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

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

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Rules on Investigations and Adjudications*, PCAOB Rulemaking Docket Matter No. 005 (July 28, 2003).

INTRODUCTION

We support the goals of the Sarbanes-Oxley Act of 2002 (the "Act") in restoring investor confidence as well as the Board's efforts to implement the Act faithfully. Section 105 of the Act authorizes the Board to conduct investigations of registered public accounting firms and associated persons, to institute disciplinary proceedings against such firms and persons in the event that the Board has detected potentially improper conduct, and to impose certain sanctions on such firms and persons through those disciplinary proceedings.

Section 105(a) of the Act requires the Board to establish "fair procedures for the investigating and disciplining of public accounting firms and the associated persons of those firms" within the limits of the Act. In this comment letter, we have sought to identify aspects of the proposed rules that should be modified or clarified to ensure that Congress's mandate under Section 105(a) of the Act is carried out.

As a general matter, the Board's rules regarding investigations and adjudications must be crafted with particular care. Congress established the Board as a private "non profit corporation" and did not designate the Board a "self regulatory organization" like the National Association of Securities Dealers.[1] The Board's rules, however, must be approved by the Securities and Exchange Commission, which is a government agency and which, therefore, must act in accordance with the Constitution, the Administrative Procedure Act, and other federal statutes regarding agency action. Even to the extent that the Board may not be directly subject to these requirements, we believe that the Board's proposed rules will be more efficient, fair, and effective if they reflect the values and protections inherent in the Constitution and the Administrative Procedure Act.

It is significant that the Board has drawn many parts of its proposal from the Commission's codified Rules of Practice. The Board's use of this model, however, must recognize that the Commission's actual practices are not defined solely by a set of codified regulations, but have been augmented and supplemented by agency custom, informal guidance, and decisional law. Additionally, the Commission's rules are implemented with the understanding that the Constitution, the Administrative Procedure Act, and a variety of other

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[1] Act, § 101(b).

statutes would govern the Commission's proceedings as well. While the Commission may have decided not explicitly to include a particular procedural protection in its Rules of Practice because the protection was provided elsewhere by governing law, the Board cannot make that same assumption. Accordingly, we suggest in certain places that the Board make explicit in its rules certain procedural protections that may not be stated in the Commission's rules. These suggestions draw on the Commission's long experience, and important constitutional and statutory principles that may not be reflected in the Commission's regulatory text, but nonetheless govern its proceedings.

To that end, we encourage the Board to make certain that registered public accounting firms and associated persons are guaranteed certain fundamental safeguards. There are several areas on which we have focused our comments, including: (1) developing more workable rules for the proposed non-cooperation proceedings; (2) recognizing the burdens on registered public accounting firms and associated persons presented by the Board's investigative procedures; (3) providing fair access to information in disciplinary proceedings; (4) ensuring impartiality through more structured separation of function rules; and (5) avoiding the use of unfair summary disposition procedures. Our comments below track the order of the proposed rules in the Board's Release No. 2003-012, dated July 28, 2003 (the "Release").

I. General Provisions And Definitions

A. The Definition Of "Disciplinary Proceeding"

The proposal uses the term "professional standards" in several places, including the definition of a "disciplinary proceeding" under Proposed Rule 1001(d)(i), the grounds for initiating both informal and formal investigations under Proposed Rules 5100(a)(4) and 5101(a)(1), and the description of sanctionable conduct under Proposed Rule 5300. Unlike the term "auditing and related professional practice standards," which is defined to include those

guidelines central to the Board's regulatory authority over the audit reports of issuers, the term "professional standards" includes generally accepted accounting principles.

Without clarification, the Board's definition of "professional standards" may subject accounting firms to discipline for departures by issuers from generally accepted accounting principles even when a firm has acted with due professional care.[2] We do not believe that registered accounting firms and associated persons should be subject to Board disciplinary proceedings and potentially severe penalties based solely on errors involving generally accepted accounting principles. Although a departure from generally accepted accounting principles might trigger an inquiry by the Board, a violation of an "auditing and professional practice standard"—which is tailored to the Board's mandate to preserve the integrity of public company audits—should serve as the touchstone to determine if a disciplinary proceeding should be commenced.

B. THE DEFINITION OF "HEARING OFFICER"

Under the proposed definition of "hearing officer," the Board may authorize "any person" to preside over a disciplinary proceeding.[3] As drafted, the Board could appoint a staff

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[2] *Compare Proposed Rules on Inspections of Registered Public Accounting Firms*, Release No. 2003-13, Proposed Rule 1001(p)(iv) (referring only to "accounting standards") *with* AU 100 (Generally Accepted Auditing Standards) ("Due professional care is to be exercised in the performance of the audit and the preparation of the report.") *and* AU 230.13 (Due Professional Care in the Performance of Work) ("Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards.").

[3] Proposed Rule 1001(h)(i).

member of the Board's Division of Enforcement and Investigations to serve as the "hearing officer" in a disciplinary proceeding.[4] While the Commission's Rules of Practice contains a similar definition of "hearing officer,"[5] the Commission elsewhere has required the officer presiding in a disciplinary proceeding to be an "administrative law judge."[6] The Commission has established a separate Office of Administrative Law Judges so that an administrative law judge cannot be a member of the interested division in a SEC proceeding.[7]

The Board's proposed rules provide no such safeguards, permitting the Secretary to choose any person that falls within the broad proposed definition to be the hearing officer.[8] The Board should follow the Commission's practice and require the use of administrative law judges from outside the interested division to preside over disciplinary proceedings. At a minimum, the Board's rules should provide that the Board will not authorize the appointment of hearing officers from an interested division. Such a limitation is essential to ensure that the "hearing officer" who is selected does not present a conflict of interest and that the appearance of impartiality is preserved.

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[4] *See* Proposed Rule 1001(i)(iv) (defining interested division). In most disciplinary proceedings, the interested division will be the Board's Division of Enforcement and Investigations. Release at A2-iv. For hearings that concern the denial of a registration application, the interested division would generally be the Division of Registration and Inspections. *Id.*

[5] 17 C.F.R. § 201.101(a)(5).

[6] *See* 17 C.F.R. § 201.110; 17 C.F.R. § 200.30-10.

[7] *See* 17 C.F.R. § 200.30-10; 17 C.F.R. § 200.14.

[8] *See* Proposed Rule 5200(b) (authorizing the Secretary of the Board to appoint the hearing officer for a disciplinary proceeding).

II. INQUIRIES AND INVESTIGATIONS

A. THE BOARD SHOULD ADOPT THE COMMISSION'S *WELLS* NOTICE AND INVESTIGATION CLOSURE PROCEDURES

The proposal provides investigated public accounting firms and persons with neither adequate notice, nor a sufficient opportunity for them to state their case to the Board, nor a procedure by which they might seek the closure of a formal investigation. These omissions are inconsistent with the Commission's long-established practices and imperil the ability of firms and persons to participate productively in a Board investigation.

While Proposed Rule 5101(a) provides procedures for initiating a formal investigation, the proposal does not suggest that the Board will inform a firm or associated person of its intent to recommend the commencement of disciplinary proceedings.[9] In doing so, the Board proposes a different path from the one embodied in the Commission's so-called *Wells* procedures. The Commission's staff generally provides an investigated party, without an explicit request, with a *Wells* notice—which states that the Commission's staff has conducted a formal investigation and that it intends to recommend the commencement of proceedings against the party, and which describes the grounds for its tentative recommendation.[10] At that point, the investigated party is

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[9] *See* Proposed Rule 5101(a). To be sure, Proposed Rule 5109(d) allows a public accounting firm or associated person to request a description of the "indicated violations" from the Board's staff, but the disposition of that request is left to the staff's "discretion." No part of the proposal indicates that the staff will affirmatively notify a public accounting firm or associated person of a formal investigation.

