Sec. & Exch. Comm’n).

We do not need to go and invent another [body]. We need to invigorate the SEC and make sure it has the tools to do the job. Let’s not reinvent the wheel. Downstream from the SEC, private sector groups can be helpful. And I do not mean to exclude that. But let’s [not] lose sight. The primary enforcer of the law needs to be the Commission.

Id.

122 *Id.* at 745 (prepared statement of Robert E. Litan, Vice President and Director, Econ. Studies Program, The Brookings Inst.) (“I urge [Congress] at least to consider whether the SEC *itself* should be performing the oversight of auditors directly, although . . . it might make sense to establish a slimmed-down [entity] to set auditing standards.”); *id.* at 208 (testimony of Walter P. Schuetze, Chief Accountant, Sec. & Exch. Comm’n, 1992–1995) (“I wouldn’t have this board. . . . [G]ive the SEC pay parity, increase their budgets so that they can do more and better jobs. But do not create another body that is going to compete with them.”); *id.* at 745 (statement of Arthur R. Wyatt, CPA).

I would be inclined to provide increased funding to the SEC and have it assume the principal role in overseeing the effectiveness of the financial reporting process. Creation of a new agency to undertake this responsibility seems unnecessary in view of the record established by the SEC over the past 65 years.

Id.

123 *Oversight Hearing*, *supra* note 42, at 724 (prepared statement of Shaun O’Malley, Chairman, 2000 Public Oversight Bd. Panel on Audit Effectiveness) (rec-

2. Legislative Proposals and Congressional Debates

Both sides of the aisle on both sides of the Capitol generated a flurry of proposals in response to the scandals as well as the concerns raised by hearing witnesses. Many of these proposals constituted comprehensive legislation that provided for, among other things, the establishment of a new entity (or entities) that would increase oversight for accounting firms that audit public companies.

Four proposals are particularly important to an understanding of the PCAOB. The first was a bill (H.R. 3763) sponsored by Representative Michael Oxley (R-Ohio), titled "The Corporate and Auditing Accountability, Responsibility, and Transparency Act" (CAARTA).¹²⁴ This bill, which passed the House of Representatives in April 2003 by a vote of 334 to 90,¹²⁵ required the SEC to establish criteria for "public regulation organizations," but the bill itself did not actually create such an entity.¹²⁶ CAARTA's critics favored an alternative bill (H.R. 3818) sponsored by Representative John LaFalce (D-N.Y.), that required the SEC to establish a "Public Accounting Regulatory Board."¹²⁷ The third proposal took the form of a draft bill disseminated by Senator Michael Enzi (R-Wyo.),¹²⁸ with input from Senator Phil Gramm (R-Tex.), that required the SEC to establish a "Professional Standards Board."¹²⁹ The last of these proposals was a bill (S. 2004) co-sponsored by Senators Christopher Dodd (D-Conn.) and Jon Corzine (D-N.J.) requiring the SEC to create an "Independent Public Accounting Board."¹³⁰ The Dodd-Corzine proposal was the one most reflected in the PCAOB.¹³¹

A side-by-side comparison of the oversight boards proposed in these four bills, along with a close reading of the legislative record, reveals that the choice between situating the board in the private sector or the public sector was not a particularly partisan one. Indeed,

ommending that the new entity resemble the expanded POB endorsed in 2000 by the Panel on Audit Effectiveness, stating "I believe that a strengthened POB would have served the interests this Committee seeks to protect").

124 Corporate and Auditing Accountability, Responsibility and Transparency Act, H.R. 3763, 107th Cong. (2002).

125 See *infra* note 142 and accompanying text.

126 H.R. 3763 § 2(b).

127 Comprehensive Investor Protection Act, H.R. 3818, 107th Cong. § 4(b) (2002).

128 At the time, Senator Enzi was the only member of Congress with the credential of a CPA. 148 CONG. REC. S6330 (daily ed. July 8, 2002) (statement of Sen. Sarbanes).

129 Investor Protection and Corporate Responsibility Act, Draft Bill, 107th Cong. (2002), available at <http://enzi.senate.gov/account.htm>.

130 Investor Confidence in Public Accounting Act, S. 2004, 107th Cong. § 101(a) (2002).

131 See *infra* note 149 and accompanying text.

like the PCAOB established by Title I of the Sarbanes-Oxley Act, both the Dodd-Corzine bill and the Enzi-Gramm alternative opted for private status.¹³² In contrast, both Representative Oxley's CAARTA and Representative LaFalce's alternative were silent as to the board's status, with neither bill specifically characterizing the entity as private or public. However, both House bills provided for application of the Freedom of Information Act,¹³³ and the LaFalce bill provided that the Board would be subject to the Administrative Procedure Act.¹³⁴ The LaFalce bill also authorized the SEC to empower the Board, or one or more officers of the Board, to subpoena witnesses for documents and testimony.¹³⁵ To say the least, these provisions would have been exceedingly odd as applied to a Board that was situated in the private sector. Although it is not possible to know what was in the minds of the House members that voted for (or against) these bills, there is evidence that some Representatives viewed the CAARTA as authorizing the establishment of a private board,¹³⁶ whereas others viewed that

132 See S. 2004 § 101(b) (providing that the Board "shall not, for any purpose, be an agency or instrumentality of the Federal Government, and no officer, employee, member of the Board, or other person associated with the Board shall be, for any purpose, an officer or employee of the Federal Government"); Investor Protection and Corporate Responsibility Act, *supra* note 129, § 101(b) (same). Although Senator Enzi's draft bill contemplated a private sector board overseen by the SEC, the draft provided that disciplinary sanctions imposed by the board may be appealed to the SEC, "to the U.S. District Court for the District of Columbia, or to the appropriate Federal district court in the State in which the firm or associated person is domiciled." *Id.* § 202(b)(6)(A).

133 Corporate and Auditing Accountability, Responsibility and Transparency Act, H.R. 3673, 107th Cong. § 2(d)(2)(D); Comprehensive Investor Protection Act, H.R. 3818, 107th Cong. § 4(g)(5)(D) (2002).

134 H.R. 3818 § 4(c)(8).

135 *Id.* § 4(g)(2)(D)(ii).

136 See, e.g., 148 CONG. REC. H1546 (daily ed. Apr. 24, 2002) (statement of Rep. Rogers). Representative Rogers rose in support of the Oxley bill, noting that it was "an important piece of legislation that does not create a new Federal bureaucracy funded by taxpayers; rather, it requires a new private sector oversight body to review the accounting firms that audit financial statements." *Id.* Representative Rogers then asked Representative Oxley for clarification on that very issue:

Mr. Rogers: [I]t is my understanding that this bill does not create a new Federal bureaucracy to oversee the accounting profession but, rather, creates a private sector regulator to do that job.

Mr. Oxley: . . . [T]hat is correct. We are giving the SEC the tools to oversee this new PRO, but it is going to be funded by the private sector.

Id. But Representative Oxley's response to Representative Rogers begs the question. It is certainly possible for Congress to create a public entity that is funded entirely by the private sector. See *infra* notes 295, 303, 498 and accompanying text (discussing the Federal Deposit Insurance Corporation and the Federal Reserve).

very same bill as authorizing a board that was public.¹³⁷

Although the legislative record does not reflect much congressional consideration of the choice between situating an oversight board in the private or public sector, it does evidence an awareness that the board that eventually became the PCAOB was “a strange kind of entity [in that we] want it to be private, but we want it to have governmental powers.”¹³⁸ It also evidences a striking awareness as to the PCAOB’s audacious power. Indeed, in the course of a Senate debate, Senator Gramm candidly acknowledged:

Anybody who thinks this board is just going to slap around a few accountants does not understand this bill. This board is going to have massive power, unchecked power, by design. I would have to say the board that Senator Enzi and I set up in our bill has massive unchecked power as well. I mean, that is the nature of what we are trying to do here. I am not criticizing Senator Sarbanes. I am just reminding people that there are two edges of this sword. 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.¹³⁹

3. The Sarbanes-Oxley Act of 2002

Few could have predicted the factors that metastasized the four proposals discussed above into the Sarbanes-Oxley Act. Over the

¹³⁷ See, e.g., 148 CONG. REC. H1556 (daily ed. Apr. 24, 2002) (statement of Rep. Shows). Representative Shows rose in support of the Oxley bill, stating:

I support CAARTA’s creation of a public regulatory organization (PRO). . . . The American public and the accounting profession will be better served by this *independent governmental body* that is given the authority to sanction and discipline those accountants who violate codes of ethics, standards of independence and competency, or securities laws.

Id. (emphasis added). Representative Shows specifically referenced Comptroller General David Walker’s testimony favoring an “*independent statutory federal government body*,” see *supra* note 111 and accompanying text, and expressed support for both Walker’s conclusion as well as the “means and degree by which CAARTA creates a public regulatory board to address [his] concerns.” 148 CONG. REC. H1557 (daily ed. Apr. 24, 2002) (statement of Rep. Shows).

¹³⁸ 148 CONG. REC. S6337 (daily ed. July 8, 2002) (statement of Sen. Gramm). The PCAOB’s “strangeness” appears to have troubled Senator Gramm. See S. REP. NO. 107-205, at 67 (2002) (stating that “before this legislation becomes law, the concerns of constitutional experts with regard to the appointment, regulatory powers, and taxing authority of this new supervisory board will need to be resolved”). Senator Gramm eventually supported the final legislation, which contained an oversight board that was virtually identical to the board that triggered this statement. See *infra* notes 148, 154 and accompanying text.

¹³⁹ 148 CONG. REC. S6334 (daily ed. July 8, 2002) (statement of Sen. Gramm).

strong objections of many House Democrats who viewed the CAARTA as delegating too much decisionmaking to the SEC¹⁴⁰ and nothing more than a “press release,”¹⁴¹ the House passed Representative Oxley’s bill (H.R. 3763) on April 25, 2002, by a vote of 334 to 90.¹⁴² A substitute bill introduced by Representative LaFalce, which closely resembled his earlier bill (H.R. 3818), had been defeated by a vote of 219 to 202.¹⁴³ The CAARTA, with the support of President Bush and the SEC, was then referred to the Senate Banking Committee. But the Chairman of that Committee, Senator Paul Sarbanes (D-Md.), was busy preparing a bill of his own (S. 2673).¹⁴⁴

Although pundits gave Senate Bill 2673 little chance of success,¹⁴⁵ their predictions soon proved incorrect. Senator Sarbanes’s bill

140 See, e.g., 148 CONG. REC. H1545 (daily ed. Apr. 24, 2002) (statement by Rep. Kanjorski) (lamenting that much of CAARTA’s “language is simply too vague to ensure that essential standards for effective oversight will be met, giving the SEC near-total flexibility in establishing guidelines for the new oversight body” and that “Congress should not shirk its responsibility by delegating these urgent problems to the SEC”); *id.* at H1541 (statement by Rep. Slaughter) (stating that CAARTA “simply side-steps the problem” and “does not provide for a strong, independent regulator for the auditing industry, but simply punts Congress’ job to the Securities and Exchange Commission”); see also H.R. REP. NO. 107-414, at 47 (2002) (presenting minority views and stating that “[i]n spite of the critical role that auditors play in the financial reporting system for publicly traded companies under our securities laws, oversight of the industry has been left entirely to the industry itself, with little input from either the SEC or the public”).

141 See, e.g., 148 CONG. REC. H1545 (daily ed. Apr. 24, 2002) (statement by Rep. LaFalce) (“The bill before us is cosmetic. The bill before us is a press release.”).

142 *Id.* at H1592.

143 *Id.* at H1588–89. By a vote of 381 to 39, *id.* at H1573, the House also voted down a substitute bill (H.R. 3795) sponsored by Representative Dennis Kucinich (D-Ohio), that would have established within the SEC a “Federal Bureau of Audits” (the FBA). See Investor, Shareholder, and Employee Protection Act, H.R. 3795, 107th Cong. § 3(a) (2002). The FBA would consist of a Director, Deputy Director, and Inspector General and would have the authority to “hold hearings, sign and issue subpoenas, administer oaths, examine witnesses, and receive evidence at any place in the United States it may designate.” H.R. 3795 § 3(g). The criticism directed to the bill was particularly pointed. See, e.g., 148 CONG. REC. H1572 (daily ed. Apr. 24, 2002) (statement of Rep. Kelly) (noting that the FBA was modeled after the FBI, and that one could see “auditors storming into companies with their calculators drawn, demanding individuals to freeze and drop their pencils”); *id.* at H1573 (statement of Rep. Oxley) (describing the bill as “essentially the neutron bomb”).

144 Sarbanes-Oxley Act, S. 2673, 107th Cong. (2002).

145 See, e.g., Alan Murray, *Gramm, Chertoff Sends Wrong Signals in Accounting Mess*, WALL ST. J., June 11, 2002, at A4.

[Senator Sarbanes] has spent the past few weeks belatedly getting his fellow Democrats in line behind a bill to increase oversight of the accounting industry. And he is holding talks with his GOP counterpart, Sen. Gramm. But

passed the Senate Banking Committee on June 18, 2002, by a vote of seventeen to four,¹⁴⁶ but even then, its chances in the full Senate were uncertain. The fate changed for Senate Bill 2673 on June 25, 2002, after WorldCom's shocking revelation that it had overstated its earnings by more than \$3.8 billion during the past five quarters, primarily because it had improperly accounted for its operating costs.¹⁴⁷ Senator Sarbanes introduced Senate Bill 2673 to the full Senate that very same day and it passed ninety-seven to zero less than three weeks later.¹⁴⁸

Title I of Senate Bill 2673 established a "Public Company Accounting Oversight Board" in the private sector, and the Senate Banking Committee Report accompanying that bill specifically notes the significant roles played by Senators Dodd, Corzine, and Enzi in the PCAOB's design and structure.¹⁴⁹ But in addition to its obvious name change, the oversight board in Senate Bill 2673 had a curious feature not included in either of the earlier Senate proposals, nor in any of the House bills sponsored by Representatives Oxley or LaFalce: the PCAOB was to be a body corporate—specifically, a nonprofit corporation chartered by Congress under the laws of the District of Columbia.¹⁵⁰

The pace with which Senate Bill 2673 passed through the Senate became even more frenetic in the fifteen days leading up to the Sarbanes-Oxley Act's enactment. After the Senate's unanimous vote on July 15, 2002, the House and the Senate formed a Conference Committee to reconcile the stark differences between Senator

there is little sign of progress. . . . Unless he can find some Republican support, Mr. Sarbanes stands no chance of getting his bill through the narrowly divided Senate this year.

Id.

146 S. REP. NO 107-205, at 1 (2002); see Michael Schroeder & Tom Hamburger, *Accounting Reform Gets Big Lift as Senate Panel Backs New Board*, WALL ST. J., June 19, 2002, at A1 (describing the contents of the bill and discussing public reaction to the Banking Committee's passage of it).

147 See Frank et al., *supra* note 99 (noting that when the entire fraud unraveled, WorldCom's restatement grew to a staggering eleven billion dollars).

148 148 CONG. REC. S6779 (daily ed. July 15, 2002). One commentator has remarked that the Sarbanes-Oxley Act "might be more appropriately referred to as the Enron/WorldCom Response Act, as the Enron demise triggered the initiative, but it took the WorldCom collapse to bring it to fruition." See HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* 21 (2004).

149 S. REP. NO 107-205, at 4 (2002) (stating that "Title I reflects significant portions of S. 2004, authored by Senators Dodd and Corzine, as well as the terms of an amendment offered at the Committee's June 18 mark-up by Senator Enzi, which was adopted by voice vote").

150 See *infra* note 158 and accompanying text.

Sarbanes's bill (S. 2673) and Representative Oxley's bill (H.R. 3763).¹⁵¹ The conference committee used Senate Bill 2673 as its framework, but rather than soften that bill to reflect more of House Bill 3763, "most changes made by the conference committee strengthened the prescriptions of S. 2673 or added new prescriptions."¹⁵² The Committee approved the final conference bill on July 24, 2002, titling it "the Sarbanes-Oxley Act of 2002."¹⁵³ The following day, both houses of Congress voted on it without change, producing an overwhelming margin of victory: 423 to 3 in the House and ninety-nine to zero in the Senate.¹⁵⁴ On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act into law, declaring that it contained some of "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."¹⁵⁵

II. THE PCAOB

Securities law scholars have put forth varying views as to whether the Sarbanes-Oxley Act actually constituted the "sweeping reform" that was depicted by Congress and the President.¹⁵⁶ But few would

151 At this time, House Bill 3763 was accompanied by a companion bill (H.R. 5118) that enhanced the earlier bill's criminal penalties. See BOSTELMAN, *supra* note 103, § 2:6.1[B], at 2-30. For procedural reasons, the Senate renumbered Senator Sarbanes's bill to House Bill 3763 and Representative Oxley's language was replaced in toto by the language of Senate Bill 2673 as it passed the Senate. See *id.* § 2:6.2, at 2-31 n.106.

152 BOSTELMAN, *supra* note 103, at 2-31. None of the work of the Conference Committee amounted to significant change in Title I of Senate Bill 2673. See H.R. CONF. REP. NO. 107-610 (2002). Although this revised bill is termed a "report," the entire document consists of the final conference bill. Thus, since the Conference Committee did not produce any legislation report of its own, the Senate Report that describes Title I constitutes the most authoritative source of legislative intent for the PCAOB. See BOSTELMAN, *supra* note 103, at 2-32.

153 H.R. CONF. REP. NO. 107-610, at 1 (2002).

154 Richard B. Schmitt et al., *Corporate-Oversight Bill Passes, Eases Path for Investor Lawsuits*, WALL ST. J., July 26, 2002, at A1.

155 Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

156 See Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 516 (2002).

[W]hen this Act is combined with other changes involving more vigilant boards and audit committees, an expanded SEC with an activist enforcement program, greater private litigation, and much voluntary restraint, for the foreseeable future there will be a material diminution of the type of accounting scandal that typified our recent past.

Id. Compare Cunningham, *supra* note 24, at 917 (observing that the President, Congress, the SEC, and other "participants and observers" of the Sarbanes-Oxley Act often

dispute that the PCAOB constitutes a radical change to the accounting profession's former system of self-regulation. The analysis that follows tracks the nine sections in Title I of the Act and highlights some of the PCAOB's activities in its first eighteen months of operation. It then compares the PCAOB to SROs in the securities industry as well as to other ostensibly private corporations created by Congress.

A. *The PCAOB's Structure, Powers, and Responsibilities*

1. Establishment and Administrative Provisions

Section 101 of Title I establishes the PCAOB and delineates the Board's principal responsibilities. Its first two provisions are important enough to be set out in full:

(a) ESTABLISHMENT OF BOARD.—There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, *in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports* for companies the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.¹⁵⁷

(b) STATUS.—The Board shall not be an agency or establishment of the United States Government, and, except as otherwise provided in this Act, shall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act. 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 by reason of such service.¹⁵⁸

Although both provisions evidence Congress's decision to situate the PCAOB as a nonprofit corporation in the private sector, the italicized portions also reflect the PCAOB's inherently governmental mission. The PCAOB's mission is further reflected in section 101's third provision, which sets out the PCAOB's four principal responsibilities: registration, standard setting, inspection, and discipline.¹⁵⁹

refer to it as "sweeping reform," but questioning whether it is "more sweep than reform"), with Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 2 (2002) (arguing that the scope of the Sarbanes-Oxley Act is "sweeping and dramatic").

157 15 U.S.C.A. § 7211(a) (West Supp. 2004) (emphasis added).

158 *Id.* § 7211(b).

159 *Id.* § 7211(c)(1)–(4). Congress elaborates on these responsibilities in sections 102, 103, 104, and 105 of Title I. See *infra* notes 172–241 and accompanying text.

There are two additional provisions in section 101 that seem antithetical to the Board's nongovernmental status. One specifies that PCAOB members are to be governmentally appointed: "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 the chairperson and other initial members of the Board."¹⁶⁰ Subsequent vacancies on the PCAOB "shall be filled in the same manner."¹⁶¹ The other provision empowers the PCAOB to fund its operations by "allocat[ing], assess[ing], and collect[ing] accounting support fees" from public companies.¹⁶²

The balance of section 101 rounds out the Board's principal features. It establishes that the Board is to be composed of five full-time members¹⁶³ who shall serve staggered, once-renewable, five-year terms;¹⁶⁴ it mandates that two Board members (but only two) shall be or have been CPAs;¹⁶⁵ it provides that Board members may be re-

160 15 U.S.C.A. § 7211(e)(4)(A). The Commission was required to make initial appointments to the PCAOB by October 30, 2002. *Id.* The PCAOB's five founding members were William H. Webster (Chair), Daniel L. Goelzer, Kayla J. Gillan, Willis D. Gradison, Jr., and Charles D. Niemeier. News Release, Securities and Exchange Commission, Commission Announces Founding Members of Public Company Accounting Oversight Board (Oct. 25, 2002). Less than three weeks into his term, William Webster resigned amid a storm of controversy concerning his service as head of the audit committee at U.S. Technologies, a company that had been accused of accounting fraud. See Michael Schroeder, *Webster Makes It Official and Quits Accounting Board*, WALL ST. J., Nov. 13, 2002, at A3. SEC Chairman Harvey Pitt had tendered his own resignation the previous week after it was revealed that Webster had informed him of the audit committee issues and Chairman Pitt had failed to share that information with his fellow commissioners. David S. Hilzenrath & Mike Allen, *Embattled Pitt Resigns as SEC Chief; Latest Controversy Cost Him White House Support*, WASH. POST, Nov. 6, 2002, at A2. PCAOB member Charles Niemeier served as Acting Chair until the SEC appointed the current Chair, William F. McDonough. See News Release, Securities and Exchange Commission, SEC Unanimously Approves William J. McDonough as Chairman of Public Company Accounting Oversight Board (May 21, 2003).

161 15 U.S.C.A. § 7211(e)(4)(B).

162 *Id.* § 7211(f)(5).

163 *Id.* § 7211(e)(1). Board members are to be

appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.

Id.

164 *Id.* § 7211(e)(5).

165 *Id.* § 7211(e)(2). If one of the CPAs is the Board's chairperson, "he or she may not have been a practicing certified public accountant for at least 5 years prior to his

moved by the SEC upon a showing of “good cause;”¹⁶⁶ it vests the Board with a number of powers,¹⁶⁷ including the power (and obligation) to make rules governing its operations;¹⁶⁸ and it requires the Board to submit an annual report to the SEC, which shall transmit a copy to the Senate Banking Committee and the House Committee on Financial Services.¹⁶⁹ Section 101 also set an April 25, 2003, deadline for the SEC’s determination that the Board was fully operational.¹⁷⁰ The SEC and the PCAOB met that deadline right at the wire.¹⁷¹

2. Registration

Section 102 of Title I makes it unlawful for any person who is not associated with a “registered public accounting firm” to prepare or issue, or participate in the preparation or issuance of, any audit report for any public company.¹⁷² Accounting firms based in the United States were to be registered by October 22, 2003—180 days after the SEC declared the PCAOB operational.¹⁷³ Foreign accounting firms involved with the audits of public companies trading in U.S. markets were also required to register, though they were accorded an addi-

or her appointment to the Board.” *Id.* Although Senator Enzi voted in favor of the Act both in the Senate Banking Committee and in the full Senate, he repeatedly emphasized that “[a]uditing standards are complicated and detailed and the setting of them requires the knowledge and expertise of individuals who understand and work in the field of accounting” and questioned whether it made sense to “allow a Board, of which the majority must be non-accountants, to establish the standards under which accountants operate.” S. REP. NO 107-205, at 68 (2002) (separate statement of Sen. Enzi).

