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

PCAOB Rulemaking Docket Matter No. 005,
Proposed Rules on Investigations and Adjudications

Dear Sir or Madam:

Ernst & Young is pleased to submit comments on the Public Company Accounting Oversight Board's proposed rules establishing procedures for the investigation and discipline of registered public accounting firms and associated persons of such firms.

We believe that for the most part the Board's proposed procedures will provide fair and reasonable mechanisms for investigating potential violations of relevant laws and regulations and will allow the Board to carry out its statutory mandate. Most of the proposed rules were adapted from similar rules of the Securities and Exchange Commission or the National Association of Securities Dealers. Those organizations have developed and refined their procedural requirements over the last several decades, and accordingly they provide an appropriate basis for the PCAOB's rulemaking. We have only a few comments on the proposals.

1. **Proposed Rule 1001(h)(i) (Definition of "Hearing Officer"):** The proposal would allow an individual Board member or "any other person duly authorized by the Board" to serve as a "hearing officer" for a PCAOB adjudication. We suggest that the rules place certain limitations on who can serve as a hearing officer, such as requiring that the person have demonstrated a lack of bias and impartiality as to the subject matter of the hearing.

2. **Proposed Rule 5100 (Informal Inquiries):** The Board should be required to close an informal inquiry within a specific time period (e.g., 90 days). In addition, a firm or its associated person should be given prompt notice of the commencement of either an informal or formal investigation.

3. **Proposed Rules 5102 (Testimony of Registered Public Accounting Firms and Associated Persons in Investigations) and 5109 (Rights of Witnesses in Inquiries and Investigations)**: Subparagraph 5102(c)(3) lists the persons who are permitted to be present when the PCAOB staff takes investigative testimony. It allows the person being examined to be represented by legal counsel, as does Rule 5109(b). Rule 5102(c)(3) also states that the Board will allow "such other persons as the Board, or the staff of the Board designated in the order of formal investigation, determine are appropriate to permit to be present." Thus, although the Board or its staff might determine it "appropriate" to allow other persons also to be present during testimony, it suggests that the normal course would be not to do so.

   We are concerned that the Board does not intend to permit lawyers who are representing accountants during testimony to be accompanied by accounting experts to assist the lawyer in a consulting capacity. Board investigations will frequently involve complex accounting and auditing issues, and most lawyers need assistance from accounting experts on such matters. Based on our experience in SEC investigations and private litigation, the presence of such accounting consultants during testimony of an accounting witness not only helps ensure that the witness' rights are fully protected but also helps produce a better and more accurate investigative record.

   Indeed, a court has recognized that expert accounting consultants are so important that it effectively *required* the SEC to allow such consultants to be present during testimony. In *SEC v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985), an accountant called as a witness in an SEC investigation sought to have another accountant present during the testimony to assist the witness's counsel in representing the witness. The court refused to enforce an SEC subpoena to the extent that the Commission's Rules of Practice excluded the accounting consultant. The court stated that, given "the extraordinary complexity of matters raised in agency investigations in this modern day, counsel trained only in the law, no matter how skillful, may on occasion be less than fully equipped to serve the client in agency proceedings." *Id*. at 49. The court therefore concluded that "it would be arbitrary and capricious to systematically deny a witness's counsel the assistance of a technical expert by his side." *Id.* at 50.

   In addition, we believe that the rule should explicitly permit counsel to represent both the firm and an associated person of the firm.

   Finally, we are concerned by the breadth of Rule 5102(a), which requires the testimony of "any person associated with a registered public accounting firm" relating to "any matter that the Board considers relevant or material to an investigation." A similarly broad requirement relates to production of documents under Rule 5104. By their terms these rules could require production of documents and testimony from members of the Office of the General Counsel, from attorneys as well as from accountants who assist attorneys in handling investigations and litigations. General Counsel personnel could, of course, assert a claim of privilege under Rule 5106, but the process for asserting a privilege is extremely burdensome (requiring a description of every document and every oral communication for which privilege is being asserted). We expect that as to both rules – Rules 5102 and 5104 – the Board would follow the traditional approach of the

SEC and other agencies and not seek testimony or documents from members of the firm's General Counsel's Office.