[10] *See*, *generally*, Securities and Exchange Commission, *Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Release No. 5310 (Feb. 28, 1973) at 1.

provided an opportunity to submit a *Wells* statement in which the party can explain the allegedly improper conduct.[11]

The Commission's *Wells* procedures are the product of years of Commission experience and should be codified in the Board's rules.[12] In this regard, the proposed rule should specify that the staff will issue a notice that includes a concise statement of the allegedly improper conduct and the staff's preliminary recommendations. Without a right to notice and information similar to the Commission's *Wells* procedures, the right to submit a "statement of position" pursuant to Rule 5109(d) provides little protection, or indeed benefit to the Board's process of informed decisionmaking.

In addition, Proposed Rule 5101(b) allows the Director of the Division of Enforcement and Investigations to recommend that the Board close a formal investigation. The proposal, however, provides no process by which a registered public accounting firm or associated person can request the closure of a formal investigation.

The absence of such a procedure is inconsistent with the well-established practices of the Commission, which permit an investigated person to petition for the closing of an investigation. The Board should similarly adopt this practice as part of its rules. Without the ability to seek closure of an investigation, registered public accounting firms may have false concerns about

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[11] *Id.* *See also* William R. McLucas, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMP. L. REV. 53, 113 (1997) (noting that generally a one-month period for preparing a *Wells* submission is permitted).

[12] The Commission's *Wells* procedures have as a matter of custom become standard Commission practice and are expected by those who appear before the Commission. The Board does not, however, have that background of customary law on which to rely. Accordingly, it is vital that the Board explicitly incorporate these procedures into the Board's rules.

impending Board action. This paralyzing uncertainty can prevent long-term business planning and cause needless anxiety for innocent public accounting firms and persons. Board staff may not have a similar incentive to close stale investigations, even if their continuation has not been justified by the evidence uncovered. Registered public accounting firms and associated persons should be able to petition the Board to lift the shadow of a formal investigation when circumstances warrant.

B. Accounting Board Demands For Testimony Require Greater Notice And Clarified Procedures

We recognize that the Board has the authority under the Act to demand testimony from a registered public accounting firm or an associated person.[13] We also appreciate the Board's attempt to provide workable rules under which that authority will be exercised. We believe, however, that certain aspects of the Board's proposed rule should be modified or clarified to ensure that the system of Board testimonial demands operates fairly and efficiently.

Appropriately, Proposed Rule 5102(b)(1) requires the Board to give an examinee "reasonable notice" of the examination. The proposed rule's commentary, however, indicates that the Board may deem this "reasonable notice" requirement to be satisfied with less than five-business-days notice.[14] Less than five days will generally not be a sufficient amount of time to arrange for the representation of competent and informed counsel and to gather the data that will be required thoroughly to answer the Board's inquiries. This problem will be especially acute when the Board seeks the examination of a registered public accounting firm itself. In such a situation, the firm will be required to designate a person to testify, and that person will be

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[13] Act, § 105(b)(2)(A).

[14] Release at A2-x.

accountable for "matters known or reasonably available to the registered public accounting firm."[15] Accordingly, the Board should eliminate its guidance that notice constituting less than five business days may be deemed "reasonable" for purposes of the rule. To the extent that the Board wishes to provide a guideline regarding what would constitute reasonable notice, we believe that fifteen business days would generally be the minimum for reasonable notice.

Second, the Board should also refine the procedures for the examination of the public accounting firm under Proposed Rule 5102(c)(4). The proposed rule's requirement that the designated examinee testify as to "matters known or reasonably available to the registered public accounting firm" is very broad. The Board and public accounting firms have a mutual interest in ensuring that this standard is sufficiently clear such that the testimonial process is efficient, productive, and avoids the wasting of time and resources. To be sure, this rule replicates the standard set forth in Federal Rule of Civil Procedure 30(b)(6). The rules governing a Board demand, however, are different from those governing civil depositions and require that the standard for the scope of designated witness testimony be more limited. Failure to produce the information required by Federal Rule of Civil Procedure 30(b)(6) does not carry the severe sanctions provided for non-cooperation with an investigation under the Board's rules.[16] Moreover, those depositions are conducted under the ultimate supervision of a life-tenured judge. The Board's proposed rules also lack any procedure by which the examinee can supplement

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[15] Proposed Rule 5102(c)(4).

[16] *See* Proposed Rule 5300(b) (authorizing fines of up to $15 million for failure to comply with an accounting board demand for testimony, in addition to the termination of registration).

examination answers.[17] To the extent that the Board would consider, in a particular instance, an examinee's inability to provide information encompassed by this broad standard as non-cooperation, the Board's rules should explicitly allow the examinee to provide supplemental written responses at a later time.

Third, the proposed sequestration rule unreasonably limits the persons who can attend a demanded examination. The proposal permits the attendance of "the person being examined and his or her counsel."[18] The Board should revise this rule, however, to confirm that persons who are assisting counsel may attend the examination. Such a revision would be consistent with judicially imposed requirements for Commission examinations, under which the Commission permits the attendance of experts, accountants, and other persons retained by counsel for advice in the representation of the examinee.[19]

Similarly, the Board should confirm that the "counsel" permitted to attend the examination of an associated person may also represent that person's accounting firm. The proposal states that the attending counsel must "represent the witness;" and we agree that such counsel should take on all the professional responsibilities attendant to representing the individual examinee.[20] It is crucial, however, that an attorney not be disqualified from attendance merely because he also represents the associated person's public accounting firm.

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[17] The proposed rule does permit an examinee to review the transcript of the examination and to make changes. Rule 5102(e). It is not clear, however, whether this capability to make changes refers to correcting errors alone or providing entirely new material. *See*, *e.g.*, Fed. R. Civ. P. 30(e).

[18] Proposed Rule 5102(c)(3).

[19] *See Securities and Exchange Comm'n v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985).

[20] Proposed Rule 5109(b).

Any other regime would place even greater financial demands on associated persons as they respond to accounting board demands. The Commission has made precisely this clarification, and it should be codified in the Board's rule.[21]

C. ACCOUNTING BOARD DEMANDS FOR THE PRODUCTION OF DOCUMENTS PROVIDE INSUFFICIENT NOTICE AND SHOULD BE SUBJECT TO BOARD REVIEW

Proposed Rule 5103 requires that a Board demand for the production of documents "set forth a reasonable time and place for production." The Board has indicated in its section-by-section analysis, however, that it interprets the rule to provide no "minimum notice requirement before production shall be due."[22] The Release states that, while the Board "anticipates that the staff will provide at least five business days notice before production is due," such notice may also "be less than five days."[23]

We are concerned that the Board's baseline of five-days notice ignores the practicalities of responding to certain document production requests served on public accounting firms. Under the proposed rule, the Board's staff would be authorized to demand the production of broad categories of documents. In many cases, the demand would be the first indication for the firm that the Board is investigating a matter and, thus, firms would not have been preparing for the possibility of a document production. In response to such a demand, an accounting firm would be required to question hundreds of employees in order to locate responsive documents. Once identified, responsive documents that may be scattered across the firm's offices or in the

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[21] *See*, *e.g.*, William R. McLucas, then-Director of the Commission's Division of Enforcement, *Contact with Corporate Officers and Employees in SEC Investigations*, 9 INSIGHTS 2 (Mar. 1995).

[22] Release at A2-xii.

[23] *Id.*

possession of auditors working at the offices of audit clients would need to be gathered into a centralized location and reviewed by attorneys for relevance and completeness. Then, the firm would generally Bates stamp the documents and send them to vendors for copying.[24]

In order to preserve the firm's privileges, a public accounting firm would be required further to review the documents for privileged material before it could responsibly produce those documents. If an accounting firm produced privileged material in response to an accounting board demand, the firm would risk waiving that privilege even with regard to entities well beyond the Board.[25] These problems are aggravated by the Board's proposed rule governing the identification of privileged information, which requires extensive documentation about material claimed to be privileged and that such documentation be filed at the time the demand response is due.[26] The practicalities of production make a benchmark of five-days notice unworkable.