166 15 U.S.C.A. § 7211(e)(6).

167 *Id.* § 7211(f). Its powers include the power to sue and be sued in its corporate name, *id.* § 7211(f)(1), to lease or purchase property, *id.* § 7211(f)(3), and to appoint employees and to fix their salaries “at a level that is comparable to private sector self-regulatory, accounting, technical, supervisory, or other staff or management positions,” *id.* § 7211(f)(4).

168 *Id.* § 7211(g). The PCAOB has promulgated many operations rules pursuant to this congressional mandate, including a Code of Ethics and Rules for Investigations and Adjudications. See Pub. Co. Accounting Oversight Bd., *Rules of the Board*, at http://www.pcaobus.org/Rules_of_the_Board/index.asp (last visited Jan. 9, 2005).

169 15 U.S.C.A. § 7211(h). The PCAOB filed with the SEC its first Annual Report (for the year 2003) in June 2004. PUB. CO. ACCOUNTING OVERSIGHT BD., 2003 ANN. REP. (2004), available at http://www.pcaobus.org/About_Us/Annual_Reports/2004.pdf.

170 15 U.S.C.A. § 7211(d).

171 See PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 169, at 7.

172 15 U.S.C.A. § 7212(a).

173 *Id.*

tional nine months.¹⁷⁴ As of June 22, 2004, the PCAOB had registered 1003 U.S. and non-U.S. public accounting firms and it continues to receive applications from both foreign and domestic firms.¹⁷⁵

Congress was specific in delineating the baseline information required in a public accounting firm's application for registration,¹⁷⁶ a list that can be added to by subsequent PCAOB or SEC rulemaking.¹⁷⁷ Registered firms are also obligated to update that information in an annual report to be filed with the PCAOB.¹⁷⁸ To cover the costs of the registration and annual review process, the Board is required to assess and collect both a registration fee and an annual fee from each registered public accounting firm.¹⁷⁹ The Board is also required to act on a firm's completed application within forty-five days after submission.¹⁸⁰ Such action includes either the approval or denial of a firm's registration request.¹⁸¹ Application denials are to be treated as a PCAOB disciplinary action and thus are reviewable by the SEC.¹⁸²

Section 102 also included a "consent" provision that was likely drawn from a draft bill authored by Senator Enzi.¹⁸³ Specifically, applications for registration are required to include a "consent executed by the public accounting firm to cooperation in and compliance with any request for testimony or the production of documents made by the Board in the furtherance of its authority and responsibilities" under the Act.¹⁸⁴ Registration is further conditioned on the firm's agreement "to secure and enforce similar consents from each of the associated persons of the public accounting firm as a condition of their continued employment by or other association with such

174 See *PCAOB Hearing*, *supra* note 79, at 6 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

175 *Id.* (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

176 15 U.S.C.A. § 7212(b)(2).

177 *Id.* § 7212(b)(2)(H).

178 *Id.* § 7212(d).

179 *Id.* §7212(f). More than ninety percent of the firms that registered paid a fee of \$500 or less. Each of the Big Four accounting firms, *see supra* note 69, paid a registration fee of \$390,000. See PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 169, at 7.

180 15 U.S.C.A. § 7212(c)(1).

181 *Id.*

182 *Id.* § 7212(c)(2). As of its 2003 Annual Report, the PCAOB had yet to deny an application for registration. See PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 169, at 7.

183 See Investor Protection and Corporate Responsibility Act, Draft Bill, 107th Cong. § 201(c)(2)(A) (2002).

184 15 U.S.C.A. § 7212(b)(3)(A).

firm.”¹⁸⁵ As we shall see, failures to cooperate may result in disciplinary actions against the registered firm or its associated persons.¹⁸⁶

3. Rulemaking

As discussed previously, section 103 of Title I places the PCAOB in the AICPA’s prior role as the primary standard-setter for auditors.¹⁸⁷ Specifically, Congress requires the PCAOB to promulgate rules establishing the auditing and related attestation standards, quality control standards, and ethics standards that are to be used by registered firms in the preparation and issuance of audit reports for public companies.¹⁸⁸ As with the baseline information elicited on applications for registration,¹⁸⁹ Congress delineated certain requirements that must be incorporated into the PCAOB’s auditing standards.¹⁹⁰

The rulemaking procedures adopted by the PCAOB are designed to ensure that all of its rules will be subject to substantial review before they become final. Proposed rules are issued by the PCAOB at open meetings and are posted on the PCAOB’s website with a time period specified for public comments. In response to these comments, the PCAOB issues the final rules that are filed with the SEC.¹⁹¹ As discussed below, PCAOB rules must be approved by the SEC before they become effective, and the SEC’s process for review includes an additional period for public notice and comment.¹⁹²

The full extent of the PCAOB’s rulemaking power cannot be appreciated without reference to Title II of the Sarbanes-Oxley Act,

185 *Id.*

186 *See infra* notes 222–30 and accompanying text.

187 *See supra* notes 78–79 and accompanying text.

188 15 U.S.C.A. § 7213(a)(1). As noted previously, the PCAOB has adopted the AICPA’s standards as interim standards, but plans to review all of these standards to determine whether they should be repealed, modified, or made permanent. *See supra* note 79. Section 103 also gives the PCAOB authority to convene expert advisory groups to make recommendations concerning the content of its standards. 15 U.S.C.A. § 7213(a)(4).

189 *See supra* note 176 and accompanying text.

190 15 U.S.C.A. § 7213(a)(2). These include a requirement that auditors prepare “audit work papers” and retain those papers for at least seven years, *id.* § 7213(a)(2)(A)(i), that audit reports be reviewed and approved by a second or “concurring” partner, *id.* § 7213(a)(2)(A)(ii), and that the auditor “describe in each audit report the scope of the auditor’s testing of the internal control structure and procedures of the issuer,” *id.* § 7213(a)(2)(A)(iii).

191 *See* Pub. Co. Accounting Oversight Bd., *PCAOB Typical Rulemaking Process*, at www.pcaobus.org/rulemaking_process.asp (last visited Jan. 9, 2005) (presenting a chart of the rulemaking process).

192 *See infra* notes 249–51 and accompanying text (discussing section 107’s review procedures for PCAOB rulemaking).

which amends the Exchange Act to make it unlawful for a registered firm to perform any of eight types of nonaudit services contemporaneously with the audit of a public company.¹⁹³ But Congress's list also includes a ninth prohibition: "any other service that the Board determines, by regulation, is impermissible."¹⁹⁴ And the PCAOB's power is even further increased through its broad authority to grant exemptions. Specifically:

The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under [Exchange Act section 10A(g)] to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.¹⁹⁵

Exemptions granted by the PCAOB under this provision are subject to SEC review.¹⁹⁶

A recent statement by the SEC's Chief Accountant forecasted an expanded role for the PCAOB on auditor independence issues, where the PCAOB would become "the primary standard-setter and the primary source of advice and guidance on these issues."¹⁹⁷ He noted, in particular, that "[a]s the PCAOB engages more staff with expertise in these areas, I expect that a great number of the independence interpretive issues that currently are handled by my office appropriately will migrate to the PCAOB."¹⁹⁸

4. Periodic Inspections

Section 104 of Title I elaborates on the responsibility that, at least in its initial years, will likely consume the lion's share of the PCAOB's attention: the periodic inspection of registered accounting firms to assess the degree of compliance "with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers."¹⁹⁹ Registered public accounting firms that regularly provide audit reports for more than 100 public companies

193 See 15 U.S.C.A. § 78j-1(g)(1)–(8) (amending 15 U.S.C. § 78j-1 (2000)).

194 *Id.* § 78j-1(g)(9); see Bratton, *supra* note 2, at 1033 (contending that the Sarbanes-Oxley Act delegates to the PCAOB the most important matters concerning professional standards).

195 15 U.S.C.A. § 7231.

196 *Id.*

197 Jonathan Weil, *Accounting Board Should Expand Its Authority, SEC Official Says*, WALL ST. J., July 15, 2004, at C3 (quoting statements by Donald T. Nicolaisen, SEC Chief Accountant).

198 *Id.*

199 15 U.S.C.A. § 7214(a).

must be inspected annually;²⁰⁰ other firms must be inspected at least once every three years.²⁰¹

Congress provided a general framework for PCAOB inspections: The PCAOB is required to

(1) inspect and review selected audit and review engagements . . . performed at various offices and by various associated persons of the firm . . . ; (2) evaluate the sufficiency of the quality control system of the firm, and the manner of documentation (of that firm) . . . ; and (3) perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate.²⁰²

It must also share with the firm under inspection a draft report and provide an opportunity for the firm to comment.²⁰³ The PCAOB must prepare a final report of its findings and must transmit that report, along with any letter of comment from the firm, to the SEC and appropriate state regulatory authorities.²⁰⁴ In addition, the PCAOB must make the nonproprietary sections of this report public, except that portions of the report dealing with criticisms of or potential defects in the firm's quality control systems shall not be made public if those criticisms or defects are addressed satisfactorily by the firm within the year following the inspection report.²⁰⁵ A registered accounting firm may seek interim SEC review of the PCAOB's report.²⁰⁶

The PCAOB's regular inspection cycle began in May 2004 and its process for inspecting the eight largest U.S. firms and a great number of small U.S. firms is currently underway.²⁰⁷ In 2003, the PCAOB

200 *Id.* § 7214(b)(1)(A). Eight such firms were registered with the PCAOB as of December 31, 2003: the "Big Four," *see supra* note 69; Grant Thornton LLP; BDO Seidman LLP; Crowe, Chizek and Company LLC; and McGladrey & Pullen, LLP. *See PCAOB Hearing, supra* note 79, at 6–7 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

201 15 U.S.C.A. § 7214(b)(1)(B). The PCAOB may, however, adjust that inspection schedule through rulemaking if it finds that "different inspection schedules are consistent with the purposes of this Act, the public interest, and the protection of investors." *Id.* § 7214(b)(2).

202 *Id.* § 7214(d)(1)–(3).

203 *Id.* § 7214(f).

204 *Id.* § 7214(g)(1).

205 *Id.* § 7214(g)(2); *see infra* note 209 and accompanying text (criticizing the confidentiality provision).

206 U.S.C.A. § 7214(h). Any SEC decision with respect to an interim review will not be treated as a "final agency action" and is thus not reviewable under Exchange Act § 25(a)(1) or section 704 of the Administrative Procedure Act (APA). *Id.* § 7214(h)(2).

207 *See PCAOB Hearing, supra* note 79, at 45 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

launched a special inspection program with “limited procedures” inspections of the Big Four firms.²⁰⁸ The PCAOB’s August 2004 report on these firms identified “‘significant audit and accounting issues that were missed by the firms,’ though none of those problems caused major shareholder losses and almost none of them affected earnings.”²⁰⁹

5. Investigations and Disciplinary Proceedings

Section 105 grants the PCAOB broad authority to conduct investigations and impose discipline. Specifically, the PCAOB is authorized to investigate any act, practice, or failure to act, by any registered firm, or its associated persons

that may violate any provision of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards, regardless of how the act, practice, or omission is brought to the attention of the Board.²¹⁰

Congress instructed the PCAOB to develop by rule “fair procedures” for its investigatory and disciplinary functions.²¹¹

Pursuant to its investigatory rules, the PCAOB may require the testimony or the production of documents (including audit papers) from any registered firm or associated person, and it may take disciplinary action for failure to cooperate with an investigation.²¹² The PCAOB may also request the testimony or the production of docu-

208 *Id.* at 6 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

209 Jonathan Weil, *Big Four Get Mixed Marks from U.S. Panel*, WALL ST. J., Aug. 27, 2004, at C1 (quoting the public portion of the reports). The confidential sections of the reports include critiques of the firms’ disciplinary policies, risk-management practices, partner compensation structures, as well as the “tone at the top” set by the firms’ top executives. *See id.*; *supra* note 205 and accompanying text. The article reported that “[w]hen Congress created the board, it acceded to pressure by the Big Four firms to include a provision in the law under which the board only would disclose the existence of deficiencies in a firm’s quality controls if the firm hadn’t fixed them within a year.” Weil, *supra*. It also reported statements by Lynn Tuner, the SEC’s Chief Accountant from 1998 to 2001, that “[u]nfortunately, we don’t know how many more infractions were not made public as a result of Congress allowing those to remain behind closed doors” and that “‘Congress needs to quickly bring that out into the sunshine.’” *Id.*

210 15 U.S.C.A. § 7215(b)(1).

211 *Id.* § 7215(a); *see infra* notes 237–40 and accompanying text (noting that, to a great extent, the PCAOB has modeled itself after the SEC).

212 15 U.S.C.A. § 7215(b)(2)(A)–(B).

ments from any other person (including a firm's audit clients).²¹³ If such testimony or documents cannot be obtained on a voluntary basis, the PCAOB may request the SEC to issue a subpoena.²¹⁴

Congress also took steps to protect the PCAOB and its officials from a litigious public by granting the type of privileges and immunities typically accorded to regulatory agencies. Often termed a "law enforcement privilege" when extended to a federal agency, Congress provided that

[A]ll documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, shall be confidential and privileged as an evidentiary matter (and not subject to civil discovery or other legal process) in any Federal or State court or administrative agency.²¹⁵

Yet, 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 (FOIA) or otherwise.²¹⁶ With respect to immunity, Congress specified that "[a]ny employee of the Board engaged in carrying out an investigation under this Act shall be immune from any civil liability arising out of such investigation in the same manner and to the same extent as an employee of the Federal Government in similar circumstances."²¹⁷

Congress was clear that the PCAOB's disciplinary rules must provide registered firms and associated persons with adequate notice and the opportunity to be heard.²¹⁸ But unlike SEC enforcement proceedings, which are public unless the SEC finds good cause to proceed confidentially,²¹⁹ PCAOB hearings shall not be public "unless otherwise ordered by the Board for good cause shown, with the con-

213 *Id.* § 7215(b)(2)(C).

214 *Id.* § 7215(b)(2)(D). The rules of the Board may

provide for procedures to seek issuance by the Commission, in a manner established by the Commission, of a subpoena to require the testimony of, and production of any document in the possession of, any person, including any client of a registered public accounting firm, that the Board considers relevant or material to an investigation under this section.

Id.

215 *Id.* § 7215(b)(5)(A).

216 *Id.*

217 *Id.* § 7215(b)(6).

218 *Id.* § 7215(c)(1). The PCAOB is also required to keep a record of the proceedings. *Id.*

219 17 C.F.R. § 201.102 (2003).

sent of the parties to such hearing.”²²⁰ The PCAOB may refer any investigation to the SEC or to other federal regulators, and on the SEC’s direction, to other specified administrative or regulatory authorities.²²¹

If the PCAOB finds a violation based on all the facts and circumstances,²²² it may impose an array of sanctions,²²³ including censure;²²⁴ required additional professional education or training;²²⁵ temporary suspension;²²⁶ permanent revocation (or in the case of an individual, a bar from association with a registered firm);²²⁷ temporary or permanent limitation on the activities, functions, or operations of such firm or person;²²⁸ and a civil monetary penalty for each such violation not to exceed \$100,000 for individuals and two million dollars for firms.²²⁹ If the violation involves intentional or knowing conduct, or repeated instances of negligent conduct, then the maximum penalty rises to \$750,000 for individuals and fifteen million dollars for firms.²³⁰ Unlike the SEC, whose monetary fines generally revert to the

220 15 U.S.C.A. § 7215(c)(2). Commentators have speculated that confidential hearings may “encourage well-healed [sic] and litigious defendants to delay repeatedly the resolution of proceedings to keep them from becoming public.” Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants and Lawyers After the Sarbanes-Oxley Act of 2002*, 56 ADMIN. L. REV. 135, 178 (2004).

221 15 U.S.C.A. § 7215(b)(4)(B). These other authorities include the Attorney General of the United States, state attorneys general, and appropriate state regulatory authorities. *Id.* § 7215(b)(4)(B)(iii).

222 Any sanction imposed by the PCAOB must be supported by a statement setting forth the act, practice, or failure to act that constitutes the violation; the specific provision of the Act, the securities laws, the PCAOB’s rules, or professional standards which have been violated; and a justification for the specific sanction(s) imposed. *Id.* § 7215(c)(3).

223 The PCAOB may also sanction registered accounting firms and their supervisory personnel for a failure to reasonably supervise a partner or employee of that firm. *See id.* § 7215(c)(6). To impose such sanctions, the PCAOB must make findings similar to those that the SEC must make in broker-dealer proceedings initiated pursuant to Exchange Act § 15(b)(4)(E). 15 U.S.C. § 78o(b)(4)(E) (2000).

224 15 U.S.C.A. § 7215(c)(4)(E).

225 *Id.* § 7215(c)(4)(F).

226 *Id.* § 7215(c)(4)(A) (providing for temporary suspension for firms); *id.* § 7215(c)(4)(B) (providing for temporary suspension for associated persons).

227 *Id.* § 7215(c)(4)(A) (providing for permanent revocation for firms); *id.* § 7215(c)(4)(B) (providing for a bar from association with a registered firm for individuals).

228 *Id.* § 7215(c)(4)(C).

229 *Id.* § 7215(c)(4)(D)(i).

230 *Id.* § 7215(c)(4)(D)(ii).

U.S. Treasury,²³¹ fines imposed by the PCAOB are to be used to fund a merit scholarship program for students pursuing undergraduate or graduate degrees in accounting.²³²

Sanctions imposed by the PCAOB are subject to SEC review,²³³ and any application for review shall operate as a stay of any such disciplinary action.²³⁴ PCAOB sanctions must be reported to the SEC, appropriate state or foreign regulatory authorities, and the public (“once any stay on the imposition of such sanction has been lifted”).²³⁵

Pursuant to section 105, the PCAOB has adopted comprehensive rules of investigations and adjudications.²³⁶ The PCAOB drew these rules from a variety of sources, including the APA and the SEC’s Rules of Fair Practice.²³⁷ Although the rules make clear in a number of places that the PCAOB is situated in the private sector,²³⁸ the PCAOB appears to have modeled itself on the SEC.²³⁹ For example, the PCAOB’s procedures permit parties under investigation to file a Wells-like submission outlining reasons why an enforcement action

231 Prior to the Sarbanes-Oxley Act, all civil monetary fines collected by the SEC were directed to the U.S. Treasury. But the Act now provides that in actions where disgorgement is ordered, the SEC may add the amount of the civil penalty to a disgorgement fund “for the benefit of the victims of such violation.” The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784–85 (codified at 15 U.S.C. § 7246).

232 15 U.S.C.A. § 7219(c)(2).

233 See *infra* notes 252–57 and accompanying text.

234 15 U.S.C.A. § 7215(e).

235 *Id.* § 7215(d).

236 See PUB. CO. ACCOUNTING OVERSIGHT BD., PCAOB RELEASE NO. 2003-015, RULES ON INVESTIGATIONS AND ADJUDICATIONS (2003), available at <http://www.pcaobus.org/rules/Release2003-015.pdf>. Because PCAOB investigations and disciplinary proceedings are nonpublic, it is difficult to tell whether such investigations or proceedings are underway. None were referenced in the PCAOB’s Annual Report, referred to (even in general terms) in recent testimony to Congress, or reported in major newspapers.

237 See Mary M. Sjoquist, *The Public Company Accounting Oversight Board: One Year Later*, INSIGHTS, Nov. 2003, at 4, 7 (stating that “the PCAOB drew from the rules of the Commission and the National Association of Securities Dealers (NASD) and rules governing civil procedures and fair hearings procedures adopted from the Administrative Procedure Act (APA), federal rules of evidence, and the Federal District Court of Southern New York”).

238 See, e.g., PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 236, app. 2 at A2-19 n.1 (noting that the “requirements of the Administrative Procedure Act are not binding on the Board”).

239 See BLOOMENTAL, *supra* note 148, at 1138 (stating that “[a]ttorneys who have appeared as counsel in SEC administrative proceedings will feel comfortable with the Board’s rules of practice”).

should not be brought against them.²⁴⁰ Moreover, unlike the NYSE and the NASD, the PCAOB does not intend to regard good-faith invocations of a Fifth Amendment privilege against self-incrimination as a sanctionable failure to cooperate.²⁴¹

6. Foreign Public Accounting Firms

Section 106 provides that accounting firms organized under the laws of countries other than the United States that issue audit reports for companies subject to U.S. securities laws are covered by the Act to the same extent as U.S. accounting firms.²⁴² However, both the PCAOB and the SEC may grant exemptions, where appropriate.²⁴³ The PCAOB is currently developing a framework for how its inspection and investigatory programs should operate in relation to non-U.S. registered firms.²⁴⁴ “[T]o the greatest extent possible,” the PCAOB seeks to cooperate with international regulators.²⁴⁵

7. SEC Oversight

Section 107 establishes a system of SEC oversight for the PCAOB that parallels the recordkeeping, rulemaking, and disciplinary review

240 PUB. CO. ACCOUNTING OVERSIGHT BD., BYLAWS AND RULES OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD R. 5109(d), at 63 (2004), available at http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/all.pdf.

241 PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 236, app. 2 at A2-33.

[W]e do not intend to invade the province of any legitimately asserted privilege that would, under prevailing law, be treated as a valid basis for declining to provide documents or information in response to a Commission subpoena, including valid assertions of the privilege against self-incrimination under the Fifth Amendment to the United States Constitution.

Id. Invoking their status as “private organizations,” the NYSE and the NASD have refused to recognize a Fifth Amendment privilege, and courts have consistently upheld their right to do so. See *infra* note 345.

242 15 U.S.C.A. § 7216(a)(1) (West Supp. 2004).

243 *Id.* § 7216(c).

The Commission, and the Board, subject to the approval of the Commission, may, by rule, regulation, or order, and as the Commission (or Board) determines necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions exempt any foreign public accounting firm, or any class of such firms, from any provision of this Act or the rules of the Board or the Commission issued under this Act.

Id.

