Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400
FAX (916) 795-2842

February 14, 2005

Office of the Secretary
Public Company Accounting
Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Rulemaking Docket Matter 017

Attn: Office of the Secretary

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the nation's largest public pension system with approximately $182 billion in assets and more than 1.4 million members.

CalPERS is pleased to provide the Board with comment regarding its proposed ethics and independence rules. We offer our compliments to the PCAOB for proposing rules aimed at increasing and maintaining the independence and objectivity of public accounting firms. As a significant institutional investor with a very long-term investment horizon, CalPERS has a vested interest in maintaining the integrity and efficiency of the capital markets. For this reason, we have been strong supporters of reform in the role of public accounting firms even prior to the devastating financial market crisis sparked by the collapse of Enron in 2001.

Investor's reliance upon and trust in the integrity of public financial statements should not be taken for granted. CalPERS focused on the independence and objectivity of the external auditor as a major component of its Financial Market Reform objectives for a number of reasons. Chief among these reasons is the conviction that when audit firms perform non-audit consulting work for their audit clients it has the very real potential to impair their objectivity and affect independence. CalPERS pointed to two very significant concerns related to this situation in its early evaluation of proposed reform in the Sarbanes-Oxley Act. First, these services may place the auditor in the position of providing an audit opinion on its own consulting advice, a clear conflict of interest. Second, any consulting work unrelated to the audit that the audit firms perform, or even attempt to perform for existing audit clients, places the auditor in the position of maintaining a special client relationship with the company.

Part of CalPERS' concern over the provision of non-audit services stems from a belief that, generally speaking, Audit Committees had done a poor job in fulfilling their oversight role in ensuring auditor independence. Take for example the fact that existing industry guidelines already prohibit firms from performing consulting work that would result in the firm auditing its own advice. Despite these guidelines and additional emphasis from the Sarbanes-Oxley Act, investors still are faced with, and harmed by, situations in which firms are allowed to perform tax consulting and advice including very aggressive tax avoidance schemes.

In another example, also referenced by the Board in the proposed rule, it is apparent that the audit industry intentionally adopted a very liberal interpretation of the Securities and Exchange Commission's (SEC) rule prohibiting contingency fee arrangements. This ultimately prompted a clarification from the Chief Accountant of the SEC.

These types of situations have served to further raise investor's concern over the role of the external auditor and the responsibility of the Audit Committee to ensure their independence. The PCAOB has appropriately placed additional emphasis on the role of the Audit Committee in ensuring the independence of the auditor. CalPERS agrees with this emphasis and strongly supports the proposal; however, CalPERS also suggests having greater transparency in the decisions made by the Audit Committee to permit greater investor oversight as well. We believe the combination of Audit Committee responsibility (and flexibility to approve certain non-audit work) with greater transparency for shareowners when Audit Committees approve this work will serve the capital markets well.

CalPERS' response to the specific questions raised by the PCAOB is attached. CalPERS is pleased to offer strong support for the Board's proposed rule. We also offer several suggestions to clarify and strengthen the rule. The most prominent of these suggestions are related to the scope of the rule in the prohibition on audit firms providing personal tax services and the disclosure of Audit Committee pre-approval justification.

Personal Tax Services

CalPERS is supportive of the provisions in the proposed rule that would effectively prohibit audit firms from providing tax services to officers in a financial oversight reporting role. However, we believe the scope of the current proposal is too narrow in this regard and should be expanded to include a broader definition of management. We would recommend the broader definition of management to include any senior officer who has "significant influence" over the financial statements. For example, this may include the Vice President of Sales as someone who is in an oversight role and has "significant influence" over the financial statements. Further, we believe it is also appropriate to include Audit Committee members within the scope of this provision as it appears to also create a clear conflict of interest if firms are providing tax services to these individuals while engaged as the company's external auditor.

Audit Committee Pre-Approval

CalPERS is strongly supportive of the provisions in the proposed rule that place additional emphasis on the Audit Committee to ensure the independence of the external auditor. In particular, we feel it is imperative to require any audit firm seeking pre-approval to:

- Provide the Audit Committee detailed documentation of the nature and scope of the proposed tax service including the audit engagement letter and any side letters or other related agreements;

- Discuss with the Audit Committee the potential effects on the firm's independence that could be caused by the firm's performance of the proposed tax service; and

- Document the firm's discussion with the Audit Committee.