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[24] In this regard, Proposed Rule 5103(b) provides that "[u]nless an accounting board demand expressly requests or permits the production of copies, original documents shall be produced." The Board should revise this proposed rule to make clear that, in all but the rarest of circumstances, the production of copies will be a sufficient response to an accounting board demand. A registered accounting firm or associated person should be able to retain the originals in order to prepare for the defense of a disciplinary proceeding or to respond to discovery requests made in parallel civil litigation. Proposed Rule 5109(c), which permits a firm or person to request copies of the documents after they have been produced to the Board, is not an adequate solution for these concerns because the Board's staff may decline that request and because the investigated party is still deprived of the use of the documents for a potentially crucial period of time.

[25] *See*, *e.g.*, *In re Columbia / HCA Healthcare Corp. Billing Practice Litig.*, 293 F.3d 289 (6th Cir. 2002) (holding that the production of privileged documents to the SEC, even under a confidentiality agreement, waived the privilege as to private third parties).

[26] Proposed Rule 5106(a) (specifying the information necessary for a claim of privilege); Proposed Rule 5016(c) (requiring privilege documentation to be filed at the time that the response is due).

Because of the challenges presented by the production of documents, the Federal Rule of Civil Procedure 34 sets a thirty-day period for responding to a request for production.[27] We recommend that the Board adopt a workable standard similar to the time-tested approach of Federal Rule of Civil Procedure 34. Specifically, the Board should revise its rule to set a minimum period of thirty days for response to an accounting board demand, and to allow accounting board demands with response periods of less than thirty days only upon the order of the Commission. Such an approach would permit the staff the flexibility to obtain accounting board demands, under the supervision of the Commission, when truly emergent circumstances are presented and when the request for documents is reasonably targeted. In other circumstances, the Board's staff would be permitted to issue demands with a reasonable minimum response period of thirty days.

Similarly, the proposed rule provides for no Board review of the scope of an accounting board demand issued by its staff before production is required. The Commission's rules provide for a strong right of independent review over its subpoenas. Commission subpoenas are not self-executing; instead, the Commission must file a petition in a federal district court to enforce the subpoena. In the course of deciding whether a subpoena should be enforced, the Commission must convince an Article III, life-tenured judge that the subpoena is statutorily authorized, is reasonable in scope, is not unduly burdensome, and was not issued in bad faith by Commission

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[27] Fed. R. Civ. P. 34(b). Even within this thirty day period, Rule 34(b) only requires a written response to the request for production, not the actual documents requested. Moreover, the federal rules themselves do not require the detailed privileged log demanded under Proposed Rule 5108 at the time of production.

staff.[28] If the court finds that these minimum requirements are met, it may issue an order enforcing the subpoena. Only after that order is issued, however, can the respondent be subject to penalties for failure to comply with the subpoena.

At a minimum, the proposed rule should be revised to permit public accounting firms and associated persons to request that the Board quash or issue a protective order limiting the accounting board demand. This amendment to the proposed rule should permit parties subject to an accounting board demand to object on the basis that it seeks irrelevant documents, is redundant of other accounting board demands, is unduly burdensome, is unreasonable in scope, or extends beyond the authorization of the order instituting a formal investigation, the Act, or the Board's rules.

Under such a suggested revision, Board staff would not be required to initiate proceedings to enforce a demand. Instead, a person or registered public accounting firm could affirmatively petition the Board to quash or to issue a protective order limiting an accounting board demand issued by Board staff. In addition, the revision would not place the disposition of a motion to quash or for a protective order before an independent external tribunal in the first instance, but would allow registered public accounting firms and associated persons to seek review from the Board itself, under at least the same scrutiny as a Commission subpoena would be reviewed before enforcement. Without such a revision, registered public accounting firms

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[28] *See*, *e.g.*, *United States v. Miller*, 425 U.S. 435, 445-46 (1976) ("The Fourth Amendment requires that administrative agency subpoenas be sufficiently limited in scope, relevant in purpose, and specific in directive so that compliance will not be unduly burdensome."); *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1023 (D.C. Cir. 1978) (considering the Commission's authority to issue the subpoena and the reasonableness of the subpoena's burdens and scope during enforcement proceedings).

and associated persons would be able to seek review of a demand only through non-compliance, exposing themselves to substantial sanctions in non-cooperation proceedings.

D. THE BOARD SHOULD PROVIDE BASIC PROCEDURAL PROTECTIONS TO THE FIRM DURING RULE 5104 EXAMINATIONS OF BOOKS AND RECORDS

The Act authorizes the Board to "inspect the books and records of such firm or associated person to verify the accuracy of any documents supplied" under an accounting board demand for documents.[29] The Board's rule repeats the Act's authorization with little specification. The Board, however, should provide basic procedural protections for applicant firms in the event of such an examination.

As currently drafted, the proposed rule permits the staff to conduct this examination in its own discretion once the Board has initiated a formal investigation. The Board should amend the proposed rule to require express Board approval before the staff conducts such an examination. The examination allowed by Proposed Rule 5104 is an extraordinary act. To be sure, the Commission is authorized to perform examinations of the books and records of broker-dealers, but that authority is expressly designed to prevent the time-sensitive possibility of illegal fund transfers. There is no such need in this case.

Another potential concern is that the proposed rule provides no protection for privileged information contained in a public accounting firm's books or records. If permitted to examine any book or record in the accounting firm's protection, the Board's staff may have effective access to otherwise privileged information, eviscerating any protection established by Proposed Rule 5106. The Board should revise the rule to allow public accounting firms to designate certain records as privileged and to withhold them from examination. Alternatively, the Board

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[29] Act, § 105(b)(2)(B).

should establish a procedure for moving to quash an examination, much like a search warrant, on the basis of protecting privileged information. (At the very least, the Board's rule should reinforce that any privileged information discovered by Board's staff during their investigation cannot be used, either in assistance of the Board's investigation or as evidence in a disciplinary hearing.)

E. THE BOARD SHOULD TAKE STEPS TO MAINTAIN THE CONFIDENTIALITY OF INVESTIGATORY RECORDS WHEN DISCLOSED TO OTHER REGULATORY AGENCIES

Proposed Rule 5108 permits the Board to disclose investigatory records to the Securities and Exchange Commission, the Attorney General of the United States, an "appropriate Federal functional regulator," state attorneys general, and "any appropriate State regulatory authority." Although we understand that making investigatory records available to these agencies is contemplated by the Act,[30] we are concerned that, unless clarified, such availability may be administered in a manner inconsistent with the Act's provisions protecting the confidentiality of this information. We suggest the following revisions in order to ensure that, as provided by the Act, the Board's investigatory information remains confidential and privileged even when provided to the agencies listed in the Act.[31]

First, the Board should release investigatory information to another agency only under a confidentiality agreement. The Board's proposed rule states in its first Note that the information shared with an agency "shall be confidential and privileged *as an evidentiary matter* (and shall not be subject to civil discovery or other legal process) in any proceedings in any federal, or

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[30] Act, § 105(b)(5)(B).

[31] Act, § 105(b)(5)(B)(ii)(IV) (requiring that "each of [the agencies receiving Board investigatory information] shall maintain such information as privileged and confidential.")

State court or administrative agency."[32] Although this Note may prevent state or federal agencies from introducing Board investigatory information *as evidence in judicial or administrative proceedings*, the Note's terms do not explicitly prevent such an agency from disclosing Board investigatory information to the public on its own initiative. If the Board were to require the agency to enter into a confidentiality agreement as a condition of receiving investigatory information, that agreement would bar the agency from releasing the information to the public, and would thereby carry out Congress's mandate that the agency keep the information confidential. Alternatively, the Board could specify explicitly in its rule that a receiving agency is prohibited from disclosing the Board's investigatory information to anyone outside the receiving agency and could require the Board's staff to advise the recipient agency of these obligations.