244 See *PCAOB Hearing*, *supra* note 79, at 51–52 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

245 *Id.* at 51 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

procedures currently in place for the NASD and other SROs. Indeed, Congress stated specifically that Exchange Act section 17(a)(1), which mandates recordkeeping and SEC access to records,²⁴⁶ and Exchange Act section 17(b)(1), which provides for examinations by the SEC,²⁴⁷ shall apply to the PCAOB “as fully as if the Board were a ‘registered securities association’ for purposes” of those provisions.²⁴⁸

The PCAOB’s rulemaking is governed by Exchange Act Section 19(b),²⁴⁹ which requires SROs to file with the SEC proposed rules or proposed changes to rules for SEC review and approval, and which specifies that no SRO rule shall become effective absent such approval.²⁵⁰ Section 19(b) also obligates the SEC to provide the public with notice of proposed SRO rules and the opportunity to comment.²⁵¹

With respect to the SEC’s review of disciplinary actions taken by the PCAOB, the governing procedures are once again those applicable to SROs by virtue of Exchange Act section 19(d)(2) and (e)(1).²⁵² Pursuant to these sections, which apply to the PCAOB “as fully as if the Board were an [SRO],” final disciplinary sanctions are reviewable by the SEC on its own motion or upon timely application by any aggrieved person.²⁵³ The SEC’s review must include notice and the opportunity to be heard.²⁵⁴ After such hearing, the SEC must issue an order affirming, modifying, remanding, or setting aside the sanction imposed by the SRO.²⁵⁵ Although Exchange Act section 19(e) does not permit the SEC to increase the sanctions imposed by an SRO, the SEC may enhance a PCAOB sanction if the SEC’s review finds it to be inadequate or otherwise not appropriate to the finding based on which the sanction was imposed.²⁵⁶ While Title I does not explicitly specify, final SEC orders on PCAOB disciplinary proceedings are re-

246 15 U.S.C. § 78q(a)(1) (2000).

247 *Id.* § 78q(b)(1).

248 15 U.S.C.A. § 7217(a).

249 15 U.S.C. § 78s(b).

250 *Id.* § 78s(b)(1). Section 107 of Title I also explicitly states that “[n]o rule of the Board shall become effective without prior approval of the Commission in accordance with this section, other than as provided in [section 103(a)(3)(B)] with respect to initial or transitional standards.” 15 U.S.C.A. § 7217(b)(2).

251 15 U.S.C. § 78s(b)(1).

252 *Id.* § 78s(d)(2), (e)(1).

253 15 U.S.C.A. § 7217(c)(2); 15 U.S.C. § 78s(d)(2). In most cases, applications by aggrieved persons must be filed with the SEC no later than thirty days after the person’s receipt of notice. *See id.*

254 15 U.S.C. § 78s(e)(1).

255 *Id.*

256 15 U.S.C.A. § 7217(c)(3).

viewable by a federal circuit court of appeals pursuant to Exchange Act section 25(a)(1).²⁵⁷

Section 107 also provides for censure and other sanctions to the PCAOB itself. The SEC, by rule, may relieve the PCAOB of any responsibility to enforce compliance with the Sarbanes-Oxley Act, the securities laws, the PCAOB's rules, or professional standards.²⁵⁸ Provided good cause is shown, the SEC may also issue an order censuring or limiting the activities of the PCAOB.²⁵⁹ Board members may be censured or removed from office by the SEC upon a showing of good cause.²⁶⁰

8. Accounting Standards

As discussed previously,²⁶¹ section 108 amends section 19(a) of the Securities Act to explicitly allow the SEC to recognize "generally accepted" accounting principles established by a private entity, provided the entity is funded according to section 109 (discussed immediately below) and has adopted certain procedures designed to distance it from the accounting profession.²⁶² The Senate Banking Committee

257 15 U.S.C. § 78y(a)(1).

A person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.

Id.

258 15 U.S.C.A. § 7217(d)(1).

259 *Id.* § 7217(d)(2). Censure or limitations on activities are conditioned on a showing that the PCAOB

(A) has violated or is unable to comply with any provision of this Act, the rules of the Board, or the securities laws; or (B) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by a registered public accounting firm or an associated person thereof.

Id.

260 *Id.* § 7217(d)(3). Censure or removal are conditioned on a showing that the PCAOB member

(A) has willfully violated any provision of this Act, the rules of the Board, or the securities laws; (B) has willfully abused the authority of that member; or (C) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by any registered public accounting firm or any associated person thereof.

Id.

261 *See supra* notes 63–64 and accompanying text.

262 15 U.S.C.A. § 77s(b)(1). Section 19(a)'s new requirement of majority voting caused the FASB to change a rule that had formerly required a supermajority (five of seven) vote. *See Cunningham, supra* note 24, at 964.

Report makes clear that the FASB was the private entity referenced in section 108.²⁶³

9. Funding

Title I's final section, section 109, is responsive to the suggestions in congressional testimony that both the PCAOB and the FASB should be provided with a guaranteed source of funding to protect their independence.²⁶⁴ To achieve this end, Congress required their primary source of funding to come from "accounting support fees" paid by public companies.²⁶⁵ Section 109 directs both the PCAOB and the FASB to allocate these fees in accordance with a formula based on their respective budgets and a company's market capitalization.²⁶⁶ The PCAOB's budget is subject to SEC approval²⁶⁷ and the SEC must approve the fees assessed on public companies by both the PCAOB and the FASB.²⁶⁸

The PCAOB's budget reveals much about the scope of its operations and its impact on both registered accounting firms and public companies. For 2004, the SEC (itself with a 2004 budget of \$811.5 million) approved a PCAOB budget of \$103 million and a total accounting support fee of \$101 million (approximately two million dollars of the PCAOB budget will come from the accounting firm registration fees collected in 2003).²⁶⁹ Personnel costs account for more than half of the budget:²⁷⁰ the PCAOB has hired a staff of more than 200 auditors, analysts, and attorneys, and expects to have close to 300 employees by the end of 2004.²⁷¹ In addition to its main office in

263 See *supra* note 64. In response to testimony by several congressional witnesses that the U.S. system of accounting is "overly-detailed," see S. REP. NO 107-205, at 13 (2002), section 108 also requires the SEC to conduct a study on the adoption by the U.S. financial reporting system of a principles-based accounting system. 15 U.S.C.A. § 7218(d)(1).

264 See *supra* notes 62, 91-94 and accompanying text.

265 15 U.S.C.A. § 7219(c)(1).

266 *Id.* § 7219(g).

267 *Id.* § 7219(b).

268 *Id.* § 7219(d)(1) (applying to the PCAOB); *id.* § 7219(e)(1) (applying to the FASB).

269 PUB. CO. ACCOUNTING OVERSIGHT BD., BUDGET: FISCAL YEAR 2004 (2003), available at http://www.pcaobus.org/about_us/budget_presentations/2004.pdf; see also *Public Company Accounting Oversight Board: PCAOB Official Says Fee Collection 'Running Smoothly' for 2004 Invoices*, 36 Sec. Reg. & L. Rep. (BNA) 1592, 1592-93 (Aug. 30, 2004) (discussing the collection process and the amount of fees collected).

270 PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 269.

271 PCAOB *Hearing*, *supra* note 79, at 37 (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

Washington, D.C., the PCAOB has offices in New York, Atlanta, Dallas, and San Francisco, and intends to open offices in Chicago and Southern California in the near future.²⁷²

B. Comparisons to SROs and Federal Government Corporations

Before turning to an analysis of the PCAOB's constitutional status (Part III) and the normative implications of Congress's decision to establish the PCAOB as a "private" entity (Part IV), this section compares the PCAOB to SROs in the securities industry and to other ostensibly private corporations created by Congress for public purposes. The comparison is useful for a host of reasons, including that it validates Part I's observation that the PCAOB is a "strange kind of entity."²⁷³ Indeed, the PCAOB's structure, powers, and responsibilities place it far apart from any of the other "strange entities" that Congress may have been involved with in the past.

1. SROs in the Securities Industry

As discussed above, in the months preceding the passage of the Sarbanes-Oxley Act, Congress heard much testimony about the securities industry's relatively successful experience with self-regulation and the great benefits that could be gained if the accounting industry were regulated by an accounting analog to the NYSE or the NASD.²⁷⁴ But if Congress aimed to model the PCAOB after the NYSE or the NASD, then it shot very far off its mark. This is so despite the stark similarities between their rulemaking, investigative, and disciplinary functions and the system of SEC oversight to which they are all subject.²⁷⁵

The PCAOB's establishment by Congress is the threshold feature that sets it apart from both the NYSE and the NASD. Congress did not create either of those SROs. Instead, both organizations were formed at the initiative of securities brokers and firms long before Congress enveloped them in a regulatory scheme. This distinction is an important one because, as we shall see in Part III of this Article, the

²⁷² *Id.* (statement of William F. McDonough, Chairman, Pub. Co. Accounting Oversight Bd.).

²⁷³ *See supra* note 138 and accompanying text (quoting the statement of Senator Phil Gramm).

²⁷⁴ *See supra* notes 108–09 and accompanying text. Much of the testimony reflects an underlying assumption that the NASD and the NYSE are comfortably situated in the private sector, notwithstanding their "quasi-governmental" powers and responsibilities. But, as we shall see, courts have, on occasion, concluded that the NYSE and NASD were state actors for purposes of the Fifth Amendment's Due Process Clause. *See infra* note 345.

²⁷⁵ *See supra* notes 246–57 and accompanying text.

fact that an ostensibly private entity owes its creation to Congress is a key factor in determining whether the Constitution will apply to its actions.²⁷⁶

As the older of the two SROs, the NYSE's history is particularly rich, dating back to 1792, when, according to the lore, twenty-four brokers signed an agreement under a buttonwood tree located at what is now 68 Wall Street.²⁷⁷ The NYSE took its self-regulatory responsibilities seriously, and its President in 1934 went so far as to argue in congressional testimony that the creation of the SEC was not necessary.²⁷⁸ Congress plainly rejected that argument, but the Exchange Act, and particularly its 1975 amendments,²⁷⁹ evidence an undeniable respect for the NYSE's self-regulatory authority.

Although it is often said that the NASD was "created" by Congress in 1938 as part of the Maloney Act, a more nuanced view of history reveals that the NASD owes its origins to a trade group founded in 1912 by several investment banks, the Investment Bankers Association of America (IBAA).²⁸⁰ That trade group created an Investment Bankers Code Committee in 1933, which reorganized itself three years later

276 See *infra* Part III.A.2.a.

277 See N.Y. Stock Exch., *Firsts and Records*, at <http://www.nyse.com/about/1022221392987.html> (last visited Jan. 9, 2005). The Buttonwood Agreement stated:

We the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter per cent. Commission on the Specie value, and that we will give a preference to each other in our Negotiations.

Gordon v. N.Y. Stock Exch., Inc., 422 U.S. 659, 663 (1975) (quoting the Buttonwood Agreement).

278 RON CHERNOW, *THE HOUSE OF MORGAN* 421 (1990) (quoting NYSE President Richard Whitney's statement to the Senate Banking and Currency Committee that "[y]ou gentleman are making a great mistake" and that "[t]he Exchange is a perfect institution"); see Richard W. Painter, *The Dubious History and Psychology of Clubs as Self Regulatory Organizations* (2004) (unpublished manuscript, American Academy of Arts and Sciences).

279 Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified in scattered sections of 15 U.S.C.). Congress amended the Exchange Act in 1975 to clarify the scope of the self-regulatory responsibilities of the stock exchanges and the NASD and to clarify and enhance the SEC's oversight role. See NAGY ET AL., *supra* note 24, at 723-44. Self-regulation has been described by William O. Douglas, a former SEC chairman and Supreme Court Justice, as "letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 82 (James Allen ed., 1940).

280 Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 23-24 (2001).

as the Investment Bankers Conference.²⁸¹ As Professor Paul Mahoney recounts:

The conference and the SEC worked with Congress to craft an amendment to the Securities Exchange Act of 1934 authorizing the formation of a self-regulatory organization for securities dealers. . . . The amendment, known as the Maloney Act, was enacted in 1938. The Investment Bankers Conference then reorganized itself into the NASD.²⁸²

At first blush, another SRO, the Municipal Securities Rulemaking Board (MSRB), may appear to be the stronger analogy to the PCAOB because it shares the feature of congressional creation—it was established by Congress in 1975 to develop rules for securities firms and banks that are involved in underwriting, trading, and selling municipal securities.²⁸³ But, as its name implies, the MSRB's congressionally designed responsibilities extend only to rulemaking.²⁸⁴ Accordingly, with neither investigative nor disciplinary authority, the MSRB possesses only a fraction of the regulatory might that is shared by the NASD, the NYSE, and the PCAOB.²⁸⁵

In addition to their very different origins, there are at least three other important distinctions setting the NYSE and the NASD apart from the PCAOB. The first concerns the manner by which their board members are appointed. In the case of the PCAOB, the ap-

281 Dean Joel Seligman recounts the rocky start of the Investment Bankers Conference as a "nationwide voluntary organization to police the over-the-counter markets." JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET 184-85* (3d ed. 2003).

282 Mahoney, *supra* note 280, at 23-24. Of the post-Enron legislative proposals discussed above, only Representative Oxley's CAARTA would have allowed for the creation of an oversight board by the accounting industry itself. Although many House Democrats criticized the bill for its vagueness, *see supra* notes 140-41, the discretion that it accorded the SEC in fact paralleled much of the Maloney Act. Thus, had CAARTA been enacted into law, an NASD-like analogue for the accounting profession could well have resulted.

283 Exchange Act § 15B, 15 U.S.C. § 78o-4 (2000).

284 The examination and enforcement of MSRB rules falls upon the SEC and NASD for securities firms and the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Comptroller of the Currency for banks. 15 U.S.C. §§ 78o-4(c)(7)(A), 78c(a)(34) (2000); *see also* Mark Thoman & Amy B. Serper, *New Disclosure Requirements for Municipal Securities*, 27 REV. OF SEC. & COMMODITIES REG. 111, 112-14 (discussing the history of SEC regulation of municipal securities) (1994).

285 For reasons discussed in Part III.A.2.b, *infra*, the MSRB's congressional creation and rulemaking mission may well be enough to render it the "government itself" for purposes of constitutional law. *See* Blount v. SEC, 61 F.3d 938, 941 (D.C. Cir. 1995) (maintaining that the MSRB's assertion that it is a purely private organization is "questionable" in light of the Supreme Court's decision in *Lebron*); *see also infra* note 392 (explaining further the D.C. Circuit's assertion).

pointment power lies with the government, in that the SEC appoints the five board members after consultation with the Chairman of the Federal Reserve and the Secretary of the Treasury.²⁸⁶ The government also dictates that two—but only two—of the PCAOB’s five members must be CPAs. In contrast, the government plays no formal role in the appointment of board members for either the NYSE²⁸⁷ or the NASD,²⁸⁸ and the government does not specify who may or may not serve. Few would dispute that the government’s power to appoint the directors of an entity results in greater government control.

There are also important differences in the way that these three organizations are funded. As we have seen, the PCAOB’s private sector funding stems from a congressional mandate that obligates public companies to pay an “accounting support fee” to fund the board’s operations.²⁸⁹ In contrast, the NYSE and NASD are funded primarily by their member firms and listed companies.²⁹⁰ To be sure, such membership fees are not truly voluntary in that securities firms are essentially compelled to belong to these organizations.²⁹¹ But the NYSE’s and the NASD’s mechanisms for member-firm funding pre-existed any congressional dictate for membership.²⁹²

A final distinction between these three organizations concerns their power to obtain documents and testimony in the course of inves-

286 See *supra* note 160 and accompanying text.

287 Members of the NYSE Board of Directors are elected by the Exchange’s membership. They are required to be “independent of management of the Exchange, the members, and issuers of securities listed on the Exchange.” CONSTITUTION OF THE NEW YORK STOCK EXCHANGE art. IV, § 2 (2003), available at <http://rules.nyse.com/NYSE/Constitution>.

288 Members of the NASD Board of Governors also are elected by its members. In addition to five prescribed executive positions, the remaining twelve to twenty-two governors must include representatives (or affiliates) of an issuer of investment company shares, an insurance company, a national retail firm, and a regional retail or independent financial planning member firm. BY-LAWS OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. art. VII, § 4(a), available at <http://www.nasd.com> (last visited Jan. 19, 2005).

289 See *supra* notes 264–68 and accompanying text.

290 N.Y. STOCK EXCH., INC., 2003 ANNUAL REPORT 22 (2004); NAT’L ASS’N OF SEC. DEALERS, INC., 2003 ANNUAL REPORT 4 (2004).

291 See Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2000) (making it unlawful for any broker-dealer registered with the SEC to effect any transaction “unless such broker or dealer is a member of a securities association registered pursuant to section 78o-3 of this title or effects transactions in securities solely on a national securities exchange of which it is a member”). The NASD is the only securities association registered pursuant to Exchange Act § 15A, 15 U.S.C. § 78o-1.

292 In addition, in contrast to the budget and fees of the NYSE and NASD, the PCAOB’s budget and its “accounting support fee” must be reviewed and approved by the SEC. See *supra* notes 267–68 and accompanying text.

tigations and disciplinary proceedings. Although all three organizations require cooperation with respect to the firms and associated persons subject to their jurisdiction, only the PCAOB has a congressionally designed avenue for compelling the production of documents and testimony from third parties. Namely, only the PCAOB has the statutory power to seek SEC issuance of a subpoena.²⁹³ The PCAOB can therefore cast a much wider investigatory net over non-regulated members of the public.

2. Corporations Created by the Federal Government

In contrast to the many references made to the NYSE and NASD in the hearings and debates leading up to Sarbanes-Oxley, the legislative record does not reflect much discussion of congressionally created *private* corporations that could serve as a model for the PCAOB. The absence of analogy is hardly surprising: although Congress has created literally dozens of corporations since the era of the New Deal,²⁹⁴ almost all of those that serve a regulatory function are entities of the federal government.²⁹⁵

293 See *supra* note 214 and accompanying text.

294 See Froomkin, *supra* note 30, at 546.

295 For example, the Federal Crop Insurance Corporation was established to help improve economic stability of agriculture by promoting and implementing a system of sound crop insurance, 7 U.S.C. § 1502(a) (2000); 7 C.F.R. pts. 400–457 (2003), the Commodity Credit Corporation was founded to stabilize and support farm income and price through loans and other programs for commodity distributors and exporters, 15 U.S.C. § 714 (2000); 7 C.F.R. pts. 1400–1482 (2003), the Export-Import Bank is authorized to issue loans, guarantees, insurance, and credits to encourage and support U.S. exports, 12 U.S.C. § 635(a) (2000); 12 C.F.R. pts. 400–413 (2003), and the Pension Benefit Guaranty Corporation (a federal government corporation in the Department of Labor) was established to encourage voluntary private pension plans and to insure for the timely and uninterrupted payment of benefits. 29 U.S.C. § 1302(a) (2000); 29 C.F.R. pts. 4000–4907 (2003). All of these corporations are entities of the federal government. See also *infra* notes 296–304 and accompanying text (discussing the Federal Deposit Insurance Corporation).

Though not a corporation, the Federal Reserve System was founded by Congress in 1913 through the Federal Reserve Act to provide the nation with a safer, more flexible, and more stable monetary and financial system. The Board of Governors acts as a federal governmental agency in conjunction with the twelve regional Reserve Banks to supervise and regulate “certain financial institutions and activities; [to provide] banking services to depository institutions and to the federal government; and [to ensure] that consumers receive adequate information and fair treatment in their business with the banking system.” Bd. of Governors of the Fed. Reserve Sys., *THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS* 1–4 (1994); see also 12 U.S.C. §§ 241–252 (codifying the composition, powers, and responsibilities of the Board of Governors of the Federal Reserve System); 12 C.F.R. pts. 201–281 (2003) (codifying the rules pertaining to the Board of Governors of the Federal Reserve System).

The Federal Deposit Insurance Corporation (FDIC) is one of the many *public* corporations that shares numerous similarities with the PCAOB (though with more than 5200 employees, its size is certainly larger).²⁹⁶ Both the FDIC and the PCAOB were created by Congress in response to a major financial crisis,²⁹⁷ both were charged with the mission of restoring and preserving public confidence,²⁹⁸ both have regulatory authority over an important private industry,²⁹⁹ both have five-person boards with members appointed by the government,³⁰⁰ and both are funded from sources other than congressional appropriation.³⁰¹

But the FDIC differs from the PCAOB in at least two important ways. First, the FDIC was established as an independent agency of the federal government.³⁰² Second, the FDIC serves a commercial function that justifies its corporate form. Namely, in addition to its regulatory responsibilities, the FDIC also functions to sell deposit insurance coverage to banks and thrift institutions.³⁰³ Thus, unlike the PCAOB, the FDIC fits squarely within the general rationale for creating a federal government corporation: “to permit the development of a facility or service with revenue producing potential.”³⁰⁴

296 See 12 U.S.C.A. § 1811 (West Supp. 2004); see also Fed. Deposit Ins. Corp., *Who Is the FDIC?*, at (last updated July 28, 2003) (providing a general overview of the FDIC’s purposes and organization).

297 Congress created the FDIC in 1933 in response to the thousands of bank failures that occurred in the Great Depression. See ALFRED M. POLLARD ET AL., *BANKING LAW IN THE UNITED STATES* 52 (1988); see also *FDIC v. Philadelphia Gear Corp.*, 476 U.S. 426, 432 (1986) (recounting the genesis of the Federal Deposit Insurance Act).

298 See POLLARD ET AL., *supra* note 297, at 52; see also *Philadelphia Gear*, 476 U.S. at 433 (citing 77 CONG. REC. 3837, 3838, 3840 (1933) (remarks of Rep. Steagall)).

299 See POLLARD ET AL., *supra* note 297, at 52.

300 See 12 U.S.C. § 1812(a)(1) (the FDIC’s five-member board consists of the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and three other members appointed by the President and confirmed by the Senate); *supra* notes 163–65 and accompanying text (describing the PCAOB Board).

301 See *infra* note 303 and accompanying text (discussing the FDIC); *supra* notes 264–66 and accompanying text (discussing PCAOB).

302 12 U.S.C. § 1819(b)(1); see also FED. DEPOSIT INS. CORP., 2003 ANN. REP. 3 (2004) (stating, in its mission statement, that the FDIC is “an independent agency created by the Congress”).

303 12 U.S.C. §§ 1811(a), 1814, 1815.

304 See SENATE COMM. ON GOVERNMENTAL AFFAIRS, 104TH CONG., *MANAGING THE PUBLIC’S BUSINESS: FEDERAL GOVERNMENT CORPORATIONS*, at XIII (Comm. Print 1995) (Ronald C. Moe, primary contributor). With an eye to their revenue producing potential, Congress has also created a number of privately owned corporations to serve the purpose of loaning money for housing, agriculture, and education. These are often referred to as “government sponsored enterprises” (GSEs), defined to include a “privately owned, federally chartered financial institution with nationwide scope and

While the PCAOB shares many similarities with the FDIC and other *public* corporations, its similarities with the other ostensibly private corporations created by Congress are few. To be sure, the PCAOB's statutory disclaimer of "not an agency or establishment of the United States Government" can be found in other statutes creating private corporations.³⁰⁵ Some of these, including the Legal Services Corporation (LSC),³⁰⁶ the Corporation for Public Broadcasting (CPB),³⁰⁷ the Securities Investor Protection Corporation (SIPC),³⁰⁸

limited lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money." Ronald C. Moe & Thomas H. Stanton, *Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 321 (1989). GSEs include the Federal Home Loan Mortgage Company (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), the Student Loan Marketing Association (Sallie Mae), the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Federal Home Loan Banks (FHLB). *Id.* A comparison of the PCAOB to these GSEs is, therefore, inapposite.