4. **Proposed Rule 5103(b) (Time and Manner of Production of Workpapers and Other Documents in Investigations):** This proposed rule states that "[u]nless an accounting board demand expressly requests or permits the production of copies, original documents shall be produced." It further states that "[u]nless an accounting board demand expressly requests or permits printed copies of electronic documents, documents that exist in electronic form shall be produced in that form." We suggest that the rule instead provide that copies of documents, including copies of electronic documents, may be produced unless the Board's demand expressly states otherwise. We have handled a great many SEC and private litigation subpoenas, and have found that production of original workpapers can often be disruptive to ongoing audit engagements. Particularly in view of Rule 5104, which would allow the Board or the Board's staff to examine the original records "to verify the accuracy of any documents or information supplied in the course of an informal inquiry or formal investigation," the requirement that originals rather than copies of documents seems unnecessary.

5. **Proposed Rule 5108 (Confidentiality of Investigatory Records):** This rule makes the record of the investigation confidential, including testimony and responses to requests for information and other materials prepared for the Board or the PCAOB staff in connection with informal and formal investigations. This protection presumably covers the "Statements of Position" (which are similar to Wells Submissions under SEC rules) as provided under Proposed Rule 5109(d), although the rule might make this coverage explicit.

   More significantly, as the Board discusses in a "Note" to Proposed Rule 5108, the relevant statutory provision, Section 105(b)(5) of the Sarbanes-Oxley Act, states that the documents described in Rule 5108 are "confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any federal or State court or administrative agency, and shall be exempt from disclosure, in the hands of an agency or establishment of the federal government, under the Freedom of Information Act (5 U.S.C. 552a) or otherwise, unless and until presented in connection with a public proceeding or released in accordance with subsection (c)" of Section 105 of the Act. It is not clear why the Proposed Rule refers to the "confidentiality" of the investigative record but not to the "privileged" nature of the record, as set forth in the statute. As the Board is presumably aware, SEC investigative transcripts and other elements of an investigative record are eagerly sought and usually obtained by plaintiffs' attorneys who seek to "piggyback" private securities lawsuits on SEC enforcement actions. Accordingly, the language of the rule should track the wording of the statute.

   Finally, the rules should authorize the Board's staff to enter into confidentiality agreements to supplement the Act's confidentiality protections. Although courts are divided on the issue, at least two recent cases hold that entering into certain confidentiality agreements with the SEC protects against a waiver of work-product

protection. *See Saito v. McKesson HBOC, Inc.,* 2002 WL 31657622 (Del. Ch. Nov. 13, 2002) and *McKesson HBOC, Inc. v. Adler*, 562 S.E.2d 809 (Ga. App. 2002).

6. **Proposed Rule 5109 (Rights of Witnesses in Inquiries and Investigations):** As noted above, Section (d) of this Proposed Rule would permit Wells-type submissions. It states that the Board's staff "in its discretion" may advise persons of the nature of the investigation and the potential violations that might be the basis of a Board disciplinary proceeding. We recommend that the rule be revised to state that such a Wells-type notice would be given to firms and associated persons absent extraordinary circumstances. The Wells process has proven to be an effective means for the SEC Commissioners to weigh the pros and cons of enforcement actions recommended by its Division of Enforcement, and we believe that it would be similarly useful to the members of the PCAOB. Wells notices are almost always given in SEC enforcement proceedings, and the same process should be followed by the PCAOB.

   In addition, there should be a provision for prompt availability of a witness's transcripts and for the Board's staff to provide copies to the witness of all exhibits introduced in the witness's testimony. The time period for the Statement of Position should not begin to run until the transcripts and exhibits are provided. Finally, there should be some assurance of sufficient time for preparation of the Statement of Position.

7. **Proposed Rule 5110(a) (Non-Cooperation with an Investigation):** Proposed rule 5110(a) provides that the Board may institute a disciplinary proceeding against a registered public accounting firm or an associated person of such a firm for failure to cooperate with a Board investigation. One of the bases for such a proceeding is where a witness "may have given testimony that is false or misleading or that omits material information." We recommend that the Board delete the phrase "or that omits material information."