Second, the final rule should explicitly confirm that state law is preempted to the extent that state law would otherwise require a state agency in receipt of the Board's investigatory information to disclose it. The Note to Rule 5108 states that the Board's investigatory information "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." This language, however, does not directly cover the status of the information in the hands of state attorneys general and other "appropriate State regulatory authorit[ies]." If the Board were to give investigatory information to a state agency, the state agency might be required by various state "freedom of information acts" or similar state laws to disclose that information whether or

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[32] Rule 5108(b) Note (emphasis added).

not requested by the public.[33] Notwithstanding the proposed rule's measures to keep investigatory information "confidential," disclosure to a state agency may effectively subject such information to public discovery if the rule's language is not clarified. Accordingly, the final rule should expressly confirm that state law is preempted to the extent that it would otherwise permit or require the receiving state agency to disclose investigatory information shared by the Board. Such a confirmation would faithfully implement the Act's requirement that receiving state agencies "maintain such information as confidential and privileged."

Third, the Board's rules should be modified to require the notification of the investigated registered public accounting firm or associated person when a Rule 5108 disclosure is made. Such a notification would enable a firm or person to protect the information more securely from disclosure by various federal and state agencies that have received the information. Public accounting firms and persons that are the subject of the investigatory information could, if given sufficient notice, intervene to seek protection from the inappropriate disclosure of confidential information in proceedings before agencies and courts. Without such notification, recipient agencies may disclose confidential Board investigatory information without challenge, if only because no entity would have both the incentive and the necessary information to seek to preserve confidentiality.

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[33] *See*, *e.g.*, Cal. Gov't Code § 6250 *et seq.*; Tex. Gov't Code § 552.001 *et seq.*; 5 Ill. Comp. Stat. 140/1, *et seq.*; N.Y. Pub. Off. Law § 84, *et seq.* Even if the agency decided not to disclose this information to the public, public interest groups and private litigants could still seek this information in the absence of preemption.

F. THE BOARD SHOULD SPECIFICALLY SET FORTH THE ACTS CONSTITUTING NON-COOPERATION WITH AN INVESTIGATION

Proposed Rule 5110 authorizes the Board to initiate a disciplinary proceeding in the event that a public accounting firm or associated person fails to cooperate with an investigation. Under the proposed rule, disciplinary proceedings may be initiated if a public accounting firm or an associated person "may have failed to comply with an accounting board demand, may have given testimony that is false or misleading or that *omits material information*, or may *otherwise have failed to cooperate in connection with an investigation*." We believe that the proposed rule's listing of those acts that will constitute non-cooperation is too vague to afford notice of prohibited conduct. Clarity and adequate notice are crucial for potential non-cooperation charges because of the grave penalties, including the termination of registration and $15 million civil penalties, and the expedited proceedings for imposing those sanctions that the Board has authorized.

First, the proposed rule prohibits a public accounting firm from "otherwise fail[ing] to cooperate in connection with an investigation." This catchall term potentially places a wide range of seemingly innocent conduct in question. For example, this broad term might expose to severe punishment the good faith adherence to a point of privilege or situations where cooperation is complicated by a parallel civil or criminal proceeding. We believe that the terms regarding false testimony and the refusal to comply with properly issued accounting board demands cover the full range of conduct that could reasonably be subject to the proposal's severe

penalties for non-cooperation.[34] If the Board believes that there is still other punishable conduct, the Board should specify those particular acts that would constitute non-cooperation for purposes of Rule 5110.

Second, we believe that the Board should not be able to initiate disciplinary proceedings directly for failure to comply with an accounting board demand issued by the staff. Instead, the Board's staff should be required to submit to the Board a motion to compel compliance. The motion to compel proceedings would provide the Board with an opportunity to exercise reasonable control over the issuance of demands by the Board's staff, and would give the investigated party one last opportunity to comply with the demand under the terms specified by the Board. If a public accounting firm or associated person were to fail to comply with the demand after the Board grants a motion to compel, the Board would then be reasonably entitled to take the grave step of initiating a disciplinary proceeding for non-cooperation.

Third, the proposed rule suggests, by designating as non-cooperation the "omi[ssion of] material information," that the failure to disclose material information to the Board constitutes punishable conduct. Nowhere does the Release specify, however, what information, in the absence of a request, a public accounting firm or associated person must disclose during an investigation. Indeed, the creation of a duty to disclose information in the absence of an appropriate inquiry to which it would be responsive would exceed the cooperation requirements

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[34] In this regard, the Board should clarify that a registered public accounting firm will not be liable for non-cooperation if a foreign public accounting firm on the opinion of which the registered firm relies refuses to produce audit workpapers. *See* Act, § 106(b)(2)(B).

for other types of investigations.[35] Without clarification, a firm that responds completely and truthfully to every inquiry made by the Board may still be exposed to liability for non-cooperation. The Board should, therefore, delete this language from the final rule because the remainder of the rule otherwise ensures that a public accounting firm will respond truthfully to the Board's inquiries.

Fourth, the Board should clarify that a registered public accounting firm is not responsible for the "non-cooperation" of one of its employees in responding to an accounting board demand directed to that employee *as an associated person*. Instead, a registered public accounting firm should at most be liable for non-cooperation with regard to an accounting board demand for documents or testimony from the firm itself. In the specific case of testimony, the firm should only be liable for violations committed in the testimony of the person designated on behalf of the firm pursuant to Proposed Rule 5102(c)(4). Given the substantial penalties for non-cooperation proceedings and the ability of the Board to gather information from a registered public accounting firm directly, respondeat superior liability is not appropriate in the context of the Board's proposed non-cooperation proceedings.

Finally, we believe that the "expedited proceedings" proposed in the Release are not appropriate for the types of matters that will be raised in non-cooperation proceedings. Specifically, the proposal establishes expedited procedures for the adjudication of non-cooperation charges, including: standards allowing less detailed allegations in the order

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[35] *See*, *e.g.*, *United States v. Larson*, 796 F.2d 244, 246-47 (8th Cir. 1986) (holding that private persons have no general duty to disclose information to the government that is material to a prosecution); *United States v. Curran*, 20 F.3d 560, 566 (3d Cir. 1994) (stating that an individual has no duty to disclose material information during questioning by the government).

instituting proceedings;[36] abbreviated deadlines for answering that order;[37] the discretion to eliminate post-hearing briefing in which respondents would ordinarily make their closing argument;[38] a shortened period for filing a petition for Board review;[39] and significantly limited discovery.[40] As proposed, non-cooperation proceedings will present very complex factual and legal issues. For example, the Board has included, under the cover of non-cooperation procedures, allegations of giving false testimony during a Board investigation. Adjudicating those charges may entail significant inquiries into events and facts entirely external to the proceedings themselves, such as the respondent's state of mind.[41] In addition, the Board has chosen to authorize very substantial penalties in non-cooperation proceedings, including enormous fines and the termination of registration. The penalties are sufficiently severe that they ought not be the product of "expedited" procedures.

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[36] *See* Proposed Rule 5201(b)(3); *see also* Part III.C. below.

[37] *See* Proposed Rule 5421(b); *see also* Part V.E.2. below.

[38] *See* Proposed Rule 5445(b).

[39] *See* Proposed Rule 5460(a)(2)(iii).

[40] *See* Proposed Rule 5422(a)(2); *see also* Part V.C.1. below.

[41] An example of these challenges would be the initiation of non-cooperation proceedings for testifying that a firm complied with Generally Accepted Auditing Standards in a particular engagement. If the Board's staff believed that statement was false, it could initiate non-cooperation proceedings. The resolution of those proceedings, however, would directly implicate the subject of the investigation itself and matters that would ordinarily be addressed in primary disciplinary proceedings.