305 See, e.g., 22 U.S.C. § 4411(a) (2000) (establishing the National Endowment for Democracy, a District of Columbia corporation); 36 U.S.C. § 151,301(b) (2000) (establishing the National Fallen Firefighters Foundation, a Maryland corporation); *id.* § 151,701(b) (establishing the National Film Preservation Foundation, a federally chartered corporation); *id.* § 152,401(b) (establishing the National Recording Preservation Foundation, a federally chartered corporation); see also *infra* notes 306–08 (discussing additional corporations).

306 The LSC, a private, nonprofit corporation established by Congress in 1974, provides civil legal assistance to those who would otherwise be unable to afford it. 42 U.S.C. § 2996b(a) (2000). Its eleven-member board of directors is appointed by the President and confirmed by the Senate. *Id.* § 2996c(a). See generally Charles J. Cooper & Michael A. Carvin, *The Price of "Political Independence": The Unconstitutional Status of the Legal Services Corporation*, 4 B.U. PUB. INT. L.J. 13, 13–38 (1994) (providing a historical background of the LSC and arguing the LSC Act violates the separation of powers doctrine).

307 The CPB, a private, nonprofit corporation established by Congress in 1967, encourages and supports public radio and television. 47 U.S.C. § 396 (2000). In 2003, the Corporation allocated \$240 million of congressionally appropriated funds for public television and radio station community service grants. CORP. FOR PUB. BROAD., 2003 ANN. REP. 4 (2004). Its nine-member board is appointed by the President and confirmed by the Senate. 47 U.S.C. § 396(c)(1). See generally Chris Johnson, *Federal Support of Public Broadcasting: Not Quite What LBJ Had in Mind*, 8 COMM. LAW CONSPECTUS 135, 135–48 (2000) (reviewing the history and purposes of the Public Broadcasting Act and examining the role of political parties in public broadcasting).

308 The SIPC, a private, nonprofit corporation established by Congress in 1970, protects investors with assets in the hands of bankrupt or otherwise illiquid brokerage firms. SEC. INVESTOR PROT. CORP., 2003 ANN. REP. 4 (2004). The SIPC was created to restore investor confidence after a wave of broker-dealer failures in the 1960s. *Id.* The Corporation is funded by its members, who are registered brokers and dealers of securities. 15 U.S.C.A. § 78ccc (West Supp. 2004). Its seven-member board consists of one member appointed by the Secretary of the Treasury from among employees of the Treasury, another member appointed by the Federal Reserve from among em-

and Amtrak³⁰⁹ also share the PCAOB's feature of governmentally appointed directors—a feature that has often prompted political scientists to label their private status as “legal fictions.”³¹⁰ And the LSC, CPB, and SIPC also perform limited regulatory functions. But research has not revealed a single “private” government corporation—or for that matter any congressionally created entity in the private sector—that shares the scope of the rulemaking, investigative, and adjudicative authority that Congress has delegated to the PCAOB. The constitutional significance of this conclusion shall be explored in the following Part.

III. A CONSTITUTIONAL ANALYSIS OF THE PCAOB

Congress's decision to establish the PCAOB as a nonprofit corporation in the private sector comports with national—and even international—trends toward the “privatization” of government.³¹¹ Although

ployees of the Federal Reserve, and five members appointed by the President and confirmed by the Senate (two public members and three from the securities industry). *Id.* § 78ccc(c)(2). See generally Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071 (1999) (reviewing the history and purposes of the SIPC and suggesting improvements to the SIPC scheme).

309 The Supreme Court addressed Congress's designation of Amtrak as a private corporation in *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 378–80 (1995). The decision is discussed extensively in Part III.A.2, *infra*.

310 See Thomas H. Stanton & Ronald C. Moe, *Government Corporations and Government-Sponsored Enterprises*, in *THE TOOLS OF GOVERNMENT* 87 (Lester M. Salamon ed., 2002) (quoting a 1981 study of the National Academy of Public Administration Report on Government, declaring it a “‘misleading fiction’ for government corporations such as Amtrak, the Legal Services Corporation or the Securities Investor Protection Corporation to be deemed by statute to be private corporations that were not agencies or instrumentalities of the United States”).

311 The term privatization is often used to describe “the range of efforts by governments to move public functions into private hands and to use market-style competition.” Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1229, 1230 (2003). “Privatization can include using publicly funded vouchers to permit eligible recipients to purchase goods or services in the private market, government contracts with private providers, and using private entities to set public standards.” *Id.* at 1230 n.4. Other terms describing essentially the same phenomenon include “government by proxy,” see, e.g., John J. DiIulio, Jr., *Government by Proxy: A Faithful Overview*, 116 HARV. L. REV. 1271, 1271 (2002) (discussing the rise of “third-party government” or increased governmental reliance on authorized proxies); “private ordering,” see, e.g., Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 (2002) (discussing the sharing of regulatory authority with private actors); and “contracting out,” see, e.g., Daniel Guttman, *Public Purpose and Private Service: The Twentieth Century Culture of Contracting Out and the Evolving Law of Diffused Sovereignty*, 52 ADMIN. L. REV. 859, 861 (2000) (noting that the terms “privatization,” “reinvention,”

the scholarly literature reflects much disagreement as to the trend's normative consequences,³¹² there is a growing consensus that expanded privatization has served to blur the distinction between the spheres of public and private.³¹³ The blurriness has prompted Professor Jody Freeman and others to argue that there is "no purely private realm and no purely public one . . . [only] the set of negotiated relationships between the public and the private."³¹⁴ The Supreme Court, however, has yet to come to grips with this more pragmatic

and "contracting out" describe the same effort "to reform and reduce 'Big Government'").

312 The legal and political science literature on privatization is voluminous, and there is substantial dispute as to whether the advantages of privatization are outweighed by its disadvantages. See *supra* note 30 (citing recent books and articles as well as symposia in the *Harvard Law Review*, *UCLA Law Review*, *Administrative Law Review*, and *Fordham Urban Law Journal*); see also THE PROVINCE OF ADMINISTRATIVE LAW (Michael Taggart ed., 1997) (collecting various perspectives on the question of whether courts should extend certain public law values into the deregulated, private environment). For extensive commentary on the privatization trend in countries outside the United States, see SASKIA SASSEN, LOSING CONTROL?: SOVEREIGNTY IN AN AGE OF GLOBALIZATION *passim* (1996); SUSAN STRANGE, THE RETREAT OF THE STATE: THE DIFFUSION OF POWER IN THE WORLD ECONOMY (1996); Symposium, *The Decline of the Nation State and Its Effect on Constitutional and International Economic Law*, 18 CARDOZO L. REV. 903 (1996). Advocates of expanded privatization generally emphasize that it substantially reduces regulatory costs and the costs of providing goods and services because the private sector is more efficient and less bureaucratic than government. Critics argue that expanded privatization escapes the many checks, constitutional and otherwise, that are placed on public actors in regulating entities, administering programs, and distributing resources. See generally Jody Freeman, *Extending Public Law Norms Through Privatization*, 116 HARV. L. REV. 1285, 1291-314 (2003) (reviewing ideological and pragmatic arguments for and against expanded privatization).

313 See Freeman, *supra* note 30, at 551-56; see also Matthew Diller, *Form and Substance in the Privatization of Poverty Programs*, 49 UCLA L. REV. 1739, 1756 (2002) (noting that "[t]he restructuring of intergovernmental relationships based on corporate models suggests that privatization can be internalized" and that "[s]uch internalization further blurs the distinctions between the public and private sectors"); Clifford J. Rosky, *Force, Inc.: The Privatization of Punishment, Policing and Military Force in Liberal States*, 36 CONN. L. REV. 879, 880 (2004) (arguing that "the boundaries between public and private uses of force have become increasingly blurred").

314 Freeman, *supra* note 30, at 548 (drawing from scholarship in critical legal studies and public choice theory); see Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 520 (2003) (observing that "prominent scholars and practitioners in nearly every field seem to have joined the negotiated governance crusade, either criticizing existing United States legal structures as overly formal and legalistic and urging a more negotiated approach, or applauding new U.S. legal developments as embracing the negotiated governance ideal").

analysis of public/private power.³¹⁵ Instead, modern constitutional law continues a longstanding allegiance to two related notions: that the categories of public and private are distinct, and that only public or “state” actors can be subject to constitutional restraint. Hence, while scholars may view the so-called state action requirement as anachronistic,³¹⁶ it remains the doctrine under which all constitutional claims are judged.

In view of this constitutional reality, this Part first contends that the PCAOB is not only a “state actor” but a public entity (the “government itself”) under prevailing Supreme Court precedent. It then explores some of the constitutional restraints to which the PCAOB will be subject. The final section discusses the PCAOB in light of the Court’s so-called nondelegation doctrine, another area of constitutional jurisprudence that is difficult to reconcile with expanded privatization.

A. *The State Action Doctrine as Applied to the PCAOB*

Although the judiciary has yet to grapple with its full implications, the privatization phenomenon has generated much constitutional litigation, with the Supreme Court delving into diverse arenas, including interscholastic athletics,³¹⁷ worker’s compensation,³¹⁸ railway transportation,³¹⁹ prisons,³²⁰ nursing homes,³²¹ and electrical utilities.³²² Because the Constitution generally does not apply to “merely private

315 See Freeman, *supra* note 30, at 576 (maintaining that “[t]he Court remains strongly committed to the public/private distinction on which the [state action] doctrine depends”); Metzger, *supra* note 30, at 1400 (observing that the Court “strictly compartmentalizes society into public and private spheres, and does not acknowledge any substantial blurring between the two”).

316 See, e.g., Freeman, *supra* note 30, at 579 (contending that the “state action doctrine demands that we demarcate the public from the private, a task that proves ever more difficult and unrealistic in the face of public/private interdependence”); Metzger, *supra* note 30, at 1371 (arguing that “constitutional law’s current approach to privatization is fundamentally inadequate in an era of increasingly privatized government” and that “[m]uch of this inadequacy results from current doctrine’s failure to appreciate how privatization can delegate government power to private hands”).

317 See *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n*, 531 U.S. 288 (2001). The Court has also analyzed intercollegiate basketball. See *Nat’l Collegiate Athletic Ass’n v. Tarkanian*, 488 U.S. 179, 192 (1988).

318 See *Am. Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40 (1999).

319 See *Lebron v. Nat’l R.R. Passenger Corp.*, 513 U.S. 374 (1995).

320 See *West v. Atkins*, 487 U.S. 42 (1988).

321 See *Blum v. Yaretsky*, 457 U.S. 991 (1982).

322 See *Jackson v. Metro. Edison Co.*, 419 U.S. 345 (1974).

conduct, no matter how discriminatory or wrongful,”³²³ the Court has attempted to “plot a line between state action . . . and private conduct.”³²⁴ In addition to its basis in the text of the Constitution,³²⁵ this state action requirement is said to further a number of policy objectives, including “preserv[ing] an area of individual freedom by limiting the reach of federal law”³²⁶ and “avoid[ing] imposing on the State . . . responsibility for conduct for which [it] cannot fairly be blamed.”³²⁷

In “traditional” state action cases, the Court’s line-plotting involves a determination as to whether a private entity’s conduct can be fairly attributed to the government for constitutional purposes. Only infrequently has the Court been confronted with a claim that an ostensibly private entity is the “government itself.” Constitutional litigation involving the PCAOB will therefore present an untraditional—but not unprecedented—state action scenario.

1. Traditional State Action Analysis

As the Supreme Court has recognized: “In the typical case raising a state-action issue, a private party has taken the decisive step that caused the harm to the plaintiff, and the question is whether the State was sufficiently involved to treat that decisive conduct as state action.”³²⁸ In other words, traditional state action analysis requires a

323 *Am. Mfrs.*, 526 U.S. at 50 (citing *Blum*, 457 U.S. at 1002). The Thirteenth Amendment stands as a notable exception to the state action doctrine because its prohibition of slavery and involuntary servitude extends to both private and public actors. See LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 1688 (1988).

324 *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n*, 531 U.S. 288, 295 (2001).

325 See *The Civil Rights Cases*, 109 U.S. 3, 11 (1883). *The Civil Rights Cases* emphasized the language in the Fourteenth Amendment that

[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Id. (quoting U.S. CONST. amend. XIV).

326 *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 936 (1982).

327 *Id.* As Professor Ronald Krotoszynski has explained, the state action doctrine is essentially “a device that permits the federal courts to balance the interests of private individuals and entities in being free from constitutional regulation against the public’s countervailing interest in ensuring that the government and its agents do not disregard constitutional constraints.” Ronald J. Krotoszynski, *Back to the Briarpatch: An Argument in Favor of Constitutional Meta-Analysis in State Action Determinations*, 94 MICH. L. REV. 302, 347 (1995).

328 *Nat’l Collegiate Athletic Ass’n v. Tarkanian*, 488 U.S. 179, 192 (1988) (holding that a state university’s adoption of, and adherence to, rules and enforcement pro-

court to determine whether “there is a sufficiently close nexus between the State and the challenged action.”³²⁹ The nexus inquiry is “necessarily fact-bound,”³³⁰ and for many years, the Court found a private entity’s acts to constitute state action only in one of three circumstances: (1) when the challenged activity resulted from the government’s exercise of “coercive power” or “significant encouragement, either overt or covert”;³³¹ (2) when the private entity performed a traditional governmental function;³³² or (3) when the challenged activity resulted from a “symbiotic” interdependence between the government and the private entity.³³³ This intensely fact-based inquiry triggered claims by constitutional scholars that the Court’s traditional state action doctrine is “incoheren[t],”³³⁴ a “conceptual disaster area”³³⁵ and a “dark thicket of constitutional law.”³³⁶ Even the Court has acknowledged that its “cases deciding when private action might be deemed that of the state have not been a model of consistency.”³³⁷

ceedings of a private organization did not render the private organization a state actor).

329 *Am. Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40, 52 (1999) (holding that a private insurer who withheld payment was not a state actor despite being subject to extensive government regulations).

330 *Lugar*, 457 U.S. at 939 (holding that a corporate creditor who acted jointly with a state official in seizing a debtor’s property amounted to a state actor for § 1983 purposes).

331 *Blum v. Yaretsky*, 457 U.S. 1004 (1982) (finding no State coercion by “[m]ere approval of or acquiescence in” adjustments of Medicaid disbursements pursuant to a private nursing home’s decision to transfer patient’s level of care to a lower level).

332 *West v. Atkins*, 487 U.S. 42, 56 (1988) (holding that a private physician’s mistreatment of an inmate constituted state action because the physician had contracted with the state prison to provide medical services to inmates).

333 See *San Francisco Arts & Athletics, Inc. v. U.S. Olympic Comm.*, 483 U.S. 522, 542–47 (1987) (holding that the authorities and resources conferred upon the U.S. Olympic Committee (USOC) by the Amateur Sports Act did not create a symbiotic relationship between the USOC and the government); *Rendell-Baker v. Kohn*, 457 U.S. 830, 843 (1982) (holding that “[n]o symbiotic relationship such as existed in *Burton* exists here”); *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163, 175–76 (1972) (finding that the state’s issuance of a liquor license to a private club that excluded minorities did not amount to a symbiotic relationship); *Burton v. Wilmington Parking Auth.*, 365 U.S. 715, 725–26 (1961) (finding a symbiotic relationship between a racially segregated restaurant and a state agency from which the restaurant leased public space).

334 *Chemerinsky*, *supra* note 31, at 505.

335 *Black*, *supra* note 32, at 95.

336 *Krotoszynski*, *supra* note 327, at 303.

337 *Lebron v. Nat’l R.R. Passenger Corp.*, 513 U.S. 374, 378 (1995) (quoting *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 632 (1991) (O’Connor, J., dissenting)).

The Court's most recent state action decision, *Brentwood Academy v. Tennessee Secondary School Athletic Ass'n*,³³⁸ provides its critics with additional fodder. The case presented a traditional state action scenario: the Tennessee Secondary School Athletic Association was a private organization overseeing athletic events for nearly all of the state's public and private secondary schools and the question presented was whether the association would violate the First and Fourteenth Amendments in enforcing a rule that restricted the manner in which its member schools could recruit student athletes. But rather than considering the three tests for state action identified above, a sharply divided Supreme Court chose instead to focus on the association's overall "entwinement" with the government.³³⁹ Over the four dissenters' strong objection, the majority held that "entwinement to the degree shown here" supports the conclusion that the association "ought to be charged with a public character and judged by constitutional standards."³⁴⁰ As constitutional scholars have observed, *Brentwood's* reasoning is strikingly different from the reasoning in *American Manufacturers Mutual Insurance Co. v. Sullivan*,³⁴¹ where only two terms before the Court insisted upon the state's involvement in "the specific conduct of which the plaintiff complains"³⁴² and not in the mere background and workings of the private insurance companies.³⁴³

Convoluting though it may be, traditional state action analysis would have been necessary had Congress enacted CAARTA instead of the Sarbanes-Oxley Act and had a "public regulatory organization" been recognized by the SEC pursuant to CAARTA's criteria.³⁴⁴ In-

338 531 U.S. 288 (2001).

339 *Id.* at 291, 296-305.

340 *Id.* at 302. The dissenters strongly chastised the majority's failure to apply the traditional tests of state action. *Id.* at 305 (Thomas, J., joined by Rehnquist, C.J., and Scalia and Kennedy, J.J., dissenting) ("We have never found state action based upon mere 'entwinement' The majority's holding . . . not only extends state-action doctrine beyond its permissible limits but also encroaches upon the realm of individual freedom that the doctrine was meant to protect.").

341 526 U.S. 40 (1999).

342 *Id.* at 51 (quoting *Blum v. Yaretsky*, 457 U.S. 991, 1004 (1982)).

343 See Metzger, *supra* note 30, at 1414 (noting that "*Sullivan* is in many ways the apogee of a formalistic state action inquiry" whereas the *Brentwood* majority's approach was "flexible, pragmatic, and situation specific").

344 See *supra* notes 124-26, 140-42 and accompanying text (discussing the CAARTA as well as concerns by its critics that the legislation left too much of the design of the public regulatory organization in the hands of the SEC and the accounting industry). Because the CAARTA did not explicitly situate the "public regulatory organizations" that were contemplated in either the public sector or the private sector, there would have been substantial confusion as to their status. See *supra* notes 136-37 (contrasting diametrically opposed views from two representatives supporting

deed, a “public regulatory organization” that was recognized by the SEC would closely resemble securities industry SROs like the NASD and the NYSE, and courts employ traditional state action analysis when SRO conduct is subject to constitutional challenge.³⁴⁵ But Congress’s creation of the PCAOB as an ostensibly private entity shifts the PCAOB from the traditional state action paradigm to a narrower one that focuses on whether an entity is the “government itself.”

the legislation). Assuming that a public regulatory organization regarded itself as a private entity and the SEC concurred, there would have been no easy answer to the question of whether its actions nonetheless would be deemed to be “state action” for purposes of the Constitution. It is quite likely that courts would analogize the organization to the NYSE or NASD and perform a state action analysis with a similarly scattershot approach. See *infra* note 345.

345 Not surprisingly, in the context of constitutional challenges to conduct by securities industry SROs, traditional state action analysis has produced results that are difficult to reconcile. Compare *Intercontinental Indus., Inc. v. Am. Stock Exch.*, 452 F.2d 935, 941 (5th Cir. 1971) (stating that “[t]he intimate involvement of the Exchange with the [Commission] brings it within the purview of the Fifth Amendment controls over governmental due process”), and *Villiani v. N.Y. Stock Exch., Inc.*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (stating that “[i]t is now beyond dispute that the Fifth Amendment due process requirements as to federal action apply to the disciplinary hearings conducted by the Exchange”), *aff’d sub nom. Sloan v. N.Y. Stock Exch., Inc.*, 489 F.2d 1 (2d Cir. 1973), with *Jones v. SEC*, 115 F.3d 1173, 1183 (4th Cir. 1997) (rejecting defendant’s constitutional challenge under the Double Jeopardy Clause in part because “[w]hile the NASD is a closely regulated corporation, it is not a governmental agency, but rather a private corporation organized under the laws of Delaware”), and *United States v. Solomon*, 509 F.2d 863, 869 (2d Cir. 1975) (holding that the NYSE’s status as a private institution insulates it from the defendant’s claim that he was denied the Fifth Amendment’s privilege against self-incrimination). The caselaw on SRO state action is even more difficult to reconcile when viewed alongside the related issue of immunity. See, e.g., *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 105 (2d Cir. 2001)

The NYSE, as a SRO, stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws. It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC’s broad oversight authority.

Id. For articles taking the position that constitutional protections should apply to SRO disciplinary actions, see William I. Friedman, *The Fourteenth Amendment’s Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited*, 23 ANN. REV. BANKING & FIN. L. 727 (2004); Richard L. Stone & Michael Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453.

2. The PCAOB as a Public Entity

a. The *Lebron* Decision

In *Lebron v. National Railroad Passenger Corp.*,³⁴⁶ Justice Scalia and seven other Justices ruled that Amtrak was a public entity (the "Government itself") for constitutional purposes, notwithstanding Congress's statutory declaration that Amtrak was a corporation under the District of Columbia's Business Corporation Act and that it "will not be an agency or establishment of the United States Government."³⁴⁷ The opinion emphasized that "government, state or federal," cannot "evade the most solemn obligations imposed in the Constitution by simply resorting to the corporate form."³⁴⁸

The case arose when Michael Lebron sought to display a provocative advertisement on the 1000 square foot billboard (known as "the Spectacular") overhanging the main entryway of Amtrak's Pennsylvania Station in New York City.³⁴⁹ Amtrak's vice president refused to display Lebron's work, invoking Amtrak's policy "that it will not allow political advertising on the [S]pectacular advertising sign."³⁵⁰ Lebron sued in federal court on the grounds that his First and Fourteenth Amendment rights had been violated, and after expedited discovery the district judge granted Lebron's request for an injunction and ordered Amtrak to display his advertisement. The district judge concluded that "based on examination of the federal government's deep and controlling entwinement in Amtrak's structure and operations, . . . when Amtrak undertakes to control the content of speech on its billboards, its conduct must be deemed governmental rather than private."³⁵¹ A divided panel of the U.S. Court of Appeals for the Second Circuit reversed, maintaining that, in creating Amtrak, Congress specifically determined that it would not be a government entity.³⁵² The panel further reasoned that the federal government was

346 513 U.S. 374 (1995).

347 *Id.* at 391 (quoting 45 U.S.C. § 541 (1988), *repealed by* Pub. L. No. 103-272, 108 Stat. 1379 (1994)).

348 *Id.* at 397.

349 *Lebron v. Nat'l R.R. Passenger Corp.*, 811 F. Supp. 993, 994-95 (S.D.N.Y. 1993), *rev'd*, 12 F.3d 388 (2d Cir. 1993), *rev'd*, 513 U.S. 374 (1995). The ad scrutinized the Coors family's right-wing affiliations by portraying "convivial drinkers of Coors beer, juxtaposed with a Nicaraguan village scene in which peasants are menaced by a can of Coors that hurtles towards them, leaving behind a trail of fire, as if it were a missile," and stating that "Coors is 'The Silver Bullet that aims The Far Right's political agenda at the heart of America.'" *Id.* at 995.