To further strengthen this provision and to permit investor oversight, CalPERS suggests that the PCAOB require disclosure of the justification for any non-audit work approved by the Committee. Again, we are supportive of the flexibility the proposal will provide the Audit Committee to approve some non-audit work. Further, we are strongly supportive of the provisions that will ensure that Audit Committees will have a robust foundation of information upon which to make these determinations. However, current disclosure of audit services (in the proxy) is not adequately granular to permit investors to truly evaluate the types of services that Audit Committees approve. CalPERS proposes that the PCAOB require this disclosure in an effort to permit investors greater ability to evaluate Audit Committee performance by transparency of the justifications for their decisions.

Appendix A provides a response to the specific questions posed by the PCAOB in its release. We would be pleased to discuss our responses with the Board and/or its staff.

Once again, CalPERS compliments the PCAOB on its efforts and we appreciate the opportunity to provide input into your rule making process. If you have any questions regarding our comments, please contact Ted White, Portfolio Manager, Corporate Governance at (916) 795-2731.

Sincerely,

Mark Anson
Chief Investment Officer

Rulemaking Docket Matter 017

Appendix A

Responses to Questions

Question 1 on Pages 16 and 17. Provision of Routine Tax Return Preparation and Tax Compliance, General Tax Planning and Advice, International Tax Services and Employee Tax Services.

"Like international assignment tax services, registered firms' provision of personal tax services for employees of their audit clients has not raised significant independence concerns, except for personal tax services for officers who function in a financial reporting oversight role at the audit client. Accordingly, the Board's proposed rules to restrict auditors from providing personal tax services to audit client employees are limited to those officers who serve in a financial reporting oversight role.

The Board invites comment on this discussion. In particular, the Board seeks comment on whether any of the types of services discussed in this section of the release raise independence concerns the Board has not identified. The Board also seeks comment on whether there are other types of tax services that could appropriately be included in this discussion."

Response

Tax services such as developing international tax strategies, international inter-company pricing agreements, result in an auditor having to audit their own work. Accordingly, we believe such services should be prohibited. In addition, we do not believe expatriate tax return work, which has recently resulted in violations of existing SEC independence rules by international accounting firms, contribute in any meaningful way to the quality of the audit.

Question 2 on Page 19. **Proposed Rule 3502** Regarding Responsibility Not to Cause Violations.

"As discussed in Section B1, Rule 3520 requires registered firms to be independent of their audit clients. When an associated person negligently causes the registered firm to not be independent, Rule 3502 would allow the Board to discipline that associated person for that action.

The Board invites comments on any aspect of proposed Rule 3502 and encourages commenters to consider certain issues in particular. First, are there categories of circumstances encompassed by the rule as proposed that should not be encompassed by the rule for some reason? Second, in a circumstance in which a firm is found to have

committed a violation that requires that the firm knowingly or recklessly engaged in the misconduct, would it be appropriate to find a Rule 3502 violation by an associated person who negligently contributed to the violation?"

Response

There should be a finding against an individual in a case where it is found a firm knowingly or recklessly engaged in misconduct. We note that disregard of the SEC independence rules is considered a violation that can result in a Rule 102(e) sanction by the Commission.

We do not believe any actions should be exempted from the proposed rule at this time.

Question 3 on Page 20. **Proposed Rule 3520** Regarding Fundamental Ethical Obligation of Registered Public Accounting Firm to be Independent Throughout the Audit and Professional Engagement Period.

"The Board invites comments on any aspect of proposed Rule 3520, and encourages commenters to consider one issue in particular. Would the scope of the ethical obligation described above impose any practical difficulties? Commenters who foresee any such difficulties are encouraged to describe in detail any ways in which the proposed scope of the rule would cause or require auditors to follow any different practices and procedures than they currently follow to comply with existing legal requirements."

Response

We believe the proposed rule is consistent with the SEC rule, Regulations S-X, 210.2-01, adopted in November 2000 which became effective in 2001. We would also incorporate into the rule the language from the AICPA's code of conduct which states that an auditor should avoid any subordination of their judgment.[1]

Accordingly, provided a registered public accounting firm and its staff have complied with the rules of the SEC, there should not be any practical difficulties in implementing the rule proposed by the PCAOB.

Question 4 on Page 23. **Proposed Rule 3521**. Contingent Fees.

"Accordingly, the exception would permit fees that are contingent on "the amount [being] fixed by courts or other public authorities and not dependent on a finding or result."[2/]

[1] Principles of Professional Conduct. ET Section 55. AICPA. Paragraph.02 states: "Regardless of service or capacity, members should protect the integrity of their work, maintain objectivity and avoid any subordination of their judgment."

[2/] Proposed Rule 3501(c)(i)(2).