According to the Release, these expedited procedures are essential to ensure prompt cooperation and to avoid the delay of a time-sensitive investigation.[42] The severe potential sanctions, however, will generally provide more than sufficient incentive for prompt cooperation. In contrast, the expedited proceedings for non-cooperation charges threaten the accuracy and fairness of the Board's determinations. Moreover, because the Board has not yet provided for procedures by which registered public accounting firms or associated persons can seek review of accounting board demands, non-cooperation proceedings will often present good faith disagreements with Board staff on discovery and cooperation matters. These truncated proceedings are inappropriate given the scope of actions that are subject to non-cooperation charges. The Board should eliminate these expedited procedures throughout its proposal.

G. ACTIONS TO ENFORCE COMMISSION SUBPOENAS REQUESTED BY THE BOARD SHOULD BE FILED UNDER SEAL

Proposed Rule 5111 authorizes the Board to seek the issuance of a subpoena by the Commission. While we recognize that the Board has this authority under Section 105(a)(2)(C) of the Act, we encourage the Board specifically to provide that any judicial action to enforce a Commission subpoena arising out of a Board investigation will be filed under seal. As explained above, Commission subpoenas are not self-executing and require the initiation of judicial proceedings for their enforcement. The initiation of judicial proceedings, however, may reveal the existence of a Board investigation concerning certain registered public accounting firms or associated persons. Such a public disclosure of this information through filing an action to enforce a subpoena is inconsistent with the Act's requirement that Board investigations remain

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[42] Release at A2-xlv.

confidential and privileged.[43] Although the recipient of a Commission subpoena could maintain the confidentiality of the investigation through immediate compliance, these recipients will generally not be the registered accounting firms and associated persons over whom the Board has regulatory authority.[44] Accordingly, these recipients will not have the same incentives to maintain the confidentiality of the investigation.

H. THE BOARD SHOULD BE EXPRESSLY PROHIBITED FROM INITIATING INVESTIGATIONS IN AID OF OTHER PROCEEDINGS

Proposed Rule 5112 requires the Board to alert the Commission of a formal investigation and permits the Board to refer an investigation to the Commission and certain other agencies. The Board should amend Proposed Rule 5112 to make clear that its cooperation with other agencies does not extend to initiating investigations in aid of another agency's parallel proceedings. Because the Board will have unique investigatory powers over registered public accounting firms and associated persons, the Board may often be called upon to gather information for use in another agency's proceedings. We believe that procuring information for another agency's proceedings would be an inappropriate and unauthorized use of the Board's investigatory powers. Instead, the proposal should expressly prohibit the Board from initiating an investigation unless it has made an independent determination that an investigation is warranted for the sole purpose of deciding whether to institute a Board disciplinary proceeding.

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[43] *See* Act § 105(b)(5)(A); Proposed Rule 5108.

[44] The Board will not generally be required to seek Commission subpoenas against registered public accounting firms and associated persons because of the availability of accounting board demands.

III. DISCIPLINARY PROCEEDINGS

A. THE BOARD SHOULD ADOPT A STRONGER SEPARATION OF FUNCTIONS RULE

The Board's proposed separation of functions rule would bar "employees or agents" of the Board who are "engaged" in the investigation or prosecution of a particular proceeding or a "factually related proceeding" to "participate or advise in a decision, or a Board review of the decision" in that proceeding.[45] As currently drafted, the proposed rule would separate those persons directly involved in the prosecution or investigation of a firm or associated person from the adjudication of the claims against that respondent. Because the rule refers to persons rather than divisions, however, the proposed rule may permit members of the Division of Enforcement and Investigations to participate or to advise in the decision of a disciplinary proceeding—as long as they are not working on the prosecution or investigation of that particular proceeding or one that is factually similar.

We believe that a rule that excludes staff members of the Division of Enforcement and Investigations from the adjudication of any disciplinary proceeding would best preserve the fairness and impartiality of the adjudicatory process. Even if a member of the Division of Enforcement and Investigations were not directly involved in the investigation of the particular firm or type of violation, it would be difficult for him to place his prosecutorial role aside. In addition, the application (for example) of an auditing standard in one case may have significance for other cases being litigated by a staff member of the Division of Enforcement and Investigations. At the very least, the participation of a Board employee who typically acts in a prosecutorial function in the adjudication of a disciplinary proceeding would raise the appearance of impartiality and would threaten the perceived integrity of the Board's adjudication

[45] Proposed Rule 5200(c).

process. For similar reasons, we have suggested that the Board exclude Division of Enforcement and Investigations staff from eligibility for hearing officer positions.[46]

B. THE ABILITY TO CONSOLIDATE DISCIPLINARY PROCEEDINGS SHOULD BE NARROWED

Proposed Rule 5200(d) permits the Board to consolidate any disciplinary proceedings involving "a common question of law or fact." We believe that this standard is excessively broad and, thus, threatens the capability of the Board to guarantee fair and individualized adjudications of the charges against a public accounting firm or an associated person. If the capability to consolidate proceedings is not sufficiently cabined, the individualized facts and other issues attendant to a particular respondent's circumstances may not receive appropriate consideration in multi-respondent hearings, leading to judgments poorly calibrated to a particular respondent's responsibility for conduct that is allegedly prohibited.

For this reason, both the federal civil and criminal joinder rules are substantially narrower, authorizing the consolidation of actions only when the claims arise out of the "same transaction or occurrence."[47] Under the standard used in federal courts, only those actions that share a core bundle of facts concerning the liability-causing event are permitted to be consolidated. In contrast, under the proposed rule, disciplinary proceedings may be consolidated if they share an abstract question of law that requires resolution. Such an approach carries obvious risks of unfairness and threatens the erroneous imposition of the grave penalties authorized by the Act and the Board's proposed rules.

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[46] *See* Part I.A above (suggesting that the definition of "hearing officer" be revised to exclude members of the "interested division").

[47] Fed. R. Civ. P. 19; Fed. R. Crim. P. 8.

That the proposed consolidation standard is only *one* of the several minimum requirements for maintaining a class action in a civil case is instructive.[48] Federal Rule of Civil Procedure 23 contains additional procedural protections that the proposed rule lacks, including the requirement that such common questions of law or fact "predominate" over individualized questions. Moreover, civil class actions are a poor model for the Board's consolidation rule in disciplinary proceedings. Whereas class actions are primarily designed to provide an efficient method for the adjudication of civil claims that plaintiffs may not otherwise have the incentive to prosecute separately, the Board's disciplinary proceedings entail substantial sanctions for respondents. Class actions, unlike Board disciplinary proceedings, are also conducted before a life-tenured Article III judge. Before the Board imposes the grave sanctions authorized by the Act, a respondent firm or associated person is entitled to an appropriately individualized hearing on the merits. The Board should adopt the time-tested joinder standard used in federal courts and permit consolidation only if the respondents are accused of participating in the same allegedly impermissible "transaction or occurrence."

C. THE PROPOSAL'S REQUIREMENTS FOR THE ORDER INSTITUTING DISCIPLINARY PROCEEDINGS FAIL TO GIVE RESPONDENTS EFFECTIVE NOTICE OF THE CHARGES

The order instituting disciplinary proceedings is of crucial importance in enabling a respondent public accounting firm or associated person to answer the order,[49] to prepare a

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[48] Fed R. Civ. P. 23(a)(2).