350 *Id.*

351 *Id.* at 997.

352 *Lebron v. Nat'l R.R. Passenger Corp.*, 12 F.3d 388, 390 (2d Cir. 1993).

not so involved with Amtrak as to render Amtrak's Vice President's decision a federal action.³⁵³ The Supreme Court granted certiorari, reversed, and remanded.

Justice Scalia's majority opinion recognized at the outset that it "may be unnecessary to traverse [the] difficult terrain" of traditional state action jurisprudence "since Lebron's first argument is that Amtrak is not a private entity but Government itself."³⁵⁴ That argument prompted the Court to "place Amtrak within its proper context in the long history of corporations created and participated in by the United States for the achievement of governmental objectives."³⁵⁵ The Court noted that World War I begat the first large-scale use of government controlled corporations, and that the Great Depression brought about the next major group "which proved to be more enduring."³⁵⁶ For the most part, these corporations were designated as government agencies and were located within existing governmental structures.³⁵⁷ But beginning with the Communications Satellite Corporation (Comsat) in 1962, Congress "turned to sponsoring corporations that it specifically designated *not* to be agencies or establishments of the United States Government."³⁵⁸ Amtrak, established by Congress in 1970, was one of those corporations with an authorizing statute declaring that it "'will not be an agency or establishment of the United States Government.'"³⁵⁹ But operated with federal funds, and controlled by a board with a majority of presidentially appointed directors,³⁶⁰ Amtrak was

353 *Id.* at 392.

354 *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 378 (1995).

355 *Id.* at 386.

356 *Id.* at 388 (citing examples including the FDIC, the Reconstruction Finance Corporation, and the Tennessee Valley Authority).

357 *Id.* at 390. In response to the growing trend of government corporations, Congress passed the Government Corporation Control Act of 1945 (GCCA), ch. 557, 59 Stat. 597 (codified as amended at 31 U.S.C. §§ 1105, 9101-9109 (2000)), which required the dissolution or liquidation of both wholly- and partially-owned government corporations unless Congress chose to reincorporate them. New government corporations could only be created pursuant to congressional approval and would be audited by the Comptroller General. *Lebron*, 513 U.S. at 389-90.

358 *Lebron*, 513 U.S. at 390. The Court seemed to regard Comsat as a truly private corporation because, while it was established by Congress to serve governmental objectives, it was capitalized entirely with private funds, and its board was to be controlled by its private shareholders (with only three out of fifteen directors appointed by the President). *Id.* at 390-91.

359 *Id.* at 391 (quoting 45 U.S.C. § 541 (1988), *repealed by* Pub. L. No. 103-272, 108 Stat. 1379 (1994)).

360 The Court provided a description of the appointment process that existed at that time. Six of Amtrak's nine board members were appointed directly by the President: the Secretary of Transportation was an *ex officio* member; three members were

expected to “avert the threatened extinction of passenger trains” in the United States.³⁶¹

The Court then turned to Amtrak’s contention that “whatever its relationship with the Federal Government,” Congress’s disclaimer of agency status “prevents it from being considered a Government entity.”³⁶² With respect to statutes and other matters in Congress’s control, such as the Administrative Procedure Act, the Federal Advisory Committee Act, and government procurement laws, the Court conceded that Congress’s “private” disclaimer would be dispositive.³⁶³ Constitutional matters, however, are not within Congress’s control and therefore “it is not for Congress to make the final determination” as to constitutional status.³⁶⁴ The Court then stated:

If Amtrak is, by its very nature, what the Constitution regards as the Government, congressional pronouncement that it is not such can no more relieve it of its First Amendment restrictions than a similar pronouncement could exempt the Federal Bureau of Investigation from the Fourth Amendment. The Constitution constrains governmental action “by whatever instruments or in whatever modes that action may be taken.” And under whatever congressional label.³⁶⁵

Drawing on language from an earlier decision involving the Reconstruction Finance Corporation, the Court also emphasized that Congress’s choosing to call an entity “‘a corporation does not alter its characteristics so as to make it something other than what it actually is.’”³⁶⁶

Ultimately, the Court had little trouble concluding that Amtrak is what this Article terms a “public/private entity”: public for purposes of the Constitution and private for those purposes over which Congress

appointed with the advice and consent of the Senate, one chosen from a list submitted by the Railway Labor Executives Association, one selected from the governors of states, and one picked as a business representative with an interest in rail transportation; two more members were appointed independently of the Senate, from a list provided by various commuter rail authorities. Two additional members were chosen by Amtrak’s preferred stock-holders; however, because the United States government held all of Amtrak’s preferred stock, the Secretary of Transportation chose these members. The final member was the board’s president, who was elected by the other eight members. *Id.* at 385.

361 *Id.* at 383.

362 *Id.* at 392.

363 *Id.*

364 *Id.*

365 *Id.* at 392–93 (quoting *Ex parte Virginia*, 100 U.S. 339, 346–47 (1880)).

366 *Id.* at 393 (quoting *Cherry Cotton Mills, Inc. v. United States*, 327 U.S. 536, 539 (1946)).

has control.³⁶⁷ The Court first highlighted past practices and understandings of government-created and -controlled corporations as being part of the federal government and drew particular attention to their policymaking functions.³⁶⁸ It then stated that “reason itself” supports the conclusion that such corporations “are (for many purposes at least) part of the Government itself.”³⁶⁹ Indeed, if converting to the corporate form allowed the government to evade its most solemn constitutional obligations, then *Plessy v. Ferguson*³⁷⁰ could have been resurrected through Louisiana’s operation of segregated trains through a state-owned Amtrak.³⁷¹ Turning to Amtrak’s particular characteristics, the Court emphasized that Amtrak “[was] established and organized under federal law for the very purpose of pursuing federal governmental objectives, under the direction and control of federal governmental appointees”³⁷² and that it was markedly similar to “so-called independent regulatory agencies such as the Federal Communications Commission or the Securities and Exchange Commission, which are run by Presidential appointees with fixed terms.”³⁷³ All of this prompted the Court to hold that “where, as here, the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment.”³⁷⁴

367 *Id.* at 394.

368 *Id.* at 394–96. In so doing, the Court distinguished Amtrak from its prior decision in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974), where the Court held that the Consolidated Rail Corp. (Conrail) was not a federal entity, *id.* at 152, despite the federal government’s power to appoint eight of fifteen of its directors, *id.* at 165 (Douglas, J., dissenting). According to the Court, Conrail was not part of the government because the government’s voting control was designed to shift to the private shareholders when Conrail’s federal financial obligations fell below half of its total indebtedness and because “[t]he responsibilities of the federal directors are not different from those of other directors—to operate Conrail at a profit for the benefit of shareholders’—which contrasts with the public-interest ‘goals’ set forth in Amtrak’s charter.” *Lebron*, 513 U.S. at 399 (quoting *Reg’l Rail Reorganization Act Cases*, 419 U.S. at 152). The Court concluded that “Amtrak is worlds apart from Conrail” because the federal government “exerts its control not as a creditor but as a policymaker.” *Id.*

369 *Lebron*, 513 U.S. at 397.

370 163 U.S. 537 (1896).

371 *Lebron*, 513 U.S. at 397.

372 *Id.* at 398.

373 *Id.*

374 *Id.* at 400. It is interesting to speculate about whether Amtrak’s denial of advertising space to Lebron would have constituted state action under traditional state action analysis. Not surprisingly, constitutional scholars offer differing conclusions.

As constitutional scholars have recognized, the *Lebron* decision ushered in a new preliminary step in state action analysis.³⁷⁵ Indeed, rather than merely assume that an entity's "private" label is controlling, courts must first consider whether the entity could actually be the government itself. And if a court finds that the entity is the government, all of that entity's actions shall be deemed state action for purposes of constitutional law.³⁷⁶

b. *Lebron's* Application to the PCAOB

In the wake of *Lebron*, lower courts have differed as to whether the Court's holding demands application of a three-prong test or permits a more flexible analysis for determining whether a purportedly private corporation will be deemed a public entity for constitutional purposes. While the latter interpretation seems truer to *Lebron's* reasoning,³⁷⁷ the PCAOB easily qualifies as the "government itself" under either alternative.

Courts interpreting *Lebron* to require the application of a three-prong test have articulated that test as follows:

"[O]nly if (1) the government created the corporate entity by special law, (2) the government created the entity to further governmental objectives, and (3) the government retains permanent authority to appoint a majority of the directors of the corporation will the corporation be deemed a government entity for the purpose of the state action requirement."³⁷⁸

Compare Froomkin, *supra* note 30, at 570–71 (maintaining that "*Lebron* was actually an easier case than the Court made it seem" and that Amtrak's nexus with the federal government was sufficient to find state action), *with* Krotoszynski, *supra* note 327, at 324 (contending that "[u]nder the Court's traditional contacts analysis tests, Amtrak probably would not qualify as a state actor"). Justice O'Connor's dissent supports Professor Krotoszynski's position. *See Lebron*, 513 U.S. at 413 (O'Connor, J., dissenting) (finding that Amtrak was not a state actor because "nothing in this case suggests that the Government controlled, coerced, or even influenced Amtrak's decision, made pursuant to corporate policy and private business judgment, to disapprove the advertisement proposed by Lebron").

375 *See* GEOFFREY R. STONE ET AL., CONSTITUTIONAL LAW 1536–37 (4th ed. 2001); Krotoszynski, *supra* note 327, at 308.

376 *See* Krotoszynski, *supra* note 327, at 314.

377 *See id.* at 345 (noting *Lebron's* "totality of the circumstances" approach and emphasizing that "[n]o one factor or set of factors was dispositive by itself"); *see also id.* at 327 n.130 (observing that the *Lebron* majority "did not specify the precise degree of control necessary for its holding to apply").

378 *Horvath v. Westport Library Ass'n*, 362 F.3d 147, 153 (2d Cir. 2004) (quoting *Hack v. President & Fellows of Yale Coll.*, 237 F.3d 81, 84 (2d Cir. 2000) (internal quotations omitted)).

Although courts have applied the “majority of directors” prong with varying degrees of rigor,³⁷⁹ there appears to be a general requirement that all three prongs must be met for purportedly private entities to be considered a part of the government.³⁸⁰

379 Compare *Horvath*, 362 F.3d at 153 (noting that although appointees by the town constituted exactly half (and therefore not a majority) of the library’s board, the third element of the *Lebron* test was satisfied because town funding of more than ninety percent of the library’s budget demonstrated the requisite government control), with *Hack v. President & Fellows of Yale Coll.*, 237 F.3d 81, 84 (2d Cir. 2000) (expressing the belief that “*Lebron* means what it says” and holding that although the state of Connecticut created Yale University by special law for the governmental objective of higher education, Yale is not a state entity when state officials constitute only two of its nineteen trustees); and *Hall v. Am. Nat’l Red Cross*, 86 F.3d 919, 922 (9th Cir. 1996) (holding that “[b]ecause the government has not retained permanent authority to appoint the majority of the Red Cross governing board, the Red Cross is not a government actor under the *Lebron* structural analysis of government chartered corporations”).

380 This “three-prong test” of *Lebron* has an interesting lineage. The test appears to have originated in *American Bankers Mortgage Corp. v. Federal Home Loan Mortgage Corp.*, 75 F.3d 1401, 1409–11 (9th Cir. 1996). Having determined that “Freddie Mac is a corporation chartered by Congress,” the court maintained that, under *Lebron*, the “two relevant criteria for judging Freddie Mac’s status as a federal entity for Fifth Amendment purposes are the extent to which its objectives are governmental and the extent to which the government directs and controls the corporation’s pursuit of those objectives.” *Id.* at 1406. The court concluded that despite its governmental objective of encouraging home ownership, Freddie Mac was not a federal entity for constitutional purposes because its more than sixty million shares were publicly traded and fewer than one-third of its directors were appointed by the government. *Id.* at 1407–09. A few months later, another panel of the Ninth Circuit cited *American Bankers Mortgage Corp.* when applying the following “government entity” test: “[A] corporation created by special law is part of the government for the purposes of the First Amendment (1) when the corporation is created for the furtherance of governmental objectives and (2) when government retains for itself permanent authority to appoint the majority of directors of the corporation.” *Hall*, 86 F.3d at 921–22. A number of courts then recognized “government creation” as the first of three elements for the test and required that “all three *Lebron* prongs need to be met for private corporations to be considered governmental actors.” *Abu-Jamal v. Nat’l Pub. Radio, No. CIV.A. 96-0594*, 1997 WL 527349, at *4 (D.D.C. Aug. 21, 1997) (finding that despite its receipt of federal funding, NPR is not an entity of the federal government because no director of NPR is “selected, appointed or confirmed by any branch of the federal government”), *aff’d*, 159 F.3d 635 (D.C. Cir. 1998) (unpublished table decision); see also *Barrios-Velazquez v. Asociacion de Empleados del Estado Libre Asociado de P.R.*, 84 F.3d 487, 492 (1st Cir. 1996) (concluding that a financial service association is not an entity of Puerto Rico because the government does not retain the power to appoint any of the association’s directors); *Remy v. Howard Univ.*, 55 F. Supp. 2d 27, 29–30 (D.D.C. 1999) (stating that a university “eludes the third *Lebron* criterion” because the government does not appoint university trustees).

Little analysis is needed to see that the PCAOB satisfies all three prongs of this test. The PCAOB was created by Congress in Title I of the Sarbanes-Oxley Act, which also authorized the SEC to appoint each of the PCAOB's five initial members and all of its subsequent members.³⁸¹ Moreover, the objectives furthered by the PCAOB are even more quintessentially governmental than those presented in prior challenges, including *Lebron* itself. Although important governmental objectives are undoubtedly served through the operation of railways,³⁸² lending institutions for home mortgages,³⁸³ humanitarian relief organizations in war and peacetime,³⁸⁴ universities,³⁸⁵ and libraries,³⁸⁶ those objectives are also met routinely by private sector entities. In contrast, the PCAOB's statutory mission of "protect[ing] the interests of investors and further[ing] the public interest" in the preparation of reliable audit reports³⁸⁷ and its rulemaking, enforcement, and adjudicative powers have a longstanding tradition of being an exclusive province of government.³⁸⁸ The PCAOB therefore passes the "three-prong test" with flying colors.

Viewing this test as too formalistic, other courts have interpreted *Lebron* to permit a more flexible analysis in determining whether a purportedly private entity will be deemed the government for constitutional purposes.³⁸⁹ Under this contextual approach, an entity's gov-

381 See *supra* notes 163–65 and accompanying text.

382 *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 400 (1995); see also *Laverty v. Alaska R.R. Corp.*, 13 P.3d 725, 732 (Alaska 2000) (finding state action because the "statutory basis and management structure of the Alaska Railroad Corporation parallels that of Amtrak as described by the Supreme Court").

383 *Am. Bankers Mortgage Corp.*, 75 F.3d at 1407.

384 *Hall*, 86 F.3d at 921.

385 *Hack v. President and Fellows of Yale Coll.*, 237 F.3d 81, 83 (2d Cir. 2000).

386 *Horvath v. Westport Library Ass'n*, 362 F.3d 147, 153 (2d Cir. 2004).

387 See *supra* text accompanying note 157 (quoting text from Title I of Sarbanes-Oxley Act).

388 See *supra* note 5 (identifying powers that are well recognized as "governmental").

389 See, e.g., *Sotack v. Pa. Prop. & Cas. Ins. Guar. Ass'n*, 104 F. Supp. 2d 471, 479 (E.D. Pa. 2000) (finding that an association of insurers is considered a state entity for constitutional purposes); *Jersawitz v. People TV*, 71 F. Supp. 2d 1330, 1338 (N.D. Ga. 1999) (holding that People TV is an agency of the city for constitutional purposes); *Becker v. Gallaudet Univ.*, 66 F. Supp. 2d 16, 20–21 (D.D.C. 1999) (holding that despite its congressional creation and governmental objectives, Gallaudet University is not an entity of the federal government for constitutional purposes); *Wilkinson v. Legal Servs. Corp.*, 27 F. Supp. 2d 32, 45 (D.D.C. 1998) (holding that LSC is an entity of the federal government for constitutional purposes); *Clark v. County of Placer*, 923 F. Supp. 1278, 1285 (E.D. Cal. 1996) (holding that nonprofit fair association is an entity of the county for constitutional purposes). The *Wilkinson* court's finding that the LSC is a federal entity for purposes of the Constitution is particularly significant

ernmental creation and governmental objectives remain as threshold requirements. However, the analysis views a board with a majority of governmental appointees not as a requirement, but rather as one of several indicia of government control over policymaking.³⁹⁰ Other indicia of control include government funding,³⁹¹ government approval of rules or policies,³⁹² and governmental supervision.³⁹³ Thus, regardless of its board membership, an entity created by the government for a governmental objective may be considered the “government itself” if the government’s capacity for control is substantial.

The conclusion that the PCAOB is part of the federal government for constitutional purposes inevitably flows from this more flexible analysis. Indeed, the PCAOB’s governmentally appointed board is but one of several factors that make it subject to substantial governmental control, at least as a formal matter. The SEC not only appoints its five board members, but it must also approve all of the PCAOB’s rules as well as the PCAOB’s budget and annual accounting support fee.³⁹⁴ In addition, the SEC has the power to review PCAOB disciplinary proceedings and, provided cause is shown, to censure the Board

because like the PCAOB, the LSC was created by Congress pursuant to a statute specifying that it “shall not be considered a department, agency or instrumentality of the federal government.” *Wilkinson*, 27 F. Supp. 2d at 44 (quoting 42 U.S.C. § 2996d(e)(1) (2000)).

390 See, e.g., *Sotack*, 104 F. Supp. 2d at 478 (finding that because the “Commonwealth of Pennsylvania controls almost every aspect of [its] operations,” the Pennsylvania Property and Casualty Insurance Guaranty Association (PPCIGA) is a governmental entity even though “the members of the Board are typically not appointed by the government”); *Becker*, 66 F. Supp. 2d at 21 n.6 (stating that the “focus of *Lebron* and its progeny is on congressional direction and control, and although the composition of the Board of Trustees is one indicator of the extent of federal control, it should not be the sole factor”); *Clark*, 923 F. Supp. at 1283–85 (finding that the county retained “ultimate control” over the Association’s operations, even though the members of the Association’s board of directors are elected by its members).

391 *Gorman-Bakos v. Cornell Coop. Extension*, 252 F.3d 545, 552–53 (2d Cir. 2001) (concluding in dicta that a state-created and state-funded agricultural cooperative was a state actor even though only two of its ten board members were appointed by the government).

392 In *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995), the D.C. Circuit stated that the Municipal Securities Rulemaking Board’s assertion that it was a private entity was “questionable” in light of the *Lebron* decision. The court made this statement despite the fact that the government no longer plays a role in appointing MSRB members; vacant seats are filled through a nomination committee composed of private individuals, with current Board members ultimately electing the committee’s nominees. 15 U.S.C. § 78o-4(b)(1) (2000).

393 See *Sotack*, 104 F. Supp. 2d at 478 (stating that the Commissioner of Insurance “has virtually limitless authority to supervise and regulate the PPCIGA at all times”).

394 See *supra* notes 249–51, 267–68 and accompanying text.

or its members, limit their activities, or remove members from the Board.³⁹⁵ Thus, Title I of the Sarbanes-Oxley Act enables the SEC to wield substantial control over the PCAOB's policymaking. Regardless of whether a court would apply the three-prong test or a more flexible alternative, the PCAOB is a public entity—the government itself—for purposes of constitutional law.

B. *Constitutional Restraints on the PCAOB*

The application of the Court's decision in *Lebron* to the PCAOB has tremendous significance: when actions by the PCAOB are challenged in court (as they inevitably will be), judges must hold the PCAOB to the Constitution in the same way and manner as any other entity of the federal government. Although one can hardly predict the full range of constitutional issues that will arise in PCAOB litigation, it is possible to create a roadmap that highlights some principal constitutional restraints, drawn in part from litigated cases involving the SEC or other federal agencies. After providing that general roadmap, this section then focuses on two questions that are likely to be threshold issues in evaluating the constitutionality of any action by the PCAOB: whether the provision for the appointment of the PCAOB's five members complies with the Appointments Clause in Article II of the Constitution and whether congressional limitations on presidential control of PCAOB officials can be reconciled with the general doctrine of separation of powers. The goal throughout this section is not to resolve the constitutional issues, but rather to frame them for future discussion and analysis.

1. A General Roadmap for the PCAOB

The Constitution operates to restrain the PCAOB's actions in at least four respects. First, as the "government itself," the PCAOB must afford its employees constitutional rights and liberties to which they would not be entitled were they working for a truly private employer.³⁹⁶ Thus, for example, the Fifth Amendment's Due Process Clause may protect PCAOB employees from being disciplined or terminated without the opportunity for a hearing,³⁹⁷ the First Amend-

395 See *supra* notes 252–57, 259–60 and accompanying text.

396 Cf. Krotoszynski, *supra* note 327, at 310 n.44 (noting that "[c]onsistent with *Lebron*, because the government cannot cease to be the government, it may not avail itself of the same freedom of conduct that private entities enjoy in their employment decisions").

397 *Perry v. Sindermann*, 408 U.S. 593, 602–03 (1972) (holding that a professor at a state college had a due process entitlement to a hearing on his claim that he was

ment guarantee of freedom of speech may protect their ability to criticize elected officials (including the President),³⁹⁸ and the Fourth Amendment's prohibition of unreasonable searches and seizures may afford PCAOB employees a zone of limited privacy in the workplace (prohibiting, for instance, mandatory random drug testing).³⁹⁹ Of course, constitutional restraints set only a floor and the PCAOB could adopt policies and procedures that are even more employee-sensitive than those constitutionally required. But then the Fifth Amendment's Due Process Clause may require the PCAOB to comply with the policies and procedures it announces.⁴⁰⁰

Second, as the "government itself," the PCAOB must conduct inspections and investigations of accounting firms and their associated persons in a manner that is consistent with the Constitution. Thus, for example, an accountant with a reasonable fear of criminal prosecution may be able to exercise a Fifth Amendment right not to testify in a PCAOB investigation, and the PCAOB may not be able to subject her to discipline solely for her failure to cooperate.⁴⁰¹ The Constitu-

terminated for exercising his First Amendment right to criticize the college administration's policies).

398 *Rankin v. McPherson*, 483 U.S. 378, 392 (1987) (holding that a clerical employee in a county constable's office was improperly discharged for remarking, after hearing of an attempt on the life of President Reagan: "If they go for him again, I hope they get him").

399 *Nat'l Treasury Employees Union v. von Raab*, 489 U.S. 656, 678-79 (1989) (upholding suspicionless urinalysis testing for United States Customs Service employees who seek transfer or promotion to certain positions directly involved in drug interdiction or required to carry firearms, but questioning the reasonableness of such testing for other positions); *see also O'Connor v. Ortega*, 480 U.S. 709, 717 (1987) (holding that the Fourth Amendment protects individuals from unreasonable searches conducted by the government, even when the government acts in its capacity as an employer).