   Whether a witness provides all "material information" during his or her testimony depends on the questions that are asked. No witness can be expected to determine, at the conclusion of the staff's questioning, whether there are any questions that should or might have been asked by the examiner but were not. Neither the SEC's Rules of Practice nor the NASD's rules have such a requirement. Witnesses should of course be required to answer questions truthfully and completely. If they do not do so, the answer could be deemed "false or misleading" and would be prohibited by those words in the proposed rule. Accordingly, the phrase "or that omits material information" is unnecessary and confusing. Moreover, under the Board's approach, witnesses in Board investigations would likely feel compelled to volunteer information that might not actually be of interest to the Board simply to ensure that the Board would not later second-guess them as to whether they have "omitted material information," a result which would be wasteful and inefficient.

8. **Proposed Rule 5200 (Commencement of Disciplinary Proceedings):** Section (a) of this Proposed Rule sets forth the grounds for commencement of disciplinary proceedings. It states, at subsection (a)(1), that a proceeding may be initiated to determine "whether a

registered public accounting firm, or the supervisory personnel of such a firm, has failed reasonably to supervise an associated person, either as required by the Rules of the Board relating to auditing or quality control standards, or otherwise . . ." The concept of a duty to supervise in this Proposed Rule tracks the statutory requirement in Section 105(c)(5) of the Act, which in turn was modeled after a similar requirement applicable to registered broker-dealers in Section 15(b)(4)(E) of the Securities Exchange Act. We acknowledge that, in view of Section 105(c)(5), the Board properly should discipline firms and associated persons for a failure to supervise. Further, Proposed Rule 5200 suggests that the Board will develop rules in this area. We comment on this provision merely to note for the Board that the supervisory structure for major accounting firms is completely unlike the structures in place at broker-dealers. We believe that the nature of this new statutory duty will need to be carefully examined by the Board, with the opportunity for considerable input from the accounting profession.

In addition, Section (a) provides for the commencement of a disciplinary proceeding when "it appears to the Board" that a firm or associated person has violated a law or regulation. We believe this standard is too low. A more appropriate standard for commencement of proceedings is where there is a "reasonable basis" for concluding that a violation has occurred.

9. **Proposed Rule 5300 (Sanctions):** We suggest that the Board provide guidance regarding when a particular sanction will be applied. For example, the Board might state that a permanent revocation or bar is intended to be an extraordinary sanction reserved for the most serious matters, such as those involving gross misconduct, derogation of professional responsibility, or significant harm to investors.

10. **Proposed Rule 5301 (Effect of Sanctions):** The Proposed Rule states that a person who is suspended or barred from being associated with a registered accounting firm may not become associated with such a firm without the consent of the Board. The Note to Section (a) further states that such a suspended or barred person may not receive "any salary, or any bonus, profit or other remuneration that results directly or indirectly from any audit fees that might have been earned during the period of the suspension or bar." We have several issues relating to this prohibition.

    First, the Board appears to contemplate that the suspended or barred person may continue to be associated with the accounting firm, as long as he or she does not participate in public company audits. In particular, the proposing release (at page 9) states:

    > In order to provide assurance that a firm that employs or continues to employ a barred person has not permitted the person to perform the activities of an associated person, the Board will consider, in connection with reporting requirements that it expects to develop in the future, whether to require such firms to provide regular reports on the activities and role within the firm of the barred person.

    However, the wording of the proposed rule suggests that the continued employment of suspended or barred persons in any capacity might be impossible. The note's prohibition

on compensation that results "directly or indirectly from any audit fees" would mean that a firm would be required to segregate its income from public company audit work from other work, but that is not how firms typically compensate their partners and employees. Compensation is generally tied, at least in part, to the overall performance of the firm. Accordingly, the Board should make clear that continued employment of suspended or barred persons is acceptable as long as they have no involvement whatsoever on public company audits.