Although the approval of a bankruptcy court is the most obvious contingency that may be imposed on auditors' fees from audit clients, the proposed exception extends to other "courts or other public authorities." The Board invites comment as to whether there are courts or other public authorities that fix fees that are not dependent on a finding or result, other than bankruptcy courts, such that the term "courts or other public authorities" is necessary."

Response

We believe an auditor should not be permitted to provide services or products for contingent fees or commissions with the exception of fees set by courts or other public authorities. Such fees should not be permitted either through direct or indirect payments.

We are not aware of "other public authorities" that would fall within the language of the proposed rule. Accordingly, if the PCOAB continues to use this language, which we believe should be deleted, we would urge it to clarify what other public authorities it is referring to.

Question 5 on Page 29. **Proposed Rule 3522** Aggressive Tax Positions and Listed Transactions.

"Although the proposed rule does not address situations in which a transaction planned, or opined on, by the auditor becomes listed after it is executed, the Board seeks comment on whether the rule should address the possible impairment of an auditor's independence in such situations. The Board also seeks comment, more generally, on whether proposed Rule 3522(a) adequately describes a class of transactions that carry an unacceptable risk of impairing an auditor's independence."

Response

We believe certain tax services such as the preparation of expatriate tax returns, tax planning and providing tax opinions do not enhance the quality of the audit or the independence of the registered public accounting firm.

We believe an auditor's independence would become impaired if a listed transaction it planned or advised on was listed subsequent to its advice or opinion. That is because we believe the independence is impaired as the firm would be placed in the position of auditing its own work. Accordingly, we believe tax planning and strategy services, in addition to developing or marketing tax shelters, listed or confidential transactions should be prohibited to avoid unnecessary conflicts and complexity in the rules.

26 C.F.R. defines listed and confidential transactions as follows:

"(2) Listed transactions. A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue

Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.

(3) Confidential transactions--(i) In general. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee.

(ii) Conditions of confidentiality. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer. A claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

(iii) Minimum fee. For purposes of this paragraph (b)(3), the minimum fee is:

(A) $250,000 for a transaction if the taxpayer is a corporation.

(B) $50,000 for all other transactions unless the taxpayer is a partnership or trust, all of the owners or beneficiaries of which are corporations (looking through any partners or beneficiaries that are themselves partnerships or trusts), in which case the minimum fee is $250,000.

(iv) Determination of minimum fee. For purposes of this paragraph (b)(3), a minimum fee includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction. These fees include consideration in whatever form paid, whether in cash or in kind, for services to analyze the transaction (whether or not related to the tax consequences of the transaction), for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. For purposes of this paragraph (b)(3), a taxpayer also is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement. A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property."

We believe the minimum fee amount of $250,000 in the above regulations should be eliminated such that regardless of the fee amount, a listed transaction would be prohibited. We believe an auditor providing services in connection with a listed transaction, regardless of the fee amount may impair independence.

We believe the final rule should incorporate the following language in the 26 C.F.R 1.6662-4(g) including defining what constitutes a tax shelter:

"(2) Tax shelter--(i) In general. For purposes of section 6662(d), the term ``tax shelter'' means--

(A) A partnership or other entity (such as a corporation or trust),

(B) An investment plan or arrangement, or

(C) Any other plan or arrangement, if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax.

The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

(ii) Principal purpose. The principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose."

Question 6 on Page 31. Proposed Rule 3522 (b) Confidential Tax Positions.

"The Board seeks comment on whether confidential transactions should be treated as *per se* impairments of a registered public accounting firm's independence from an audit client. More broadly, the Board also seeks comment on whether other provisions of the Treasury's regulation on reportable transactions – that is, other than the provisions on listed and confidential transactions included here – should be incorporated by reference in the Board's rules on tax-oriented transactions that impair independence."

Response

We note 26 C.F.R. 1.6011-4 includes six categories of transactions. These include (1) listed transactions, (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference, and (6) transactions involving a brief asset holding period. A transactions with contractual protection is a transaction for which the taxpayer or a related party (as described in section 267(b) or 707(b)) has the right to a full or partial refund of fees (as described in paragraph (b)(4)(ii) of this section) if all or part of the intended tax consequences from the transaction are not sustained.

A transaction with contractual protection also is a transaction for which fees (as described in paragraph (b)(4)(ii) of this section) are contingent on the taxpayer's realization of tax benefits from the transaction. We believe transactions with contractual

protection result in an auditor who has advised on such a transaction, and the company who has paid a fee for such services, as having a mutual interest, in addition to requiring the auditor to audit their own tax advice and work. Accordingly, such services should be specifically prohibited. The Board may also consider these transactions prohibited by the nature of the contingent fee.