400 *See United States ex rel. Accardi v. Shaughnessy*, 347 U.S. 260, 266-67 (1954) (holding that public agencies must adhere to voluntarily adopted, binding policies that limit their discretion); *Wilkinson v. Legal Servs. Corp.*, 27 F. Supp. 2d 32, 62 (D.D.C. 1998) (finding that despite statutory language designating it as a "private, nonprofit corporation," the LSC is a government actor that is required to conform with the Due Process Clause and the *Accardi* doctrine in terminating its employees).

401 *See Bellis v. United States*, 417 U.S. 85, 87 (1974) (stating that "[i]t has long been established, of course, that the Fifth Amendment privilege against compulsory self-incrimination protects an individual from compelled production of his personal papers and effects as well as compelled oral testimony"); *cf. SEC v. Dunlap*, 253 F.3d 768, 774 (4th Cir. 2001) (stating that "[t]o the extent that the Injunction Order and the Contempt Order require Dunlap to produce his personal records, or to create and produce a sworn accounting regarding his personal financial transactions and assets, those orders implicate his Fifth Amendment protections . . . [and] should be modified as necessary"). *See generally Seymour Glanzer et al., The Use of the Fifth Amend-*

tion, however, would not preclude the PCAOB (or other fact finders) from drawing a negative inference from that failure to testify, except in the context of a criminal prosecution.⁴⁰² The Fifth Amendment's privilege against self-incrimination may also affect the enforceability of the "consents" to cooperation that accountants are required to sign as a condition of their employment with a registered accounting firm.⁴⁰³ Accounting firms and their associated persons may also be able to challenge other actions that could occur in the course of PCAOB investigations, such as unreasonable searches or seizures of property⁴⁰⁴ or unreasonable interferences with a firm's or individual's choice of counsel.⁴⁰⁵ The caselaw, however, is clear that accounting

ment in SEC Investigations, 41 WASH. & LEE L. REV. 895, 899-913 (1984) (discussing the scope of the Fifth Amendment in SEC investigations).

As noted previously, the PCAOB has announced its intention to honor good-faith invocations of the Fifth Amendment's self-incrimination privilege, although it has done so in a comment to a Rule rather than in a rule itself. See *supra* note 241. But PCAOB officials have emphasized that this is a *voluntary* measure that distinguishes the PCAOB from the NASD and other SROs. See Mary M. Sjoquist & Marilyn H. Weimer, *The PCAOB Takes on Enforcement*, 7 WALL STREET LAW. 1, Mar. 2004, at 1, 3-7, available at <http://www.realcorporatelawyer.com/wsl/ws10304.html>.

402 Cf. *SEC v. Colello*, 139 F.3d 674, 677 (9th Cir. 1998) (stating that "[p]arties are free to invoke the Fifth Amendment in civil cases, but the court is equally free to draw adverse inferences from their failure of proof"). See generally Marvin G. Pickholz & Allison J. Unger, *Use and Misuse of the "Adverse Inference" in SEC Civil Enforcement Actions*, 24 SEC. REG. L.J. 38, 44-53 (1996) (examining the problems raised by the use of the adverse inference in SEC civil enforcement actions).

403 Cf. *Lefkowitz v. Cunningham*, 431 U.S. 801, 808 n.5 (1977) (stating that the Fifth Amendment is violated when "refusal to waive the Fifth Amendment privilege leads automatically and without more to imposition of sanctions"). As noted previously, an accounting firm's registration is conditioned on its agreement to secure and enforce written consents from each employee as a condition of his or her employment. See *supra* notes 184-85 and accompanying text. Presumably, this means that accounting firms are required to terminate the employment of an accountant or other employee who refuses to cooperate in a PCAOB investigation.

404 See *Soldal v. Cook County*, 506 U.S. 56, 69 (1992) (holding that the Fourth Amendment's standard of "reasonableness" applies to any seizure by the government in any context); cf. *Colello v. SEC*, 908 F. Supp. 738, 752-55 (C.D. Cal. 1995) (ruling that an asset freeze by Swiss authorities at the request of the Department of Justice and the SEC violated the Fourth Amendment in that a treaty allowed seizure based on reasonable suspicion rather than probable cause), *aff'd*, 139 F.3d 674 (9th Cir. 1998); *OKC Corp. v. Williams*, 461 F. Supp. 540, 551 (N.D. Tex. 1978) (stating that if the SEC "knew or should have known at the time of the seizure's occurrence" that the informant was conducting a private party search, then the SEC violated Fourth Amendment rights).

405 Cf. *SEC v. Csapo*, 533 F.2d 7, 12 (D.C. Cir. 1976).

Since any statement made by Csapo during the course of his questioning may later be referred to the Department of Justice for future consideration

firms and their associated persons, firms, and individuals will not have a constitutional right to be notified if they become “targets” of a PCAOB investigation.⁴⁰⁶

Third, the PCAOB’s disciplinary proceedings must be conducted in accordance with due process and other constitutional requirements, and sanctions imposed by the PCAOB must not violate the Constitution. In the context of adjudications, constitutional due process generally requires four safeguards: (1) adequate notice of issues presented, (2) an opportunity to present facts and arguments either in writing or orally, (3) a decision by a neutral decisionmaker, and (4) a statement of reasons for the decision.⁴⁰⁷ Although Title I of Sarbanes-Oxley requires the PCAOB to provide each of these four safeguards in its disciplinary proceedings,⁴⁰⁸ any failure on the PCAOB’s part to do so in a particular case could constitute a constitutional violation.⁴⁰⁹ Where the PCAOB imposes civil monetary sanctions on a firm or individual, there would be at least an argument that

by a grand jury, perhaps followed by an indictment and prosecution on criminal charges, Csapo’s choice of counsel to accompany and advise him during his SEC interview is obviously a crucial one.

Id.; SEC v. Whitman, 613 F. Supp. 48, 49 (D.D.C. 1985) (stating that “[u]nless the lawyer can receive substantive guidance from an expert technician—in this case, an accountant—when he determines in his professional judgment that such assistance is essential, his client’s absolute right to counsel during the proceedings would become substantially qualified”). Although the “right to counsel” referenced in these cases is a right provided under the APA, there is some authority for the proposition that the respondents in SEC proceedings have a constitutional due process interest in their choice of counsel. See *In re Lynch, Pierce, Fenner & Smith*, [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,608, at 83,633 (ALJ 1974) (refusing an SEC request to bar a law firm’s simultaneous representation of a brokerage firm and forty-seven registered representatives, and maintaining that “a respondent in administrative proceedings normally has the right to be represented by counsel of his choice, and that an unfair denial of that right might constitute a denial of due process under the Constitution”).

406 SEC v. Jerry T. O’Brien, Inc., 467 U.S. 735, 742 (1984) (“[T]he Due Process Clause . . . is [not] offended when a federal administrative agency, without notifying a person under investigation, uses its subpoena power to gather evidence adverse to him. The Due Process Clause is not implicated under such circumstances because an administrative investigation adjudicates no legal rights.”).

407 RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 561 (4th ed. 2002).

408 See *supra* notes 218–22 and accompanying text.

409 See, e.g., *Cleveland Bd. of Educ. v. Loudermill*, 470 U.S. 532, 547–48 (1985) (noting that the denial of a hearing prior to dismissal deprived an employee of his due process right to present his account of the facts); *Gibson v. Berryhill*, 411 U.S. 564, 578 (1973) (stating that board actions that served the personal interests of private practitioners serving on an optometry board violated the due process rights of a business employing optometrists).

subsequent sanctions by the SEC or DOJ could constitute a violation of the Fifth Amendment's Double Jeopardy Clause.⁴¹⁰

Finally, the PCAOB's rulemaking may be subject to constitutional challenge, both in terms of its procedural compliance as well as its substantive content. Once again, for procedural challenges, the Due Process Clause of the Fifth Amendment is the hallmark, preventing, for example, retroactive application of announced rules.⁴¹¹ The substance of a PCAOB auditing standard could also be challenged, for example, under the First Amendment if it restricted an accounting firm's or an accountant's right to free speech or association.⁴¹²

The above roadmap merely sketches a trail of the possible types of litigation that the PCAOB may encounter because of the public nature of this otherwise private corporation. But the rulemaking, enforcement, and adjudicative experiences of the SEC and other federal agencies will undoubtedly serve as a good predictor as to what lies ahead.

2. Specific Constitutional Restraints

The Sarbanes-Oxley Act's disclaimer that "[n]o member or person employed by . . . the Board shall be deemed to be an officer or employee of . . . the Federal Government"⁴¹³ may well have convinced Congress that the structural restraints imposed by the Constitution, including the Appointments Clause and the general doctrine of separation of powers, would not apply to the PCAOB. But the Court's

410 The Double Jeopardy Clause of the Fifth Amendment protects defendants against multiple criminal prosecutions and multiple criminal punishments for the same offense. Although statutory interpretation generally determines whether a particular punishment is criminal or civil, even when a statute specifically labels a sanction as civil, the sanction may be "so punitive either in purpose or effect, as to 'transfor[m] what was clearly intended as a civil remedy into a criminal penalty.'" *SEC v. Palmisano*, 135 F.3d 860, 864 (2d Cir. 1998) (quoting *Hudson v. United States*, 522 U.S. 93, 99 (1997)). The *Hudson* test is difficult to meet and the plaintiff was not able to do so in *Palmisano*. See *id.* at 866 (holding that the SEC's civil penalty was not excessive in relation to its nonpunitive goals, "such as encouraging investor confidence, increasing the efficiency of financial markets, and promoting the stability of the securities industry").

411 *Nat'l Mining Ass'n v. Dep't of Labor*, 292 F.3d 849, 860 (D.C. Cir. 2002) (per curiam) (holding that the due process guarantee of the Constitution was violated because the rulemaking procedure was inadequate).

412 See *Blount v. SEC*, 61 F.3d 938, 944-48 (D.C. Cir. 1995) (applying the so-called "strict scrutiny" test under the First Amendment and upholding a regulation by the Municipal Securities Rulemaking Board that restricted the ability of municipal securities professionals to contribute to and solicit contributions for political campaigns of state officials from whom they solicit or obtain business).

413 See *supra* note 158 and accompanying text (quoting the statute).

decision in *Lebron* commands an opposite conclusion: as the “government itself,” the PCAOB’s composition and powers are subject to the same constitutional checks and balances that apply to any entity or official of the federal government. Thus, the PCAOB’s consistency with the Appointments Clause and the general doctrine of separation of powers are threshold issues that will affect the legality of its actions.⁴¹⁴

a. The Appointments Clause

By limiting the nature of persons eligible to appoint federal officers, the Appointments Clause functions as a structural restraint on Congress’s ability to widely disburse political power.⁴¹⁵ Its text 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 otherwise provided for; and which shall be established by Law; 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 Heads of Departments.⁴¹⁶

As the Court stated in *Buckley v. Valeo*,⁴¹⁷ the Clause requires “any appointee exercising significant authority pursuant to the laws of the United States” to be appointed in the prescribed manner.⁴¹⁸ Because

414 See *Metro. Washington Airports Auth. v. Citizens for the Abatement of Aircraft Noise, Inc.*, 501 U.S. 252, 255 (1991) (concluding that a statutory condition requiring a “Board of Review” comprised of members of Congress and having veto power over decisions of a regional airport authority violated the separation of powers doctrine); *Morrison v. Olson*, 487 U.S. 654, 660 (1988) (concluding that subpoenas issued by an Independent Counsel to three former government officials were enforceable because the independent counsel provisions of the Ethics in Government Act violated neither the Appointments Clause nor the limitations of Article III, “nor do they impermissibly interfere with the President’s authority under Article II in violation of the constitutional principle of separation of powers”); *Buckley v. Valeo*, 424 U.S. 1, 138–39 (1976) (invalidating certain powers of the Federal Election Commission because Congress cannot provide for the appointment of officers of the United States except through a procedure that “comports with” the Appointments Clause).

415 *Freytag v. Comm’r of Internal Revenue*, 501 U.S. 868, 880 (1991).

416 U.S. CONST. art. II, § 2, cl. 2. As the Court recognized in *Edmond v. United States*, “the Appointments Clause of Article II is more than a matter of ‘etiquette or protocol’; it is among the significant structural safeguards of the constitutional scheme.” 520 U.S. 651, 659 (1997) (citing *Buckley*, 424 U.S. at 125).

417 424 U.S. 1.

418 *Id.* at 126. Although it is not relevant here because the PCAOB is part of the government for purposes of the Constitution, opinions differ as to whether the Ap-

there seems little doubt that the five members of the PCAOB are exercising “significant authority pursuant to the laws of the United States,”⁴¹⁹ and because Congress in the Sarbanes-Oxley Act vested their appointment with the SEC,⁴²⁰ the primary questions in controversy will be: (1) whether the PCAOB’s board members qualify as “inferior” or “principal” officers and (2) whether SEC commissioners, acting together, qualify as “Heads of Departments.”

Let us assume for a moment that the PCAOB’s five board members are “inferior officers” such that Congress may authorize their appointment by “Heads of Departments.” One preliminary question is whether the SEC qualifies as a “Department” within the meaning of the Appointments Clause. Remarkably, the Supreme Court has never decided, and on one occasion has reserved, the question of whether an independent regulatory agency such as the SEC is a “Department.”⁴²¹ Assuming the SEC qualifies as a “Department,”⁴²² there is a

pointments Clause operates as a structural restraint on only federal entities. Compare Walter Dellinger, *The Constitutional Separation of Powers Between the President and Congress*, 63 LAW & CONTEMP. PROBS. 513, 535 (2000) (stating that “[t]he Appointments Clause simply is not implicated when significant authority is devolved upon non-federal actors”), with Jack M. Beermann, *Privatization and Political Accountability*, 28 FORDHAM URB. L.J. 1507, 1511 (2001) (observing that the Appointments Clause may be the best constitutional “candidate” for restraining the expanded privatization of federal functions and programs).

419 See *supra* Part II.A.3–5 (describing the rulemaking, investigatory, and adjudicative functions of the PCAOB). In *United States v. Maurice*, 26 F. Cas. 1211 (C.C.D. Va. 1823) (No. 15,747), Chief Justice Marshall viewed the term “officer” in the Appointments Clause to connote a person who performs duties that are continuing and that are “defined by rules prescribed by the government, and not by contract.” *Id.* at 1214.

420 See *supra* notes 160–61 and accompanying text (describing the process of appointing the PCAOB’s five board members).

421 *Freytag v. Comm’r of Internal Revenue*, 501 U.S. 868, 887 n.4 (1991).

We do not address here any question involving an appointment of an inferior officer by the head of one of the principal agencies, such as the Federal Trade Commission, the Securities and Exchange Commission, the Federal Energy Regulatory Commission, the Central Intelligence Agency, and the Federal Reserve Bank of St. Louis.

Id. *Freytag* concerned the validity of a statute that authorized the Chief Judge of the U.S. Tax Court to appoint special tax judges. The majority concluded that special tax judges were “‘inferior office[rs]’ whose appointment must conform to the Appointments Clause,” *id.* at 881, and the Tax Court was a “‘Cour[t] of Law’ within the meaning of the Appointments Clause,” *id.* at 890.

422 The validity of this assumption is very open to question. Although the Court in *Freytag* expressed doubt at the petitioner’s argument that the term “Department” in the Appointments Clause was confined to Cabinet-level departments, *id.* at 886, it agreed with the general proposition that the term must be construed narrowly to “reflec[t] our Framers’ conclusion that widely distributed appointment power sub-

substantial question as to who is its “Head.” One possibility is that the SEC is “headed” by its five Commissioners as a collegial body.⁴²³ But another possibility is that the SEC is headed by its Chairman, who is “the SEC’s top executive.”⁴²⁴ A judicial finding that the Chairman

verts democratic government,” *id.* at 885, and warned that “[g]iven 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,” *id.*

Justice Scalia’s concurring opinion also sends a mixed message. He expresses support on the one hand for the “proposition that ‘Heads of Departments’ includes the heads of all agencies immediately below the President in the organizational structure of the Executive Branch” and identifies several inferior officers (including various officers of the SEC) whose appointments would be rendered constitutionally suspect by the majority’s interpretation of the phrase. *Id.* at 918 (Scalia, J., concurring in part and concurring in the judgment). On the other hand, he specifically acknowledges that “permitting appointment of inferior officers by the [independent regulatory] agency head may not ensure the high degree of insulation from congressional control that was the purpose of the appointments scheme elaborated in the Constitution.” *Id.* at 920–21 (Scalia, J., concurring in part and concurring in the judgment).

For an analysis of *Freytag* that would support the view that the SEC qualifies as a “Department,” see Dellinger, *supra* note 418, at 543 (offering the conclusion of a then-Assistant Attorney General that “[w]e see no reason to exclude the independent regulatory agencies from the class of entities that are ‘Departments’ for Appointments Clause purposes”).

423 Section 4 of the Exchange Act creates an SEC with five Commissioners, no more than three of whom may be from one political party. 15 U.S.C. § 78d(a) (2000). The President appoints each commissioner, with the advice and consent of the Senate, and commissioners serve for five-year terms, or until their successors are nominated, confirmed, and sworn in. *Id.* There is certainly authority for the proposition that a collective body can constitute the “Head” of a department. See *Silver v. U.S. Postal Serv.*, 951 F.2d 1033, 1041 (9th Cir. 1991) (concluding that the Governors of the Postal Service could be deemed a “collective” head of a department, such that the Governors could appoint the Postmaster General and the Deputy Postmaster General as inferior officers pursuant to the Appointments Clause); see also Dellinger, *supra* note 418, at 542 (citing a 1933 opinion by Acting Attorney General Biggs, 37 Op. Att’y Gen. 227 (1933), that Congress could authorize the three-member Civil Service Commission to appoint an inferior officer).

424 See Sec. & Exch. Comm’n, *Current SEC Commissioners*, at <http://www.sec.gov/about/commissioner.shtml> (last modified Apr. 9, 2003) (stating that the President “designates one of the Commissioners as Chairman, the SEC’s top executive”); see also BIRC, *supra* note 24, at 6–7 (emphasizing the statement from website and concluding that the SEC “is governed by the Chairman”).

The development of the role of SEC Chairman is itself an interesting story that bolsters the conclusion that the SEC has a unitary “head.” Although section 4 of the Exchange Act contains no reference to a “Chairman,” until 1950 the full Commission elected a Chairman annually. See *SEC v. Blinder, Robinson & Co.*, 855 F.2d 677, 681 (10th Cir. 1988). In section 3 of the Reorganization Plan No. 10 of 1950, Congress transferred this function from the Commission to the President, who now has exclusive authority to designate a “Chairman” from among the five Commissioners. Reorg.

“heads” the SEC within the meaning of the Appointments Clause would likely mean that the appointment power for the PCAOB could not be vested with the full Commission.

Because the Appointments Clause requires all officers other than “inferior officers” to be appointed by the President with the advice and consent of the Senate, Congress’s decision to vest the power to appoint PCAOB members in the full Commission would also be unconstitutional if the PCAOB’s five members are found to be “principal” rather than “inferior” officers. As the Court acknowledged in *Morrison v. Olson*,⁴²⁵ “[t]he line between ‘inferior’ and ‘principal’ officers is one that is far from clear, and the Framers provided little guidance into where it should be drawn.”⁴²⁶ The Court provided additional guidance in *Edmond v. United States*,⁴²⁷ when it said:

Generally speaking, the term “inferior officer” connotes a relationship with some higher ranking officer or officers below the President: Whether one is an “inferior” officer depends on whether he has a superior. It is not enough that other officers may be identified who formally maintain a higher rank, or possess responsibilities of a greater magnitude. . . . Rather, in the context of a Clause designed to preserve political accountability relative to important Government assignments, we think it evident that “inferior officers” are officers whose work is *directed and supervised at some level by others* who were appointed by Presidential nomination with the advice and consent of the Senate.⁴²⁸

But with respect to the PCAOB, *Edmond* leaves much open to question. To some, the SEC’s oversight responsibilities for the PCAOB might suggest that the SEC’s Commissioners are “superior” to

Plan No. 10 of 1950, 3 C.F.R. 1006 (1951), *reprinted in* 5 U.S.C. app. at 107–08 (2000), *and in* 64 Stat. 1265 (1950). The Reorganization Plan also transferred from the full Commission to the Chairman the “executive and administrative functions of the Commission, including functions of the Commission with respect to (1) the appointment and supervision of personnel employed under the Commission, (2) the distribution of business among such personnel and among administrative units of the Commission, and (3) the use and expenditure of funds.” *Id.* It also specified that “[t]he appointment by the Chairman of the heads of major administrative units under the Commission shall be subject to the approval of the Commission.” *Id.* The Reorganization Plan therefore provides solid support for the proposition that the Chairman is the SEC’s unitary head.

425 487 U.S. 654 (1988).

426 *Id.* at 671–72 (finding that the Independent Prosecutor was an “inferior officer” because she is subject to removal by a higher Executive Branch official, namely, the Attorney General; she is “empowered by the Act to perform only certain, limited duties;” and her office is “limited in jurisdiction” and “limited in tenure”).

427 520 U.S. 651 (1997).

428 *Id.* at 662–63 (emphasis added).

PCAOB members. Yet a strong argument can be made that federal officers with fixed terms, who can be removed only when “good cause” is shown, have no superiors to whom they are answerable.⁴²⁹ It is also unclear whether the PCAOB’s work is “directed and supervised at some level” by the SEC. In some areas, such as rulemaking and adjudications, the PCAOB could properly be said to be “supervised” by the SEC, though not necessarily directed by it.⁴³⁰ Yet in other areas, such as 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. Indeed, in the words of one influential Senator, Congress gave the PCAOB “massive power, unchecked power, by design.”⁴³¹ The PCAOB’s congressionally designed independence could bolster a conclusion that PCAOB members are “principal officers” such that the Appointments Clause requires PCAOB members to be appointed by the President with the advice and consent of the Senate.

b. Separation of Powers

The constitutional doctrine of separation of powers is a self-executing, structural safeguard that enforces the Framers’ decision to “dispers[e] the federal power among three branches—the Legislative,

429 See *infra* Part III.B.2.b (discussing whether limitations on presidential removal violate separation of powers). Of course, a similar argument was rejected by a majority of the Court in *Morrison*. See *Morrison*, 487 U.S. at 706–10 (Scalia, J., dissenting) (discussing the majority’s holding). But the majority’s conclusion that the independent counsel was an “inferior officer” was based in part on the very limited duties of the special prosecutor and the fact that her tenure was of limited duration to accomplish only a single task. *Id.* at 655.

430 See *supra* Part II.A.7 (discussing SEC oversight of PCAOB rulemaking and adjudication). Although all rules promulgated by the PCAOB must be approved by the SEC before they become final, the PCAOB retains substantial discretion with respect to its rulemaking agenda and priorities. Other than its ultimate approval of the PCAOB’s budget (a power that Congress itself has over the SEC), it is difficult to see how the SEC “directs” that agenda.

