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CLIENT ALERT

Sarbanes-Oxley Survives but Supreme Court Bolsters Discretion to Remove PCAOB Members

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On June 28, 2010, the U.S. Supreme Court issued an opinion striking down as unconstitutional the provision of Sarbanes-Oxley that controls the removal procedures of members of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") . *Free Enterprise Fund v. Public Company Accounting Oversight Bd.*, 561 U.S. __ (2010), No. 08-861. In a 5-4 opinion, Chief Justice John Roberts, writing for the majority, determined that the current structure of the PCAOB failed to provide sufficient authority to the President to remove Board members who function as "inferior officers" of the United States. Sarbanes-Oxley, however, remains "fully operative as a law" according to the majority opinion.

Created by Congress as a part of the Sarbanes-Oxley Act ("SOX") in 2002, the PCAOB is a government entity that has the power to inspect, investigate, and sanction registered accounting firms in disciplinary proceedings. Registered firms include all accounting firms (foreign and domestic) that perform audits of public companies pursuant to the U.S. securities laws. The PCAOB is comprised of five board members, each appointed by the Securities and Exchange Commission, who sit for staggered five year terms, up to two terms. Board members are also highly compensated-- the Chairman currently receives a salary of $673,000, and other members $547,000. However, under SOX, the SEC was unable to remove Board members other than for "good cause." In turn, SEC Commissioners themselves are subject to removal by the President only where there is "inefficiency, neglect of duty, or malfeasance of office." (Slip Op. at 5.)

The Free Enterprise Fund and a small Nevada-based accounting firm registered with the PCAOB brought suit following an unfavorable audit of the accounting firm by the PCAOB, "seeking (among other things) a declaratory judgment that the Board is unconstitutional and injunction preventing the Board from exercising its powers." (*Id.* at 6.) The District Court and Court of Appeals agreed that "the President's influence over the [SEC] implies a constitutionally sufficient influence over the Board." (*Id.* at 7.) The Supreme Court reversed. Framing the issue as one that implicates the separation of powers, the majority noted that the President "cannot 'take Care that the laws be faithfully executed,'" as mandated by the Constitution, "if he cannot oversee the faithfulness of the officers who executed them." (*Id.* at 2.) That is, because removal of Board members may only be effected through a multi-layer system, "the President cannot remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly." (*Id.*) The Court severed the Board member removal provision of SOX, the effect of which was to create "at will" removal for the Board members. The rest of the legislation was left intact. In his dissent, Justice Breyer noted that the Board removal provision of SOX did not violate separation of powers principles, and advocated a "functional approach" to review specific statutory provisions in context. (Breyer, J. dissenting, at 6-10.) According to the dissent, this functional approach reveals that, in practice, the SEC had "full authority and virtually comprehensive control over all of the Board's functions," and thus, the President's control over the Board, via the SEC, was sufficient. (*Id.* at 14-17.)

SEC Chairman Mary L. Schapiro made an official statement on June 28, 2010, acknowledging the favorable decision which provides the SEC with an additional control over the Board: "I am pleased that the Court has determined that the Board's operations may continue and the Sarbanes-Oxley Act, with the Board's tenure restrictions excised, remains fully in effect. The

PCAOB is a cornerstone of the Sarbanes-Oxley Act and serves a critical role in promoting investor protection and audit quality." Ms. Schapiro will likely now work to promptly fill the three available seats on the Board, which had remained open until *Free Enterprise Fund* was resolved.

Another practical effect of the ruling lies with the further expansion of the power of the SEC, and the Commissioners in particular. The ability to remove Board members at will presents an opportunity for Commissioners to keep Board members in line with the SEC's current enforcement policies, beyond the course of a presidential administration. In addition, because the Court severed the now unconstitutional provision from SOX, the SEC retains its ability to control or alter the PCAOB's rule-making and sanction authority. 15 U.S.C. §§ 7217(b)-(c). And, if the proposed financial regulation bill passes, the Board's authority will expand to include accounting firms that perform audits on registered broker dealers -- whether or not the firm has public clients.

Click here for a copy of the Court's opinion.

Click here for a copy of the SEC press release.

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