[49] Proposed Rule 5421 authorizes the Board to require a respondent to file an answer to the order instituting disciplinary proceedings. In that answer, the respondent must admit or deny the allegations and advance any affirmative defenses on which the respondent intends to rely. The order, however, must be sufficiently specific so that the respondent can assess which affirmative defenses may apply and respond intelligently and accurately to the allegations. The need for specificity is particularly strong because the proposal lacks any procedure for

[Footnote continued on next page]

defense, and to participate effectively in a disciplinary proceeding. Proposed Rule 5201(b) requires the Board to "specify in reasonable detail" the "conduct alleged to" be prohibited, as well as the legal basis for that prohibition. The Board, however, should amend the proposed rule in order to provide minimum requirements for the facts that must be alleged in the order instituting proceedings. Some standards of detail, for example, would not be adequate to place a respondent on notice regarding the events that will be subject of a disciplinary proceeding. The "notice pleading" standard of the Federal Rules of Civil Procedure, for example, would not be appropriate for Board disciplinary proceedings.[50] Whereas the assumption of the Federal Rules of Civil Procedure is that civil defendants will be able to determine the contours of the plaintiff's claims through liberal discovery rules, the proposal grants respondents very limited discovery against the Board and specifically forbids respondents to question Board staff regarding the basis for its charges through depositions or even written interrogatories.[51] Accordingly, it is essential to the fairness of the Board's disciplinary proceedings that the order instituting proceedings supply at least some semblance of the detail that the respondent would ordinarily obtain through civil discovery.

One potential standard for the detail that the Board should require in its order instituting proceedings is the heightened pleading requirements of Federal Rule of Civil Procedure 9(b).

[Footnote continued from previous page]
the respondent to request a more definite statement before the answer is due. *See*, *e.g.*, Fed. R. Civ. P. 12(e).

[50] *See* Fed. R. Civ. P. 8(a).

[51] *See Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 511 (2002) ("The [Federal Rules of Civil Procedure's] simplified pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims.").

Under such heightened pleading requirements, the Board should, at a minimum, be required to specify where and when the allegedly prohibited conduct occurred, who committed the relevant acts, and any specific statements or acts alleged to be prohibited.

Aggravating these notice problems is the Board and the hearing officer's broad authority to amend the order instituting proceedings. Proposed Rule 5201(d) authorizes the Board to amend the order instituting disciplinary proceedings at any time during the proceedings. The order initiating proceedings is designed to serve the function of a complaint, informing the respondent of the charges or claims against him. This broad authority to amend, however, prevents the order from serving as effective notice. Under the proposed rule, the Board's authority to amend the order is completely unfettered: the Board could add new charges arising out of the same incident or completely different events. Because of the possibility that a Board amendment may fundamentally transform the nature of the case, respondents cannot reliably plan their defense.

Similarly, the power afforded to the hearing officer to amend the order imperils the respondent's ability to prepare its defense. Even the Federal Rules of Civil Procedure limit the court's ability to grant amendments of civil complaints during proceedings if amendment would "prejudice" the defendant.[52] At the very least, the Board should add a "prejudice" limitation to Proposed Rule 5201(d)(2), providing that the hearing officer may not amend if it would unfairly prejudice the respondent.

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[52] *See* Fed. R. Civ. P. 15(b).

D. THE BOARD SHOULD REVISE ITS SETTLEMENT PROCEDURES TO PROMOTE EFFICIENT SETTLEMENTS AND TO PRESERVE IMPARTIALITY OF THE ADJUDICATION PROCESS

While we share the Board's belief that the proposed rules should provide for settlement procedures, there are aspects of Proposed Rule 5205 that threaten the efficiency of settlement discussions, the confidentiality of information in settlement proceedings, and the impartiality of the adjudication process. We suggest, therefore, three modifications to the rule to make the rule more workable and more consistent with prevailing settlement procedures.

First, the proposed rule includes a broad waiver provision—requiring the respondent to waive any right to either judicial or Board review of any matter in the proceedings.[53] As drafted, the Board deprives the settling parties of discretion as to what rights should be waived by making certain waivers mandatory. Specifically, the proposed rule's requirement that the respondent waive any right to Board or judicial review forecloses the possibility of conditional pleas or settlements. Under a conditional plea or settlement, if the Board and the respondent disagreed on only one discrete legal issue, the parties could resolve the remainder of the case and the respondent could seek hearing officer, Board, and judicial consideration of the one legal question in dispute. Traditionally, conditional pleas or settlements have been a means of conserving judicial resources by focusing the questions in dispute. For example, Federal Rule of Criminal Procedure 11(a)(2) enables defendants, with the consent of the government, to reserve the right of appellate review on discrete issues, even when pleading guilty.

The Board could provide its staff maximum flexibility in obtaining efficient settlements of disciplinary proceedings by leaving the rights that will be waived through settlement to the

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[53] Rule 5205(c)(2)-(3).

terms of the settlement agreement itself. As a matter of course, many of the waivers in the proposed rule may become terms of most settlements; but removing the mandatory waivers from the rule would prevent the breakdown of settlement negotiations because of unacceptable waiver terms. Alternatively, the Board could modify the rule to permit, but not to require, the Board's staff to seek the waiver of the rights listed in Proposed Rule 5205(c)(2)-(3).[54]

Second, the Board should delete Proposed Rule 5205(c)(3)(i), which would permit any employee of the Board, including members of the Division of Enforcement and Investigations prosecuting the defendant, to advise the Board or the hearing officer regarding an offer of settlement. This provision appears both to require a waiver of the separation of functions requirement and to permit ex parte communications between the prosecutorial staff and the Board. This provision is unnecessary and threatens the impartiality of the adjudications process.

To be sure, the prosecutorial staff should be able to *advocate* their position on the settlement to the Board or a hearing officer. Any arguments or recommendations the staff might have, however, should be *on the record with an opportunity for the respondent to respond*. Under the proposed waiver rule, the prosecutorial staff may make all sorts of claims about the facts in the case that the respondent will not be permitted to test adversarially. This impact on the fairness of the process extends far beyond the determination of whether the settlement offer should be rejected or accepted. If the offer is rejected, the Division of Enforcement's ex parte advice and recommendations, including assertions about the facts in the case, could taint the subsequent adjudication of responsibility. This provision endangers the proposal's attempt to

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[54] To accomplish this change, the Board could substitute the following text for Proposed Rule 5205(c)(2): "Before recommending an offer of settlement, the Division of Enforcement and Investigations may require the offer, subject to acceptance, to waive:" The rule could then list the authorized waivers.

ensure that a respondent has a fair hearing before an impartial judge through adversarially tested arguments. Accordingly, the Board should delete Proposed Rule 5205(c)(3)(i).

Third, the rule should explicitly provide that settlement negotiations and offers are both privileged and confidential. These protections are explicitly provided to parties in federal civil and criminal judicial proceedings.[55] It is true that other parts of the proposal are designed to ensure that disciplinary proceedings are protected from disclosure to the general public. However, generally settlement offers and discussions are also privileged against evidentiary use in the proceedings themselves. The extension of privilege to settlement negotiations and offers is designed to enable candid and productive settlement discussions between the parties. Providing for the privileged and confidential nature of settlement negotiations and offers will facilitate the settlement process and advance the efficient resolution of disciplinary proceedings without the unnecessary consumption of Board resources.

IV. THE RULES OF BOARD PROCEDURE

A. PARTIES SHOULD BE PERMITTED AN IMMEDIATE INTERLOCUTORY APPEAL FOR DENIAL OF A MOTION FOR HEARING OFFICER WITHDRAWAL

Rule 5402 allows a party to move for the withdrawal of the assigned hearing officer from a disciplinary proceeding if the party "has a reasonable, good faith basis to believe that a hearing officer has a conflict of interest or personal bias, or circumstances otherwise exist such that the hearing officer's fairness may reasonably be questioned."[56] After such a motion is made, the hearing officer himself may deny the motion and "continue to preside over the proceeding." The

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[55] *See* Fed. R. Crim. P. 11(e)(6); Fed. R. Evid. 408.

[56] Proposed Rule 5402(a).

rule itself does not directly provide for Board review of the hearing officer's decision on the motion until after a final order concludes the proceedings.[57]

We believe that prompt interlocutory review of denials of motions for withdrawal is necessary to preserve the appearance of impartiality in the adjudication process. Under the proposed rules, the Board will not, in advance, exercise any discretion over the selection of a hearing officer in a particular proceeding.[58] Providing for interlocutory appeals when such a selection is contested will permit the Board efficiently to exercise control over the selection process. Moreover, such interlocutory review will avoid wasteful proceedings that may be irredeemably tainted by the invalid selection of a hearing officer. These problems could be especially common given the proposed broad eligibility of Board staff for appointment as a hearing officer.[59] Accordingly, the Board should state in the rule that a party may immediately appeal the denial of a motion for withdrawal to the Board.