431 See *supra* note 139 and accompanying text (quoting the full statement by Senator Phil Gramm). As the Court noted in *Edmond*, “[b]y requiring the joint participation of the President and the Senate, the Appointments Clause was designed to ensure public accountability for both the making of a bad appointment and the rejection of a good one.” *Edmond*, 520 U.S. at 660. It is certainly possible that Congress was intentionally dodging responsibility when it rejected the Comptroller General’s recommendation to create a public oversight board with its members appointed by the President with the advice and consent of the Senate. See *supra* notes 114, 117 and accompanying text (quoting statements by Comptroller General David Walker). This possibility is explored *infra* Part IV.A.2.

the Executive, and the Judicial.”⁴³² Embodied in constitutional provisions such as the Appointments Clause, the doctrine operates to ensure that one branch of government does not encroach on the duties and responsibilities of another branch, and that power is not aggrandized by one branch at the expense of another.⁴³³ As the Court has recognized: “The ultimate purpose of this separation of powers is to protect the liberty and security of the governed.”⁴³⁴ Thus, actions that violate the separation of powers doctrine must be declared unconstitutional, even if Congress and the President are comfortable with the manner in which the responsibility or power was redistributed.⁴³⁵

The primary separation of powers question raised by the PCAOB is whether Congress can shield that entity’s enforcement function from presidential control by placing the responsibility for oversight—including the power to remove the PCAOB’s five members—in a source other than the President. To be sure, the Supreme Court has already opined on the constitutionality of so-called independent regulatory agencies that combine rulemaking, enforcement, and adjudicative functions with members who serve for fixed terms and are not removable by the President in the absence of cause.⁴³⁶ These decisions are criticized sharply by constitutional formalists who advocate a “unitary executive” model of the presidency,⁴³⁷ but embraced by “con-

432 *Metro. Washington Airports Auth. v. Citizens for the Abatement of Aircraft Noise, Inc.*, 501 U.S. 252, 272 (1991).

433 *Buckley v. Valeo*, 424 U.S. 1, 122 (1976).

434 *Metro. Washington Airports Auth.*, 501 U.S. at 272.

435 *INS v. Chadha*, 462 U.S. 919, 942 n.13 (1983) (stating that “[t]he assent of the Executive to a bill which contains a provision contrary to the Constitution does not shield it from judicial review”).

436 *See* *Mistretta v. United States*, 488 U.S. 361, 412 (1989) (holding that the establishment of the Federal Sentencing Commission as an independent agency situated in the judicial branch did not violate separation of powers doctrine); *Wiener v. United States*, 357 U.S. 349, 355–56 (1958) (upholding implied congressional limitations on the President’s power to remove members of the War Claims Commission); *Humphrey’s Ex’r v. United States*, 295 U.S. 602, 631–32 (1935) (upholding a statutory provision that limited the President’s power to remove members of the Federal Trade Commission to a showing of cause); *cf.* *Morrison v. Olson*, 487 U.S. 654, 670–97 (1988) (upholding the constitutionality of an independent prosecutorial agency). *But see* *Freytag v. Comm’r of Internal Revenue*, 501 U.S. 868, 921 (1991) (Scalia, J., dissenting) (maintaining, for himself and Justices O’Connor, Kennedy, and Souter, that the decision in *Humphrey’s Executor* helped to create a “headless Fourth Branch” of government, and expressing the view that “adjusting the remainder of the Constitution to compensate for *Humphrey’s Executor* is a fruitless endeavor”).

437 *See* Steven G. Calabresi & Kevin H. Rhodes, *The Structural Constitution: Unitary Executive, Plural Judiciary*, 105 HARV. L. REV. 1153, 1165–68 (1992); *see also* Stephen L. Carter, *Constitutional Improprieties: Reflections on Mistretta, Morrison, and Administrative Government*, 57 U. CHI. L. REV. 357, 404–06 (1990) (questioning the constitutional

stitutional functionalists” who are more concerned with the ultimate balance of power than its strict separation.⁴³⁸ The PCAOB’s structure, however, is a substantial step removed from the type of independence from the executive garnering tacit approval in prior Court decisions: the PCAOB is itself an entity with rulemaking, enforcement, and adjudicative functions whose members serve for fixed terms and are removable only for cause *by the SEC*. A public/private entity overseen by an independent regulatory agency elevates to a whole new level conventional concerns about how the Framers’ three-branch system can be reconciled with a “headless fourth branch” of government.⁴³⁹

There are at least two reasons why the PCAOB’s structure may not pass constitutional muster under either formalist or functionalist approaches to separation of powers. First, because the President’s connection to the PCAOB is even more attenuated than his connections to independent agencies, Congress may have crossed the constitutional line by impermissibly interfering with the President’s constitutional responsibility to “take care that the laws be faithfully

status of independent agencies); Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231, 1242 (1994) (stating that “if a statute vests discretionary authority directly in an agency official (as do most regulatory statutes) rather than in the President, the Article II Vesting Clause seems to require that such discretionary authority be subject to the President’s control”) (footnote omitted); Martin H. Redish, *Legislative Courts, Administrative Agencies, and the Northern Pipeline Decision*, 1983 DUKE L.J. 197, 228 (acknowledging the practical problems that would ensue from a Supreme Court holding that independent agencies are unconstitutional, but contending that the language of the Constitution simply does not allow such agencies).

438 See Peter L. Strauss, *Formal and Functional Approaches to Separation-of-Powers Questions—A Foolish Inconsistency?*, 72 CORNELL L. REV. 488, 526 (1987) (stating that “[a]lthough formalism has its advantages and functionalism its dangers, the former is simply incapable of describing the government we have”); see also Cynthia R. Farina, *The “Chief Executive” and the Quiet Constitutional Revolution*, 49 ADMIN. L. REV. 179, 179 (1997) (discussing the development and the dangers of the “cult of the Chief Executive”); A. Michael Froomkin, *The Imperial Presidency’s New Vestments*, 88 NW. U. L. REV. 1346 *passim* (1994) (emphasizing role of Congress in structuring the executive branch and criticizing arguments for absolute presidential control). Professor Stephen Carter has speculated that without a functionalist doctrine, “there would be no independent regulatory agencies in the federal government.” Stephen L. Carter, *From Sick Chicken to Synar: The Evolution and Subsequent De-Evolution of the Separation of Powers*, 1987 BYU L. REV. 719, 727.

439 See generally Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 667–69 (1984) (arguing that the Constitution does not really separate the federal government into three distinct branches); Symposium, *The Independence of Independent Agencies*, 1988 DUKE L.J. 215 (discussing how the administrative state fits into the Constitution).

executed.”⁴⁴⁰ Indeed, with federal independent regulatory agencies, the President’s “take care” responsibilities are arguably fulfilled (at least in the minds of functionalists) because the President generally appoints members when there are vacancies, chooses the Chair, and can remove members for cause. But the President possesses none of these powers with respect to the PCAOB, and the oversight provided by the formally independent SEC cannot plausibly be expected to function as a presidential surrogate.⁴⁴¹ Accordingly, defenders of the PCAOB’s structure will have their work cut out for them in arguing that the Constitution allows the PCAOB’s five members to be even more independent from the President than the members of federal independent agencies.

The PCAOB presents a second separation of powers argument that both formalists and functionalists may find compelling. Unlike the congressional limitations on the President’s removal power that passed constitutional muster in *Humphrey’s Executor*,⁴⁴² and the more recent cases of *Morrison v. Olson*⁴⁴³ and *Mistretta v. United States*,⁴⁴⁴ with the PCAOB it could be argued that Congress has acted to “increase its own powers at the expense of the Executive Branch.”⁴⁴⁵ After all, the PCAOB owes its life to Congress and by declaring the PCAOB a failed experiment, Congress could abolish the PCAOB far more easily than it could a longstanding federal independent regulatory agency.⁴⁴⁶ Whether Congress aggrandized its power enough to trigger a constitu-

440 See Harold I. Abramson, *A Fifth Branch of Government: The Private Regulators and Their Constitutionality*, 16 HASTINGS CONST. L.Q. 165, 180–83 (1989) (emphasizing that private delegates may elude executive oversight and control); Froomkin, *supra* note 30, at 548 (stating that some federal government corporations may raise separation of powers concerns because they “weaken[] presidential . . . control over the federal administrative machinery”); Harold J. Krent, *Fragmenting the Unitary Executive: Congressional Delegations of Administrative Authority Outside the Federal Government*, 85 Nw. U. L. REV. 62, 72–80 (1990) (contending that congressional delegations to entities outside of the President’s control may prevent the President from fulfilling his constitutional responsibility for implementing policy).

441 See *Morrison*, 487 U.S. at 692 (holding that the Ethics in Government Act does not violate the separation of powers doctrine because the Attorney General, a subordinate of the President, has the statutory right to remove an independent prosecutor for cause).

442 *Humphrey’s Ex’r v. United States*, 295 U.S. 602 (1935).

443 487 U.S. at 670–97.

444 488 U.S. 361, 412 (1989).

445 *Morrison*, 487 U.S. at 694; see *Bowsher v. Synar*, 478 U.S. 714, 736 (1986) (holding that Congress could not vest executive functions in the Comptroller General, an agent subject to its control).

446 See Krent, *supra* note 440, at 67 (noting that when a recipient of delegated power is accountable to Congress rather than the President, “Congress may be able to

tional violation is an essential question that may challenge courts and scholars for years to come.

C. *The Nondelegation Doctrine and the PCAOB*

A constitutional analysis of the PCAOB is incomplete without an examination—even a brief one—of the Supreme Court’s nondelegation doctrine. In its broadest iteration, the doctrine prohibits Congress from delegating its legislative power to other institutions, whether public or private.⁴⁴⁷ Rooted in constitutional principles of separation of powers and due process, nondelegation ensures that fundamental policy choices are made by Congress, the governmental unit elected directly by, and most accountable to, the public.⁴⁴⁸ Although as currently interpreted it does not raise much constitutional doubt as to the validity of Congress’s delegation to the PCAOB, the nondelegation doctrine does provide valuable insight into congressional decisions regarding the PCAOB’s design and structure.

When applied to administrative agencies or the executive branch itself, the nondelegation doctrine prohibits only those delegations that fail to lay “down by legislative act an intelligible principle to which the person or body authorized to [take action] is directed to conform.”⁴⁴⁹ Accordingly, under the so-called “public” nondelegation doctrine, Congress may vest agencies with vast policymaking power,

keep the reigns of power without facing direct electoral accountability for the subsequent formulation of policy”).

447 STONE ET AL., *supra* note 375, at 365.

448 See DAVID SCHOENBROD, *POWER WITHOUT RESPONSIBILITY: HOW CONGRESS ABUSES THE PEOPLE THROUGH DELEGATION* 3 (1993) (bemoaning that “[w]hen the lawmakers we elect have others make the law, the people lose”). Recently, scholars have debated whether the Constitution’s text and history supports such a doctrine. See Gary Lawson, *Delegation and Original Meaning*, 88 VA. L. REV. 327, 330 (2002) (“The nondelegation doctrine . . . is the Energizer Bunny of constitutional law: No matter how many times it gets broken, beaten, or buried, it just keeps on going and going.”); Symposium, *The Phoenix Rises Again: The Nondelegation Doctrine from Constitutional and Policy Perspectives*, 20 CARDOZO L. REV. 731 (1999). Compare Eric A. Posner & Adrian Vermeule, *Interring the Nondelegation Doctrine*, 69 U. CHI. L. REV. 1721, 1722 (2002) (arguing that “there just is no constitutional nondelegation rule, nor has there ever been”), with Larry Alexander & Saikrishna Prakash, *Reports of the Nondelegation Doctrine’s Death Are Greatly Exaggerated*, 70 U. CHI. L. REV. 1297 (2003) (advancing textual and historical arguments for the nondelegation doctrine).

449 *Hampton v. United States*, 276 U.S. 394, 409 (1928); see also *Whitman v. Am. Trucking Ass’ns*, 531 U.S. 457, 472 (2001) (emphasizing that Congress must articulate an “intelligible principle” to guide an agency’s discretion when it delegates rulemaking authority to an administrative agency, but finding that the Clean Air Act did contain an “intelligible principle”).

provided it is not “standardless.”⁴⁵⁰ However, since even nebulous phrases such as “in the public interest” and “just and reasonable” qualify as standards that are “intelligible,”⁴⁵¹ it is hardly surprising that the last delegations to administrative agencies invalidated by the Supreme Court were the ones at issue in the New Deal cases of *A.L.A. Schechter Poultry Corp. v. United States*⁴⁵² and *Panama Refinery Co. v. Ryan*.⁴⁵³ Indeed, constitutional scholars rather routinely claim that “the nondelegation doctrine has all but disappeared as a constraint on the delegation of authority to administrative agencies.”⁴⁵⁴ Many find this lack of constraint troubling because administrative agencies are less accountable to the public than Congress or the President, though their discretionary power is considerable.⁴⁵⁵

Congressional delegations to private entities raise issues that are even more troubling than those stemming from congressional delegations to administrative agencies. When invalidating a New Deal statutory scheme that allowed a majority of coal miners and producers to establish standards for the entire industry, the Court had this to say about private delegations:

This is legislative delegation in its most obnoxious form; for it is not even delegation to an official or official body; presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others in the same business And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property.⁴⁵⁶

Although *Carter Coal* highlights a concern with private parties’ self-interestedness, scholars observe the Court’s wariness of an addi-

450 *Whitman*, 531 U.S. at 473 (rejecting the D.C. Circuit Court’s suggestion that an “agency can cure an unconstitutionally standardless delegation of power by declining to exercise some of that power”); see A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L.J. 17, 144–45 (2000) (stating that the “public nondelegation doctrine . . . limits Congress’s ability to make standardless delegations to administrative agencies by imposing a limited particularity requirement on delegations of congressional authority to federal agencies”).

451 See generally Randolph J. May, *The Public Interest Standard: Is It Too Indeterminate to Be Constitutional?*, 53 FED. COMM. L.J. 427, 427–52 (2001) (discussing the history and current implications of the nondelegation doctrine).

452 295 U.S. 495 (1935).

453 293 U.S. 388 (1935).

454 STONE ET AL., *supra* note 375, at 366.

455 See *supra* notes 437–38 and accompanying text.

456 *Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936). The Court also criticized a congressional delegation to private groups when it invalidated the National Recovery Act in *Schechter Poultry*. 295 U.S. at 541–42.

tional danger from private delegation: that “public sovereignty would be gifted to private parties, perhaps for populist, redistributive, or simply commercial, rent-seeking ends.”⁴⁵⁷ The greater risks posed by Congress ceding public power to private entities have prompted some scholars to speculate that federal courts may be less reluctant to invalidate private delegations, particularly if the congressional delegation involved “core” governmental powers.⁴⁵⁸ But court decisions, including by the Supreme Court, demonstrate that governmental oversight of private decisionmaking will generally insulate Congress’s private delegations from constitutional challenge.⁴⁵⁹

Interpreted as such, neither the public nor the private nondelegation doctrine holds much hope for constitutional challenge to the PCAOB. As the “government itself,” the PCAOB’s rulemaking is guided by the “in the public interest” standard that appears throughout Title I of the Sarbanes-Oxley Act.⁴⁶⁰ Thus, the PCAOB’s actions will likely pass constitutional muster under the public nondelegation doctrine. And the result is the same even if the PCAOB were evaluated under the doctrine of private nondelegation. The SEC’s ultimate authority with respect to PCAOB rulemaking and adjudication will likely shield the rules of the PCAOB from constitutional attack.

All that said, the private nondelegation doctrine appears to have functioned as a constitutional prophylactic during the critical period when Congress was structuring the PCAOB. Indeed, while the legislative record reflects a strong consensus for decisionmaking by a private, independent regulator, it also reflects a sensitivity to the importance

457 James Boyle, *A Nondelegation Doctrine for the Digital Age?*, 50 DUKE L.J. 5, 14 (2000).

458 Freeman, *supra* note 30, at 584; *see also* Froomkin, *supra* note 450, at 155 (stating that “even though the Supreme Court has not decided a case turning on the private nondelegation doctrine in sixty years, there is reason to believe that *Carter Coal*’s fundamental limit on delegations of public power to private groups retains its validity”) (footnote omitted).

459 *See* *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 398–400 (1940) (upholding a post-*Carter Coal* version of the Bituminous Coal Act that allowed private coal boards to set rules governing the sale of coal, with the board’s rulemaking subject to approval, disapproval, or modification by the government’s Bituminous Coal Commission). For cases upholding SEC delegations to private entities, *see* *Todd & Co. v. SEC*, 557 F.2d 1008, 1012–14 (3d Cir. 1977) (finding the SEC’s delegation of registration of broker-dealers to the NASD was a valid exercise of legislative authority given that the NASD’s rules and disciplinary actions “were subject to full review by the S.E.C., a wholly public body, which must base its decision on its own findings”); *R.H. Johnson & Co. v. SEC*, 198 F.2d 690, 695 (2d Cir. 1965) (same analysis); *Arthur Andersen & Co. v. SEC*, [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,374 (N.D. Ill. 1978) (*dicta*), *available at* 1978 WL 1073.

460 *See supra* note 157 and accompanying text.

of SEC oversight, particularly with respect to the PCAOB's rulemaking and adjudication.⁴⁶¹ This balance between independence and oversight was candidly acknowledged by Senator Phil Gramm in comparing his and Senator Enzi's proposal with the PCAOB: "Ours is a little more independent of the SEC; though, in the end, *to meet the constitutional test*, the SEC has to have authority over it."⁴⁶² The private nondelegation doctrine is very likely the "test" to which Senator Gramm was referring.

The SEC's authority over the PCAOB may have prevented a constitutional infirmity under the private nondelegation doctrine, but it helped to trigger another one: the SEC's formal control over the congressionally created PCAOB renders the PCAOB a public entity for purposes of the Constitution.⁴⁶³ In point of fact, Congress probably could have navigated around both doctrines. That is, an oversight board that was created by the accounting industry itself, "recognized" by the SEC, and subject to SEC oversight potentially could have steered clear of both a finding of state action and an impermissible private delegation.⁴⁶⁴ This possibility evidences a constitutional conundrum: the *more* policymaking authority delegated by Congress to private actors, the *less* likely it is that the Constitution constrains their actions.⁴⁶⁵ Scholarly criticism of the Court's state action and nondelegation jurisprudence therefore seems very well founded.

461 See *supra* notes 108–09 and accompanying text.

462 147 CONG. REC. S6335 (daily ed. July 8, 2002) (statement of Sen. Gramm) (emphasis added); see also *supra* note 138 and accompanying text (quoting Senator Gramm's statement that we "want it to be private, but we want it to have governmental powers").

463 See *supra* Part III.A.2.b.

464 See *supra* note 344 (postulating that had CAARTA been enacted in place of the Sarbanes-Oxley Act, the "public regulatory organization" recognized by the SEC would have likely been viewed much like the NYSE and the NASD).

465 See Metzger, *supra* note 30, at 1425. As Professor Metzger sees it,

[t]he inverse relationship between the extent of government involvement and private authority means that current doctrine has it nearly exactly backwards. Private actors given broader discretion in their exercise of government power are less likely to be subject to constitutional constraints than those who operate under close government supervision and whose potential for abusive action is thus more curtailed. . . . [T]he Court uses state action doctrine to police against intentional evasion and bad faith by those who are indisputably government actors, but it does not view the doctrine as a safeguard against private actors wielding government power outside of constitutional constraints.

Id. Professor Metzger develops and advocates a new constitutional analysis that focuses on whether a private entity has been structured so that it may provide persons with

IV. A POLICY CRITIQUE OF PUBLIC/PRIVATE REGULATORS

The foregoing part demonstrated the doctrinal flaw in Congress's decision to establish the PCAOB as a nonprofit corporation in the private sector: an entity that is created by the federal government, with board members appointed by the government, and accorded governmental powers and privileges to fulfill governmental objectives can only be characterized as the government for purposes of constitutional law. Thus, when it established the PCAOB, Congress created what may be more appropriately termed a "public/private regulator"—public for purposes of the rights, liberties, and structures protected by the Constitution, and private for other purposes.

This final Part shifts from doctrine to policy and contends that entities established by federal law with a combination of rulemaking, enforcement, and adjudicative power should be part of the federal government for all purposes, not merely for those purposes which the Constitution places beyond Congress's purview. It advances three arguments against the creation of such public/private regulators. First, Congress's ability to designate an entity as private circumvents the statutory obligations and protections that apply only to federal agencies. Public/private regulators are therefore less accountable to the public, their actions are less transparent, and their policymaking is less legitimate than their purely public counterparts. Circumvention of statutory obligations and protections is particularly troubling when the powers possessed by the public/private regulator mirror those of federal independent regulatory agencies. Second, the pursuit of policy through a public/private regulator significantly lessens Congress's and the President's accountability to the public because it obscures responsibility for unpopular decisions or unwise policies. Third, congressional creation of a public/private regulator produces inefficiencies that could be avoided were the regulator officially part of the federal government.

This Part concludes with a discussion of pending legislation that would create an ostensibly private "Mutual Fund Oversight Board" in response to the current industry crisis. Even if Congress opts to retain the PCAOB's status as a private, nonprofit corporation, it should break the mold from which it was cast and resist the temptation to create other public/private regulators.

adequate means of enforcing constitutional limits even though it is exempt from direct constitutional scrutiny. *See id.* at 1461–85.

A. Arguments Against Public/Private Regulators

1. Circumvented Procedures and Protections

Although a public/private regulator can have the look and feel of a federal independent regulatory agency, Congress's declaration that it is "not an agency" allows that regulator to exercise rulemaking, enforcement, and adjudicative power unfettered by administrative statutes designed to curb the discretion of unelected officials and ensure that policymaking is rational, transparent, and accountable. This circumvention of administrative procedures and protections is troubling because for most members of the regulated and protected public, the statutory checks that Congress has placed on agency power may be even more important than the constitutional checks imposed by the framers.⁴⁶⁶

Statutory checks on agency power include the judicial review, notice, and comment provisions in the APA;⁴⁶⁷ the access to records mandated by the FOIA;⁴⁶⁸ and the open-meeting requirements of the Government in the Sunshine Act.⁴⁶⁹ Each of these statutes operates to curb agency discretion by opening government "to the light of pub-

466 See *id.* at 1452 (recognizing that while constitutional rights "may assure baseline protection," the substance of those rights often "may be so thin that they offer little defense against abuse of power").

467 Administrative Procedure Act, 5 U.S.C. §§ 551–559, 701–706 (2000), affords interested parties the right to participate in an agency's rulemaking process. For rulemaking to be valid, the agency must (1) publish general notice of the proposed rule in the Federal Register, *id.* § 553(b), and (2) give interested persons "an opportunity to participate in the rule making through submission of written data, views, or arguments," *id.* § 553(c). The APA also specifies that agencies must "incorporate in the rules adopted a concise general statement of their basis and purpose" and must publish a final rule in the Federal Register at least thirty days before it becomes effective. *Id.* Its judicial review provisions include § 702, which provides that "[a] person suffering legal wrong because of agency action . . . is entitled to judicial review thereof," and § 704, which permits a federal district court to reverse final agency action that is, among other things, "arbitrary" or "capricious."

