



To read the transcript of the oral argument in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, please [click here](#).

The Supreme Court Considers the Constitutionality of the Public Company Accounting Oversight Board

December 9, 2009

The Supreme Court heard oral arguments this past Monday in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, No. 08-861, in which the Court is expected to address the constitutionality of Congress's creation of the Public Company Accounting Oversight Board ("PCAOB") through the Sarbanes-Oxley Act of 2002 (the "Act"). The Act requires, for the first time, that auditors of U.S. public companies be subject to external and independent oversight, charging the PCAOB with this responsibility. Although it has commenced few major enforcement actions, the PCAOB has significant authority over the rules and standards applicable to auditors of public companies; it recently adopted a new auditing standard and has proposed a suite of seven new standards. The PCAOB also performs annual inspections of registered firms that regularly audit more than 100 public companies, and at least triennial inspections of all other registered firms. Specifically at issue here, the Court will consider whether Congress ran afoul of the Appointments Clause of the Constitution when it granted authority to appoint and remove Board members of the PCAOB to the Securities and Exchange Commission ("SEC") rather than the President.

BACKGROUND

In the wake of the collapses of Enron and Worldcom, Congress passed the Sarbanes-Oxley Act of 2002, which, among other reforms, created the PCAOB. The PCAOB, which consists of five members appointed by the SEC and removable by the SEC "for good cause," is charged with overseeing auditors of public companies by registering public accounting firms, establishing audit and ethics standards, conducting inspections and investigations of registered accounting firms, and disciplining violators.

The PCAOB is subject to significant oversight and control by the SEC: among other restrictions, (i) the PCAOB could commence operations only upon SEC approval of its organization and procedures, (ii) its rules are effective only upon prior approval by the SEC, (iii) its existing rules may be modified by the SEC, and (iv) its adjudications are subject to de novo review by the SEC.

Free Enterprise Fund, a non-profit public interest organization, and Beckstead and Watts LLP, an accounting firm subject to a formal investigation by the PCAOB, brought a facial challenge against the constitutionality of the PCAOB's creation in the United States District Court for the District of Columbia. Plaintiffs alleged that the Act's creation of the PCAOB violated the Appointments Clause, the separation of powers doctrine, and non-delegation principles. Plaintiffs argued that the Act did not permit adequate Presidential control of the PCAOB, and that the absence of day-to-day supervision of the PCAOB by the SEC and the for-cause limitation on the SEC's removal

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JUSTICE BREYER

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JUSTICE SCALIA

power meant the PCAOB's Board members were not inferior officers and therefore must be appointed by the President.

Defendants—the PCAOB and the United States—moved for summary judgment. Defendants argued that the PCAOB was composed of inferior officers within the meaning of the Appointments Clause, and that the SEC is a Department that may be assigned appointment power. Accordingly, Congress had constitutional authority to vest appointment and termination authority in the SEC. The district court agreed and granted Defendants' motion for summary judgment.

On appeal, the Court of Appeals for the District of Columbia Circuit affirmed the district court's finding that the PCAOB Board members were inferior officers. The court reasoned that exercise of the PCAOB's powers under the Act is subject to comprehensive control by the SEC and PCAOB Board members are accountable to and removable by the SEC. The court further determined that the Act ensures that all PCAOB functions are subject to pervasive SEC control, including approval of its annual budget and supporting fees. The President's ability to appoint and remove SEC Commissioners, and the Commissioners' ability to appoint PCAOB Board members and remove them for cause, "preserves sufficient Executive influence over the Board through the Commission so as not to render the President unable to perform his constitutional duties." *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 537 F.3d 667, 682-83 (D.C. Cir. 2008). The court similarly rejected Plaintiffs' argument that for-cause removal unconstitutionally limits the SEC's removal power because the SEC's power to change or limit PCAOB functions at will blunts the constitutional impact of for-cause removal. *Id.* at 683.

The D.C. Circuit, like the district court, also rejected Plaintiffs' contentions that, even if PCAOB Board members are inferior officers, they cannot be appointed by the SEC because the SEC is not a "Department" and the Commissioners of the SEC are not its "Head" within the meaning of Article II. The SEC is "Cabinet-like," the court explained, because "it exercises executive authority over a major aspect of government policy, and its principal officers are appointed by the President with the advice and consent of the Senate." *Id.*

In his dissenting opinion, Judge Kavanaugh of the D.C. Circuit observed that for-cause removal has long been criticized as inconsistent with the text of the Constitution. Noting that both SEC Commissioners and PCAOB Board members are only removable for cause, Judge Kavanaugh stated that the Act created a "double for-cause removal structure [that] . . . completely strips the President's removal power and . . . poses a greater restriction on the President's constitutional authority than a single for-cause provision." *Free Enter. Fund*, 537 F.3d at 701 (Kavanaugh, J., dissenting).