B. THE EX PARTE COMMUNICATIONS PROHIBITION SHOULD BE EXPANDED

Proposed Rule 5403(b) prohibits a "*party*" from communicating with the hearing officer or a member of the Board about "a fact in issue . . . without notice and opportunity for all parties to participate." Proposed Rule 5403(b) is only a prohibition on a "party," which is elsewhere defined to include the private party that is the subject of the proceedings and "the interested

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[57] As a general matter, the proposal suggests that interlocutory review by the Board of a non-final order will occur "only in extraordinary circumstances." Proposed Rule 5461(a). Proposed Rule 5461 does not provide much comfort that prompt review of the denial of a motion for withdrawal will be realistically available.

[58] *See* Proposed Rule 5200(b) (providing that the Secretary of the Board shall assign a hearing officer to a particular proceeding).

[59] *See* Part I.B. above.

division" of the Board.[60] The "interested division" definition is limited to refer to "a division or office of the Board assigned *primary responsibility* by the Board to participate in a particular proceeding."[61]

Under the Board's proposed definitions, staff of the Board who are representing the Board or otherwise participating in disciplinary proceedings, but who are not members of the division "assigned primary responsibility" for prosecuting a particular matter, may communicate with the hearing officer or members of the Board about facts in issue.[62] The ex parte prohibition is, thus, incomplete. In order to preserve the fairness of the proceedings, no Board employee with any responsibility for participating in a disciplinary proceeding should be permitted to communicate ex parte with the hearing officer or a member of the Board about a fact in issue. The Board should revise the proposed rule so that it applies symmetrically to the Board and the respondent and prohibits any representative of either side from any ex parte communications.

C. THE DISCOVERY MEASURES AVAILABLE TO RESPONDENT FIRMS AND ASSOCIATED PERSONS ARE INADEQUATE

The proposed rules provide the Board's prosecutorial staff with a battery of discovery measures for use against respondents. Just as an example, the proposed rule authorizes the Board and, under certain circumstances, its staff to issue "accounting board demands" for the testimony of registered public accounting firms or associated persons and for the nearly

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[60] Proposed Rule 1001(p)(iii).

[61] Proposed Rule 1001(i)(iv) (emphasis added).

[62] Indeed, the definition of "interested division" does not even make clear that *every employee* of the division with primary responsibility to participate in a proceeding is covered by the bar. Without clarification, the ex parte communications bar may only prevent communicating official statements of the interested division's position ex parte.

immediate production of original documents under severe penalties for non-compliance.[63] In contrast, the Board has provided respondent firms and associated persons with some discovery tools, but has imposed significant and often inexplicable limitations on their scope. This asymmetrical availability of discovery promises fundamentally to undermine the fairness, and indeed the accuracy, of the Board's disciplinary proceedings. We identify below the limitations on respondent discovery that are particularly problematic and propose modifications that would resolve those problems. These proposals reflect procedural protections that are afforded defendants in civil and criminal proceedings throughout federal and state courts, as well as before the Securities and Exchange Commission.

1. THE PROPOSED RULE PROTECTS CERTAIN TYPES OF DOCUMENTS FROM DISCOVERY WITHOUT JUSTIFICATION

The proposed rule prevents certain types of documents from discovery by respondents—including documents that a plaintiff or prosecuting authority would be required to produce in any civil or criminal judicial proceeding. The Board offers no compelling reasons for the withholding of these documents.

First, Proposed Rule 5422(a)(1)(iv)(A) allows the Board to withhold from inspection any document that has been prepared by any member of the Board's staff and shared only inside the Board or with persons retained by the Board in connection with the investigation or disciplinary proceeding. This limitation on the Board's production would permit the prosecuting division to share documents with Board members (who may ultimately review or serve as a hearing officer during a disciplinary proceeding) or even with the hearing officer (who may be part of the

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[63] *See* Proposed Rules 5102, 5103, and 5300(b).

Board's staff).[64] As a matter of fairness, a respondent should be able to inspect every document reviewed by a Board official who may ultimately participate in the decision of a respondent's case.

We understand that this provision may have been designed to ensure that the Division of Enforcement and Investigations may prepare confidentially for a case, just as a U.S. Attorney's office or a private law firm should be able to prepare private memoranda evaluating the facts and law candidly. This concern, however, is fully addressed by the proposed rule exempting documents covered by the attorney-work-product protection from disclosure.[65] Alternatively, the Board could revise the rule to protect documents prepared by the Division of Enforcement and Investigations and not disclosed outside *that division* other than to persons retained by the division for assistance in the investigation. Such a revision would remove the exception from discovery for documents disclosed to Board members and other Board staff outside the Division of Enforcement and Investigations. These changes are necessary to preserve the appearance of impartiality and to provide the respondent an opportunity to respond to documents previously provided to those Board members and staff that will participate in the decision of the case.

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[64] Although the ex parte communication prohibition may prevent some of this activity once proceedings have been initiated, the proposed rule would exclude from discovery documents regarding the events at issue to which the Board or a potential hearing officer had been exposed before the initiation of proceedings.

[65] *See* Proposed Rule 5422(a)(1)(iv)(B). In this regard, the Board should make clear that its proposal incorporates the full definition of the attorney work product protection from Federal Rule of Civil Procedure 26(b)(3). Thus, the proposed rule should state that a respondent would be able to obtain materials prepared by the Division of Enforcement in preparation for the disciplinary proceedings if the respondent "has a substantial need of the materials in the preparation of [the respondent's] case and . . . is unable without undue hardship to obtain the substantial equivalent of the materials by other means."

Second, Proposed Rule 5422(a)(1)(iv)(D) allows the hearing officer to permit the withholding of a document obtained or prepared by the Division of Enforcement and Investigations in connection with an investigation "for good cause shown." This broad and vague exception threatens the limited rights to discovery that the proposed rule does provide respondents. The Board should delete this exception. If the Board is concerned that there are other documents that must be withheld, the Board should, at a minimum, specify the precise types of documents that a hearing officer may permit the Division to withhold.

Third, the proposed rule arbitrarily cuts off the respondent's discovery when disciplinary proceedings are initiated. Under the proposed rule, the Board is required to make available for inspection and copying "documents prepared or obtained by the Division of Enforcement and Investigations in connection with the investigation *prior to the initiation of proceedings*."[66] There is no reason, however, why this duty should not continue during the pendency of proceedings. Terminating discovery of this material upon the initiation of proceedings is inconsistent with the most basic constitutional requirements that attach to a typical criminal proceeding. A criminal prosecutor's obligations to disclose *Brady v. Maryland* material to defendants, for example, continue after indictment and at least until the conviction is final. The Board's disclosure requirements should be no less demanding.

In this regard, the Commission has recognized that it must disclose at least as much information as would be required of a prosecutor in criminal judicial proceedings. Accordingly, the Commission requires the affirmative disclosure to the respondent of all exculpatory information that would meet the requirements of *Brady v. Maryland*, if it were obtained in a

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[66] Proposed Rule 5422(a)(1)(iv) (emphasis added).

typical criminal case.[67] In contrast, the Board's proposal places no general requirement on the Division of Enforcement and Investigations even to grant the respondent access to exculpatory information in the Division's possession, much less actively to disclose such information to the respondent. The Board's production requirements should continue throughout the proceedings and, at the very least, provide for disclosure of exculpatory material at any time.