Question 7 in Footnote 70 on page 34. Proposed Rule 3522 (c) Aggressive Tax Positions.

"Cf. 26 C.F.R. § 1.6664-4(f)(2)(i)(B)(1) (incorporating by reference methodology set forth in 26 C.F.R. 1.6662-4(d)(3)(ii) for analysis of whether a tax treatment has "substantial authority" or, in the case of tax shelters, is "more likely than not" the proper treatment, for purposes of determining whether a penalty may be due on a substantial understatement of income tax). The Board seeks comment on whether the analysis described in the Treasury's regulations provides useful guidance on the application of proposed Rule 3522(c)."

Response

Regulations 1.6662-4(d) discusses substantial authority as follows:

"The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in Sec. 1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied."

We believe the appropriate standard to be applied to Listed, Confidential, Aggressive and Contractual protection transactions is the "more likely than not" standard rather than the less stringent "substantial authority" standard. We believe transactions that do not meet the "more likely than not" standard for prevailing with the taxing authorities and courts, result in the auditor having to advocate for a transaction they have advised or opined on when there is less than a 50 percent chance of prevailing. This creates a very significant conflict for an auditor as the applicable criteria for determining the proper accounting for a tax position in financial statements is the "probable" standard included in Statement of Financial Standard No. 5.

Question 8 on Page 35. **Proposed Rule 3522 (c)** Aggressive Tax Positions.

"The Board invites comments on any aspect of proposed Rule 3522(c) and encourages commenters to consider certain issues in particular. First, is the term "initially recommended by the registered public accounting firm or another tax advisor" sufficiently clear? Is there a better way to describe aggressive tax transactions, strategies, and

products that a registered public accounting firm ought not to sell to an audit client? Second, does the "more likely than not" standard draw the right line between aggressive tax strategies and products that a registered public accounting firm ought not to plan, or opine on the tax treatment of, for an audit client and routine tax planning and advice? In addition, the Board invites comments on whether the Board also should require a registered public accounting firm to obtain a third-party tax opinion in support of the tax treatment, if the potential effect of the treatment could have a material effect on the audit client's financial statements."

Response

As previously noted, we believe auditors should be prohibited from providing tax services other than tax compliance. However, should the PCOAB determine to permit such services in some circumstances, it should be narrow and the Audit Committee should be required to disclose its justification for approving the work. We believe:

- The more likely than not standard is an appropriate standard.
- The PCAOB should clarify what is meant by "initially recommended."
- This rule should prohibit an auditor from providing a tax opinion on a transaction the auditor must then examine in the course of the audit.

Question 9 on Page 37. **Rule 3523** Tax Services for Senior Officers of Audit Client.

"The Board invites comments on any aspect of proposed Rule 3523 and encourages commenters to consider certain issues in particular. Are there other classes of employees to whom an accounting firm should not offer tax services? Would a registered public accounting firm's independence be perceived to be impaired if it offered tax services to members of an audit client's Audit Committee, or to other members of the audit client's board of directors?"

Response

As previously stated, we believe an auditor should not provide any services to the Section 16(b) officers, including any officers in a financial reporting oversight role and any directors on the Audit Committee. We also believe senior officers in a financial reporting oversight role should be expanded to include the officer with key responsibility for sales, because misstated sales are often the cause of misstated financial statements.

Question 10 on Pages 42 and 43. Rule 3524 Audit Committee Pre-approval of Certain Tax Services.

"The Board welcomes comment on any aspect of proposed Rule 3524 and encourages comment on certain matters in particular. Should additional information or documentation that is not described in proposed Rule 3524 be provided to Audit Committees in the pre-approval process? In addition to the communications required by

proposed Rule 3524, should auditors be required to have additional communications with the Audit Committee with regard to the tax advice that has been provided to the audit client?"

Response

The SEC has defined the test for determining an auditor's independence as a reasonable investor with knowledge of all relevant facts and circumstances. The Audit Committee is the investors' elected representative and accordingly, is put in the position of assessing whether an auditor's independence is impaired and accordingly should not be pre-approved. In making that judgment, we believe the Audit Committee should be provided with all the relevant facts and circumstances. To meet that test, we believe it is imperative the Audit Committee obtain copies of the actual engagement letters. We believe the failure of auditors to disclose circumstances to Audit Committees such as contingent fees support this requirement.