468 Freedom of Information Act, 5 U.S.C.A. § 552 (West 1996 & Supp. 2004), permits "any person" to request and obtain access to all federal agency records, subject only to nine enumerated exemptions. *Id.* § 552a. The nine exemptions permit an agency to shield from disclosure information including records pertaining to national security, internal personnel rules, matters specifically exempted from disclosure by other federal acts, trade secrets, inter-agency or intra-agency memoranda, personnel and medical files, records or information compiled for pending investigatory or enforcement purposes, matters concerning the operation of financial institutions, and geological information. *Id.* § 552b(c)(1)–(9).

469 The Government in the Sunshine Act, 5 U.S.C.A. § 552b (West Supp. 2004), requires open meetings for agencies headed by multi-member commissions or boards.

lic scrutiny.”⁴⁷⁰ The APA also curbs discretion by encouraging widespread public participation in the early stages of rulemaking, before policy decisions get “chiseled into bureaucratic stone.”⁴⁷¹ An agency that seeks widespread input and operates in full public view is more likely to produce policy that is legitimate,⁴⁷² accountable,⁴⁷³ and rational,⁴⁷⁴ and is less likely to be captured by powerful constituencies.⁴⁷⁵

To be sure, the absence of general statutory checks on administrative action does not preclude a private regulator from voluntarily adopting rules and procedures that embody the same democratic values,⁴⁷⁶ nor does it prevent Congress from conditioning its delegation of power on the regulator’s adoption of specific procedures.⁴⁷⁷ But the public’s “right to know what their government is up to”⁴⁷⁸ and the public’s right to participate in policymaking should not be dependent on a private regulator’s good will or perceived self-interest. And Con-

470 *Dep’t of the Air Force v. Rose*, 425 U.S. 352, 372 (1976) (referring to the FOIA).

471 *Alcaraz v. Block*, 746 F.2d 593, 610 (9th Cir. 1984) (quoting *Am. Fed’n of Gov’t Employees v. Block*, 655 F.2d 1153, 1157 (D.C. Cir. 1981)).

472 Because it affects compliance with the law, legitimacy is a particularly important democratic value. See TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 57 (1990) (emphasizing that legitimacy is often “believed to be the key to the success of legal authorities” and that “[i]f authorities have legitimacy they can function effectively; if they lack it it is difficult and perhaps impossible for them to regulate public behavior”).

473 See *Beermann*, *supra* note 418, at 1553–56 (discussing how the FOIA, the APA, and the Sunshine Act enhance agency accountability).

474 See *Freeman*, *supra* note 30, at 1303 (noting that “[p]rocedural regularity is also instrumental . . . [because] procedures designed to ensure public participation and individual fairness might improve the rationality of decisionmaking”).

475 See *infra* note 479 (discussing the PCAOB and the risk of capture). See generally IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 54–73 (1992) (providing an overview of capture theory and the debates surrounding it).

476 See *supra* note 191 and accompanying text (discussing notice and comment procedures and open-meeting provisions adopted voluntarily by the PCAOB). But see *supra* notes 215–16 (discussing Title I’s mandate of confidentiality which prohibits the PCAOB from sharing most investigative and disciplinary records with the public).

477 See *supra* note 168 and accompanying text (discussing Title I’s requirement that the PCAOB establish ethical rules and standards of conduct for its members and staff, including a one-year bar on practice before the PCAOB for former members and appropriate periods, not to exceed a year, for former staff); see also *supra* note 211 and accompanying text (discussing Title I’s requirement that the PCAOB adopt “fair procedures” for investigations and disciplinary proceedings).

478 *EPA v. Mink*, 410 U.S. 73, 105 (1973) (Douglas, J., dissenting) (quoting Henry Steele Cornmeger, *The Defeat of America*, N.Y. REV. OF BOOKS, Oct. 5, 1972, at 7).

gress cannot be counted on to secure those rights in the legislation that creates a public/private regulator because political compromises often eliminate democratic checks that seem too bureaucratic for an ostensibly private entity.⁴⁷⁹

Circumventing administrative procedures through a congressional declaration that a private regulator is not an entity of the federal government, and that its employees are not federal employees, has an additional downside: it generally exempts the public/private regulator from coverage under federal statutes and regulations designed to further the integrity of an agency's process and to protect agency activities from fraud, corruption, and other illegality. Examples include the prohibition on lying to a federal official,⁴⁸⁰ the requirement that certain administrative officials file detailed financial reports,⁴⁸¹ the criminalization of offers or receipts of bribes or illegal gratuities to or by public officials,⁴⁸² and the prohibition on false claims against the government.⁴⁸³ A fledgling public/private regula-

479 Consider, for example, the statutory checks that were proposed, but ultimately rejected, in the congressional design of the PCAOB: both the CAARTA and the bill sponsored by Representative LaFalce would have required an oversight board to comply with the FOIA, see *supra* note 133 and accompanying text, the LaFalce bill also would have required the board to comply with the APA, see *supra* note 134, and the Enzi-Gramm draft bill would have provided for direct federal district court review of oversight board decisions in final disciplinary proceedings, see *supra* note 132. It is ironic that the same Congress that specifically exempted the PCAOB from the FOIA, 15 U.S.C.A. § 7215(b)(5)(A) (West Supp. 2004), was concerned enough about the risk of capture to flatly prohibit the service of more than two CPAs on the Board at one time. See *supra* note 165 and accompanying text.

Securities law scholars have emphasized that a key to the PCAOB's success lies with its ability to "successfully resist[] capture by the interests of the actors it regulates." Bratton, *supra* note 2, at 1032. Professor Bratton highlights the powerful force of the accounting industry lobby and the "[e]normous rents [that] remain at stake, in respect of both auditing services and outside consulting." *Id.* at 1033. He warns that "[t]he political climate remains volatile, creating openings in which the voice of influence can effectively be raised." *Id.* If applied to the PCAOB, administrative statutes like the FOIA would go a long way toward exposing those openings and lessening the risk of capture.

480 18 U.S.C. § 1001 (2000).

481 Executive Personnel Financial Disclosure Requirements, 5 U.S.C. app. §§ 201–211 (2000).

482 18 U.S.C.A. § 201(b)–(c) (West 2000 & Supp. 2004).

483 The False Claim Act, 31 U.S.C. §§ 3729–3733 (2000). The federal statute that criminalizes the obstruction, or attempted obstruction, of a "Federal auditor in the performance of official duties," 18 U.S.C.A. § 1516, presents another example. In *United States v. Plasser American Corp.*, 57 F. Supp. 2d 140 (E.D. Pa. 1999), the defendants conceded having attempted to obstruct an audit conducted by Amtrak, but contended that it was not a federal audit within the meaning of the statute. *Id.* at 140.

tor without the might of a longstanding federal agency may be particularly vulnerable to abuses by third parties and rogue employees.

Thus, the policy reasons for applying administrative procedures and protections to public/private regulators are as strong—or perhaps even stronger—than the reasons for applying them to their purely public counterparts. And, as we shall see, the economic effects of circumvention will often be negative ones.⁴⁸⁴

2. Diminished Electoral Accountability

The pursuit of policy through a public/private regulator allows elected officials to create for themselves a troubling “win-win” scenario: Congress and the President can claim credit for the ingenuity that resulted in regulatory successes and they can avoid blame for the private regulator’s unpopular decisions or unwise policies. But that scenario is obviously a losing one for the general public—blurring the lines of responsibility reduces the effective functioning of a representative democracy. The more confusion that is created, the lesser the likelihood that voters can express accurate preferences for retaining or removing elected officials.⁴⁸⁵

The court granted the defendants’ motion to dismiss, reasoning that while the Court’s decision in *Lebron* held that Amtrak was a federal actor for purposes of the Constitution, Congress’s determination in the enabling statute that Amtrak “is not a department, agency, or instrumentality of the United States Government” was controlling for purposes of the obstructions statute. *Id.* at 140–41.

484 See *infra* Part IV.A.3. Although some might argue that statutory checks on agency power (e.g., the APA and FOIA) should apply to any entity that is created by the federal government to serve a governmental purpose, there is a strong counterargument that these statutory checks may be too restraining for a congressionally created commercial entity that is subject to private sector competition and that does not function primarily as a regulator. See Froomkin, *supra* note 30, at 557–58 (discussing the economic rationales for creating federal government corporations). Congressional decisionmaking, however, is often laden with irony: while both Amtrak and the PCAOB were designated by Congress as “not an agency or instrumentality” of the federal government, Amtrak was required to comply with the FOIA, 45 U.S.C. § 546(g) (repealed 1994), whereas PCAOB records are specifically exempt, 15 U.S.C.A. § 7215. Precisely the opposite conclusion would be assumed from the relative balance of their commercial functions and policymaking responsibilities.

485 See Beermann, *supra* note 418, at 1509 (stating that “the clarity of responsibility for an action or policy involves the degree to which the body politic can discern who in the political system is responsible for a decision, policy, or activity, so that efforts to exert political influence can be directed to the proper authorities”); see also Froomkin, *supra* note 30, at 548 (stating that “[p]lacing public funds, public monopolies, or public power, in the hands of unelected, unappointed, almost certainly unimpeachable, and largely unaccountable private parties poses a serious and largely unexplored challenge to accountable, efficient, democratic national government”).

In this regard, the PCAOB's structure raises even more concern than other congressionally created public/private regulators. As discussed previously, the three closest analogues to the PCAOB—the Legal Services Corporation (LSC), the Corporation for Public Broadcasting (CPB), and Securities Investor Protection Corporation (SIPC)—each have their members appointed by the President and confirmed by the Senate.⁴⁸⁶ Such joint participation holds both branches accountable for the “making of a bad appointment and the rejection of a good one.”⁴⁸⁷ But even this minimal accountability is not present with the PCAOB because the power to appoint its members lies with the full Commission. The SEC's role as buffer, both in the appointments process and as the PCAOB's overseer, diminishes electoral accountability.

3. Inefficiencies

Although Congress is often drawn to the private sector to reduce the costs of regulation,⁴⁸⁸ policymaking through a public/private regulator may actually serve to increase the total costs of a regulatory program. At least three factors account for why a public/private regulator may operate less efficiently than one that is purely public. First, public/private regulators may expend valuable resources in proposing and adopting customized rules and procedures where existing requirements for federal agencies would have functioned as well or better.⁴⁸⁹ Second, the workload of a purely public regulator may have to be increased substantially to allow for effective oversight of a public/private regulator. Such inefficiencies are compounded when the principal impetus for oversight is the avoidance of constitutional problems under the private nondelegation doctrine.⁴⁹⁰ Finally, substantial costs may be generated by the uncertainty surrounding the

486 See *supra* notes 306–08 and accompanying text.

487 *Edmond v. United States*, 520 U.S. 651, 660 (1997).

488 See Freeman, *supra* note 311, at 1296 (noting that, from a pragmatic perspective, “privatization is a means of improving productive efficiency: obtaining high-quality services at the lowest possible cost, thereby freeing up resources that might otherwise go to waste and allocating them elsewhere to maximize welfare”); Schwarz, *supra* note 311, at 321–22 (stating that “[i]f the goal of commercial regulation is economic efficiency, private institutions can achieve that goal more easily than public actors”).

489 See *supra* notes 168, 236 and accompanying text (discussing the PCAOB's development of rules for ethical conduct for members and staff and rules for investigation and disciplinary proceedings).

490 See *supra* note 462 and accompanying text (quoting a statement by Senator Phil Gramm suggesting that constitutional requirements may have dictated the scheme of SEC oversight for the ostensibly private PCAOB).

regulator's legal status as a public/private regulator.⁴⁹¹ Weighed against these costs are the possible gains in flexibility from the public/private regulator's ability to avoid time consuming administrative procedures like notice and comment.⁴⁹² But to increase the quality and legitimacy of its policymaking, a public/private regulator may be tempted to forgo those gains and employ such procedures voluntarily.⁴⁹³

In light of these factors, a strong case can be made that Congress could have structured the PCAOB to operate more efficiently as an official part of the federal government. One possibility, as former SEC Chairman David Breeden and other congressional witnesses recommended, would have been to infuse the SEC with additional resources to enable it to play the primary role in auditor oversight. These witnesses emphasized that the SEC's long and impressive general enforcement record rendered it unnecessary to "reinvent the wheel."⁴⁹⁴ Another possibility, in accordance with Comptroller General David Walker's favored recommendation, would have been to structure the PCAOB as an independent governmental entity housed within the SEC. As the Comptroller General emphasized, the new entity could have received "administrative support from the SEC including human resources [and] payroll," and its venue would have "facilitate[d] communication and provide[d] for maximum coordination with the SEC."⁴⁹⁵ A third possibility, also endorsed by the Comptroller General, would have been to organize the PCAOB as an independent stand-alone government agency.⁴⁹⁶

491 See Froomkin, *supra* note 30, at 548 (noting that with some government corporations, "otherwise simple civil cases become complicated, as courts struggle to determine whether an entity is a private party, a state actor, or part of the state itself"). In light of the PCAOB's rulemaking, enforcement, and disciplinary functions, an expectation of substantial litigation would certainly seem reasonable.

492 See *supra* note 484.

493 Ironically, a private entity's decision to forgo its blanket "exemption" and voluntarily adopt APA-like procedures negates the very rationale that most often justifies its creation as a private entity in the first place. Another irony is that when voluntary notice and comment procedures are adopted by a private entity, there is often a double opportunity for notice and comment because the APA may require the private entity's public overseer to provide notice and comment before approving a final rule. See *supra* note 191 and accompanying text (describing the process by which the PCAOB first proposes a rule, provides a period of notice and comment, finalizes that rule, and transmits the rule to the SEC, which provides for notice and comment before SEC approval of final rule).

494 See *supra* notes 121–22 and accompanying text.

495 See *supra* note 119 and accompanying text (quoting a letter from Comptroller General Walker to Senator Paul Sarbanes).

496 See *supra* note 119 and accompanying text.

In connection with any of these alternatives, Congress could have imbued the new SEC division or independent governmental body with *attributes* from the private sector. For instance, Congress could have provided for funding of the new SEC division or independent public body by authorizing it to collect accounting support fees from public companies.⁴⁹⁷ As governmental bodies like the FDIC and the Federal Reserve evidence, Congress certainly does not need to create a private entity to provide for private funding.⁴⁹⁸ Moreover, as it has done with the FDIC and the Federal Reserve (and more recently with the SEC itself), Congress could have exempted the independent government body from the federal civil service pay scales that could interfere with its ability to attract highly competent board members and support staff.⁴⁹⁹ Indeed, Congress could have authorized an independent government body to compensate its staff at levels even higher than the SEC and the federal bank regulators.⁵⁰⁰ Thus, if Congress

497 See *supra* notes 265–66 and accompanying text (discussing the PCAOB’s power to allocate and collect accounting support fees from public companies).

498 See *supra* notes 295, 303 and accompanying text (noting that both the FDIC and the Federal Reserve were established as entities of the federal government, though both are funded through fees paid by banks and other financial institutions rather than through general appropriations); see also Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 238–39 (2004) (noting that the registration and other fees collected by the SEC far exceed its annual appropriations).

499 For decades, pay parity between the SEC staff (who were compensated at standard civil service pay levels) and the more well-compensated staff of the federal financial institution regulators (the FDIC, the Federal Reserve, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) had been the subject of impassioned requests by SEC Chairmen in reports and testimony to Congress. See, e.g., *supra* note 97 (quoting statement by former SEC Chairman Breeden); see also 148 CONG. REC. S7352 (daily ed. July 25, 2002) (statement by Senator Paul Sarbanes) (characterizing the salary discrepancies between the SEC and the five federal bank regulatory agencies as an “intolerable situation”). Although Congress acceded to the SEC’s request in January 2002, the money to fund it did not come until seven months later as part of the appropriations in the Sarbanes-Oxley Act. See *id.* (stating that “[p]ay parity has been authorized and now must be funded; this legislation specifically provides the necessary funding”).

500 A separate question entirely is whether it would have been efficient for Congress to have used that power. Indeed, even with the post-Sarbanes-Oxley Act changes to their compensation structure, staff at the SEC are paid significantly less than their counterparts at the PCAOB. The large discrepancy in salary structure creates a reasonable fear that the PCAOB can drain the SEC of its staff most skilled in accounting matters. Of course, the SEC is used to dealing with the possibility that key staff can be lured away by the higher salaries offered by SROs like the NYSE and the NASD. But there the competition is not from a congressionally created entity.

A large disparity between SEC and PCAOB salaries also creates the possibility that the judgment of SEC staff could be influenced subconsciously by the hoped for op-

chose to situate the PCAOB in the private sector to provide its members and staff with more competitive compensation,⁵⁰¹ it did so for reasons of politics rather than law.

B. *Breaking the Mold*

Even if the PCAOB remains a private nonprofit corporation with public status only for purposes of constitutional law, Congress should break the mold from which it was cast and resist the temptation to create other public/private regulators. As the foregoing section demonstrates, not only are centaur-like creatures less accountable, legitimate, and transparent than “official” federal regulators, but the total costs of the regulatory programs they administer may actually be higher.

The concern that Congress may be tempted to employ the PCAOB as a regulatory model is not at all a hypothetical one. In response to a perceived crisis in the mutual fund industry, Senator Thomas Daschle (D-N.D.), joined by Senators Ted Kennedy (D-Mass.)

portunity of PCAOB employment later down the road. *Cf.* Mundstock, *supra* note 45, at 834–85 (noting that “accountants at the SEC leave to go to the FASB for higher-paying (non civil service) staff jobs, a possibility which must unconsciously color the Agency’s (or, at least the Office of the Chief Accountant’s) view of the Board”).

501 When the PCAOB’s Chairman was asked at a recent lecture to comment on the reasons behind Congress’s choice to organize the PCAOB as a nonprofit corporation, he offered the following explanation:

We were created as a not-for profit corporation largely so the PCAOB could pay better than the government. . . . [Members of Congress] realized that they were piling an immense responsibility on a startup, and so one of the things they figured out is you’re going to have to pay people better than the government can pay.

So we are competitive with a big accounting firm, and we pay about twice as much as the U.S. Government can pay for a similar position. That is why we are a not-for-profit.

William J. McDonough, *The Fourth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law*, 9 FORDHAM J. CORP. & FIN. L. 583, 599–600 (2004). Chairman McDonough’s explanation for the PCAOB’s private status is consistent with a statement made several months before by Charles Niemeier, who was the Chief Accountant for the SEC’s Division of Enforcement immediately before his appointment as a member of the PCAOB:

Congress had a stroke of genius when it chose to organize the board as an independent not-for-profit organization rather than as a unit of government.

The board will be able to offer a compensation structure that will attract highly qualified individuals and offer them a career path that simply is not possible for people in the government.

Robert H. Colson, *Maintaining Public Credibility: An Interview with Charles D. Niemeier*, CPA JOURNAL, Apr. 1, 2003, at 18, 19–20 (quoting statement).

and John Kerry (D-Mass.), introduced a bill that, among other things, would create an ostensibly private “Mutual Fund Oversight Board.”⁵⁰² The proposed board would possess registration, investigation, disciplinary, and rulemaking authority over mutual fund directors.⁵⁰³ Its members would be selected by the SEC⁵⁰⁴ and it would be funded by assessments against mutual fund assets or management fees.⁵⁰⁵ Senator Kerry provided the following rationale for its creation, one far more candid than any offered in Congress for the PCAOB:

The actions by the SEC show that it is incapable of protecting investors from securities fraud by mutual fund companies and will not prosecute this type of fraud to the full extent of the law. Therefore, we must take the day-to-day oversight of mutual funds away from the SEC and develop a new Mutual Fund Oversight Board to provide oversight, examination and enforcement of mutual funds. This new board will be similar to the Public Company Accounting Oversight Board developed in the Sarbanes-Oxley Act.⁵⁰⁶

Whether or not the SEC’s record of mutual fund regulation deserves such staunch criticism, the proposed cure—the creation of yet another private board to regulate yet another securities-related area—

502 The Mutual Fund Protection Act of 2003, S. 1958, 108th Congress § 201(a) (2003). In wording drawn verbatim from Title I of the Sarbanes-Oxley Act, *see supra* notes 157–58 and accompanying text, the Mutual Fund Oversight Board shall be “a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress” and “shall not be an agency or establishment of the United States Government, and, except as otherwise provided in this Act, shall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act.” S. 1958 § 201(b). Moreover, “[n]o 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 by reason of such service.” *Id.*

Following closely on the heels of the Daschle-Kennedy-Kerry bill was a bill introduced by Senator Christopher Dodd and Senator Jon Corzine, joined this time by Senator Joseph Lieberman (D-Conn.), that, among other things, would require the General Accounting Office to “conduct a study to determine the feasibility of, and assess what, if any, benefits to shareholders, mutual fund governance and mutual fund supervision would result from establishing a ‘Mutual Fund Oversight Board.’” The Mutual Fund Investor Confidence Restoration Act of 2003, S. 1971, 108th Cong. § 104 (2003). Both bills, and a number of others, were referred to the Senate Committee on Banking, Housing, and Urban Affairs, which conducted a series of “mutual fund” hearings in winter 2004. Rachel McTague, *Mutual Funds: Consumer, Investor Groups Tell Senators of Need for Improved Fund Fee Disclosure*, 36 Sec. Reg. & L. Rep. (BNA) 560, 560 (2004). The bills remain in that Committee.

503 S. 1958 §§ 202–205.

504 *Id.* § 207(d)(1).

505 *Id.* § 201(e)(3).

506 149 CONG. REC. S19,584 (daily ed. Nov. 25, 2003) (statement of Sen. Kerry).

is worse than the diagnosed problem. A public/private regulator to oversee the mutual fund industry will trample once again on democratic values and will further fragment efficient securities regulation.

If further study and consideration of the mutual fund industry demonstrates that regulatory change is warranted, then Congress has at least two preferable alternatives: it can use its power of the purse to encourage even more vigilant enforcement efforts by the SEC's Division of Investment Management or it can remove mutual fund oversight from the SEC's jurisdiction and assign it to a newly created governmental body. But for all of the reasons discussed in this Article, Congress should not replicate the PCAOB's structural flaws in a public/private regulator for the mutual fund industry.

CONCLUSION

Congress's decision to create the PCAOB as a new watchdog for the accounting profession raises tremendously important issues, both from a doctrinal perspective as well as a normative one. The principal doctrinal question is whether the PCAOB's congressionally designated status as a private corporation will insulate its actions from constitutional challenge. Supreme Court precedent answers that question with a resounding "no." The principal normative question is whether a congressionally created "private" entity with a combination of rulemaking, enforcement, and adjudicative power stands in tension with democratic values such as accountability, transparency, and legitimacy. Finding such public/private regulators in tension with those values, and few actual benefits from their designation as private, this Article urges Congress to cease playing peekaboo with public/private regulators modeled after the PCAOB.