Second, it is not clear if this prohibition would extend to retirement, health, disability, life insurance, or other benefits paid to suspended or barred personnel who are no longer associated persons of the firm. If it is so intended, we urge the PCAOB to reconsider. Such payments are generally paid from current firm profits and should not be considered prohibited payments.

11. **Proposed Rule 5404 (Service of Papers by Parties):** The Proposed Rule provides for service of papers on each party "in a manner calculated to bring the paper to the attention of the party to be served." It would seem preferable for the rule to be more precise. It should specify a process – most likely, service of papers by first-class mail – that would be used unless the hearing officer specifies otherwise.

12. **Foreign Firms as "Associated Persons":** In the past three weeks, representatives of Ernst & Young and other major accounting firms have been engaged in discussions with the Board staff of an issue that was not made clear in the Board's registration rules adopted earlier this year. Board staff members have advised us that the Board would consider foreign accounting firms to be "associated persons" of the U.S. accounting firm if they otherwise meet the definition of associated persons in Rule 1001(p)(i) – that is, if among other things they "receive compensation" in connection with the preparation or issuance of any audit report.

    This position has significant impact on many elements of the proposed investigations/adjudication rules. In its rulemakings relating to registration and inspections, the Board has specifically recognized the presence of important international comity and international jurisdictional concerns raised by the rule. For example, in its release on the proposed rule on inspections, the Board recognized that "special issues" relate to foreign firms and stated that it is "committed to finding ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessary burdens or conflicting requirements." Release No. 2003-013 at page 10.

    The same recognition of foreign firms' conflicting legal obligations should apply to the investigation/adjudication rule proposal as well. Under the Board staff's approach to foreign firms as "associated persons," a firm that performs very little work in connection with the audit of U.S. issuer, and thus is not required separately to register with the PCAOB, will nonetheless be subject to the full range of investigative and disciplinary requirements set forth in the Proposed Rules. That approach will clearly raise a wide range of issues relating to foreign firms' compliance obligations. Those issues cannot be resolved in the context of this rulemaking, but the Board should acknowledge their

existence and repeat its commitment to working with foreign firms and foreign regulators in dealing with them.

13. **Additional issues:** We have three minor additional comments.

First, Proposed Rule 5103, "Production of Audit Workpapers and Other Documents in Investigations," provides procedures for accounting board demands for production of documents in the possession of a registered public accounting firm and its associated persons. It is parallel to Rule 5105, which is titled "Requests for Testimony or Production of Documents from Persons Not Associated With Registered Public Accounting Firms," and it complements Rule 5102, which is titled "Testimony of Registered Public Accounting Firms and Associated Persons in Investigations." We believe that it might be helpful to caption Rule 5103 so that these rules would more clearly relate to the two types of Board investigative procedures – accounting board "demands" (applicable to registered firms and associated persons) and accounting board "requests" (applicable to others). Thus, a better caption for this rule might be "Demands for Production of Audit Workpapers and Other Documents in Possession of Registered Public Accounting Firms and Associated Persons."

Second, in Proposed Rule 5424 (Accounting Board Demands and Commission Subpoenas) the Board generally uses the word "party" to refer to an registered firm or an associated person who is a respondent in a Board administrative proceeding and the word "person" to refer to the hearing officer "or other person designated by the Board" to issue accounting board demands. However, the words are not used consistently in this fashion (*see, e.g.,* the following sentence in Section (a) – "A person whose application for such a demand or request has been denied . . ."). And, in subsection (a)(3), the rule uses the word "applicant" instead of the word "party." Accordingly, we suggest some minor technical fixes to avoid confusion.

Third, words appear to have been omitted from the following sentence in the Section-by-Section analysis relating to Proposed Rule 5467 on Page A2-lx: "Rule 5467, a registered public accounting firm must notify the Secretary, or any requirements of the Federal Rules of Appellate Procedure or any court within 10 days after the firm or any person associated with the firm files with the Commission a petition for review of a Board decision or files a petition for court review of a Commission order with respect to such a sanction."

* * *

Again, we commend the Board for proposing, in very little time, a thorough and thoughtful set of rules. We appreciate the opportunity to provide these comments, and we would welcome discussion of any points that require further explanation.

Respectfully submitted,

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