SUMMARY OF THE ARGUMENT

Before the Supreme Court, Plaintiffs-Petitioners argued that the Act violated the separation of powers by insulating the PCAOB from Presidential supervision and control and that the Act violated the Appointments Clause because the PCAOB members are not inferior officers and the SEC is not a Department Head. Petitioners asserted that the PCAOB is "unique among Federal regulatory agencies in that the President can neither appoint nor remove its members, nor does he have the ability to designate the chairman or review the work product, so he is stripped of the traditional means of control that he has over the traditional independent agencies."

"Well, the Board can act, and the SEC can, I suppose, retroactively veto their actions, but the SEC doesn't propose what actions the Board takes, actions which can have significant, devastating consequences for the regulated bodies."

CHIEF JUSTICE
ROBERTS

Justice Kennedy began by asking what harms or dangers other than the cost of compliance are "inherent in the power of the board unmonitored or unchecked by the SEC, to investigate?" Petitioners identified the cost of compliance and burdensome investigation beyond SEC review as among the chief hardships imposed by the Act. In clarifying the difference between a cabinet head and the SEC in response to Justice Sotomayor's questioning, Petitioners stated that an independent agency is not subject to the President's plenary control while a cabinet head is.

Justice Breyer inquired whether there is a law preventing the President from removing an SEC Commissioner without cause. Although there is no explicit prohibition on at-will removal of Commissioners, Petitioners noted that the SEC is modeled after the FTC and, under a prior case where the President was precluded from terminating membership in the War Claims Commission, one must look at the function of the agency in determining if removal is for cause or at will. Justice Breyer further pressed the Petitioners, noting that "if an executive officer appoints an inferior officer, which the executive officer can remove for cause, I can't see a Constitutional problem." Petitioners responded that the President cannot control the appointment of Board members.

Defendant-Respondent United States, represented by the Solicitor General's office, maintained that the President has constitutionally sufficient control over the SEC, and the SEC has comprehensive control over the PCAOB. As such, the President has constitutionally sufficient control over the PCAOB. Justice Scalia, however, observed that "the Chairman [of the SEC,] which is . . . the knife that the President has into the SEC, has no role in the control of the Board." According to the Government, there is no difference between the SEC's supervision of the PCAOB and the supervision of any other SEC function because the SEC could reach out and abrogate any PCAOB rules or promulgate its own rules, which includes delegating control of the PCAOB to the Chairman of the SEC. Chief Justice Roberts responded, "Well the Board can act, and the SEC can, I suppose, retroactively veto their actions, but the SEC doesn't propose what actions the Board takes, actions which can have significant, devastating consequences for the regulated bodies."

Chief Justice Roberts then posed the question, "Why did Congress set up a separate Board if it was going to be entirely controlled by the SEC?" The Government replied that Congress did not want the PCAOB to compete with the "resource-strapped" SEC for resources. Additionally, by placing the PCAOB outside of the normal civil services laws, the PCAOB may attract employees it could not attract on normal civil service salaries. In response to the Government's assertion that for-cause removal was previously approved by the Court, Chief Justice Roberts noted that the two for-cause removal provisions create "for-cause squared," leading to a "significant limitation" that prior case law did not recognize.

Defendant-Respondent PCAOB similarly argued that the SEC has pervasive authority over the Board because (i) the SEC can rescind the Board's authority, (ii) Board inspections and investigations are subject to plenary SEC control, and (iii) the SEC controls the Board's budget and salaries. Justice Scalia asked the PCAOB's counsel: "Do you know any parallel situation where there is a, supposedly, agency composed of inferior officers who have the power to tax the public unless it's overturned by somebody else?" PCAOB replied that it is not an uncommon feature, but the most critical aspect of the Act is that the judgment and decisions of the SEC control the Board: "[T]he Board can propose, but it's the SEC that decides." Justice Scalia opined, "I think if the President

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JUSTICE SCALIA

called up the FCC and said, I want you to rule this way, I think there would be an impeachment motion in Congress."

IMPLICATIONS

In *Free Enterprise Fund*, the Court has the opportunity to clarify the extent to which Congress may assign appointment and removal authority to entities other than the President that are not directly controlled by the President. If the Court sides with the Petitioners-Plaintiffs, one of the centerpieces of the Sarbanes-Oxley reforms—the creation of the PCAOB—will be sidelined. But Congress and the Obama Administration could probably remedy that result by making members of the PCAOB directly appointed by the President (and still subject to removal only for cause) or by making members of the PCAOB removable at will by the SEC, as suggested by Chief Justice Roberts.

In the long term, however, a finding of unconstitutionality would place significant limits on the ability of Congress to create additional independent agencies or executive positions that are not directly subject to significant Presidential appointment and removal power.

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