Fourth, Proposed Rule 5422(a)(1)(iv)(C) excludes from discovery "any document that would disclose the identity of a confidential source." The Board should make clear, however, that this restriction is coterminous with the common law confidential informant privilege.[68] At common law, the government's privilege against revealing a confidential source is "by no means absolute," and does not extend to an informant "who was a participant, an eyewitness, or a person who was otherwise in a position to give direct testimony concerning the" allegedly illegal conduct and whose testimony, therefore, may assist in the respondent's defense.[69] If this proposed rule were interpreted to protect from discovery any document concerning an informant "who would prefer to remain anonymous," the rule would unjustifiably expand the traditional privilege and would aggravate the respondent's distinct informational disadvantage in the Board's disciplinary proceedings. Accordingly, the Board should amend its proposed rule by restricting from disclosure only "any document that would be covered by the common law confidential informant privilege."

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[67] 17 C.F.R. § 201.230(b)(2).

[68] *See*, *e.g.*, *Roviaro v. United States*, 353 U.S. 53 (1957).

[69] *United States v. Warren*, 42 F.3d 647, 654 (D.C. Cir. 1995).

Fifth, the Proposed Rule 5422(a)(2) discovery obligations of the Board in non-cooperation proceedings are wholly insufficient. As drafted, the rule requires Board officials to make available only those documents "upon which the Division intends to rely in seeking a finding of non-cooperation." The rule is essentially an invitation to the Division to withhold exculpatory evidence on which the Division, of course, would not rely. The Board suggests that this disclosure is limited because not all investigation documents will be relevant to non-cooperation proceedings and their disclosure would slow the process.[70] The Board, however, could solve this problem by limiting disclosure to documents relevant to the non-cooperation allegations. The Board is also concerned that disclosures in non-cooperation proceedings (which may occur before disciplinary proceedings for violations of the Act or Board rules) could compromise its investigation.[71] If that were true, however, the Board has the option of delaying non-cooperation proceedings until the commencement of other disciplinary proceedings when it would have to disclose that information.[72] At the very least, the proposed rule should require the Division of Enforcement and Investigations to make some showing that the disclosure of the information otherwise relevant to the non-cooperation charges will actually jeopardize an investigation.

The Release suggests that non-cooperation proceedings will be straight forward, will not involve extensive factual disputes, and therefore will not require significant discovery. However, under the title of non-cooperation, for example, the proposal allows prosecution for

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[70] Release at A2-xlv.

[71] Release at A2-xlv-xlvi.

[72] *See* Proposed Rule 5422(a)(1).

allegedly providing false testimony. The disposition of such false testimony charges will inevitably require the examination of events investigated by the Board.[73] The Board has established grave sanctions for non-cooperation, and respondent firms and associated persons are entitled to documents relevant to their defense.

2. THE PROPOSED RULE DENIES RESPONDENT FIRMS AND ASSOCIATED PERSONS REMOTELY EQUAL PROCEDURAL PROTECTIONS IN DISCOVERY

In addition to withholding substantive categories of documents relevant to the defense of a disciplinary proceeding, the proposed rule also provides a two-track discovery procedure that unfairly disadvantages the respondent. First, the proposed rule provides the respondent no means to interview witnesses or to secure testimony outside of the disciplinary proceeding itself. Well before the beginning of proceedings, the proposal authorizes the Board to demand the testimony of registered public accounting firms and associated persons and to seek the issuance of Commission subpoenas for the testimony of others. The Board is able to use these examinations not only as an investigative tool, but also in preparation for disciplinary proceedings. The Board has afforded the target of an investigation no right even to be present at these proceedings, much less to ask questions of the examinees.[74]

While respondents are permitted to request the Board to issue accounting board demands for the testimony of registered public accounting firms or associated persons or to seek the issuance of subpoenas by the Commission for the testimony of others, these measures are for the

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[73] *See* Part II.F. above.

[74] *See* Proposed Rule 5102(c)(3).

exclusive purpose of securing the presence of witnesses at the disciplinary proceeding itself.[75] Respondents are granted no procedure by which they can require the attendance of fact witnesses at pre-proceeding depositions or interviews.[76] Even with regard to this limited power to seek the attendance of witnesses at the hearing itself, the proposal leaves the issuance of demands and requests for subpoenas to the discretion of the hearing officer. Conversely, the Division of Enforcement and Investigations requires no such hearing officer or Board permission to issue accounting board demands.[77] In effect, the proposal creates a discovery system that will not provide for a vigorous adversarial process to test the accuracy of evidence—it would permit the Board significant advance preparation and leave the respondent to hear witness testimony for the first time at the hearing.

Second, the Division of Enforcement and Investigations need not produce to the respondent a log of withheld documents.[78] Instead, the hearing officer "may" order that such a log be submitted to the hearing officer. No provision is made for the respondent to gain access to such a log. Without such access, respondents cannot even begin to contest Board decisions to withhold documents. In contrast to the Division's reporting responsibilities, a respondent is required to produce to the Division a privilege log that extensively describes the documents

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[75] Proposed Rule 5424(a) (permitting respondents to request accounting board demands that "call for the attendance and testimony of a witness *at the designated time and place of the hearing*") (emphasis added); Proposed Rule 5424(b) (allowing respondents to ask the Board to seek the issuance of Commission subpoenas "in connection with any hearing ordered by the Board").

[76] Indeed, the proposal expressly denies to respondents the use of depositions for discovery purposes. Proposed Rule 5425(a), Note.

[77] Proposed Rules 5102(a).

[78] Proposed Rule 5422(b).

withheld from an accounting board demand for documents.[79] This inequitable distinction between the Board and the respondent again deprives the respondent of the ability to participate in the proceedings to the same extent as the Board and compromises the fairness of the proceedings.

D. Resolving Disciplinary Proceedings Against Respondents On Motions For Summary Disposition Is Inappropriate

Proposed Rule 5427 would permit the Board's enforcement division to seek summary judgment, without an evidentiary hearing, in a disciplinary proceeding. Such a procedure, similar to Fed. R. Civ. P. 56 proceedings, is inappropriate in this quasi-criminal context. Moreover, because a respondent firm or associated person is limited in the extent to which it can seek discovery before a hearing by the Board's current proposed rules, the respondent will be unfairly handicapped in its ability to set forth evidence establishing a genuine issue of material fact. This rule should be deleted, or modified only to permit such summary proceedings in favor of the respondent. The latter solution would be fair because the Board has access to a full battery of pre-hearing discovery tools.

E. Other Board Procedural Rules Should Be Modified

We have several other suggested changes that would enhance the consistency of the rules.

1. Proposed Rule 5420 Concerning Motions To Participate

Proposed Rule 5420, concerning the ability of parties other than the Board and the respondent to participate, should require those participating entities not to disclose information

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[79] Proposed Rule 5108(a).

from those proceedings. This revision would be consistent with the Board's general requirement that disciplinary proceedings be kept confidential.[80]

2. PROPOSED RULE 5421 CONCERNING PROCEDURES FOR ANSWERING ORDERS INITIATING DISCIPLINARY PROCEEDINGS

Proposed Rule 5421(b) allows responding parties only five days to file an answer to an order instituting non-cooperation proceedings. The proposed rule requires a respondent to admit or deny the allegations set forth in the answer and to state any affirmative defenses, suggesting that defenses not so stated will be waived. This five-day period is far too short for a party to gather the information required by the answer. Lawyers will have to determine the relevant personnel and to investigate many of the facts before they can responsibly plead.[81] The answer period should be no less than the twenty days provided by the proposed rule for other types of disciplinary proceedings. At the very least, the proposed rule should explicitly permit a respondent to provide an amended answer within twenty days and that such an amended answer will be sufficient to preserve any issue pleaded therein.

3. PROPOSED RULE 5468(A) PETITIONS FOR REVIEW OF DELEGATED AUTHORITY

Proposed Rule 5468(a) permits only five days to seek Board review of an action taken under delegated authority. The petition for review must contain relevant facts and legal support. This time period is not sufficient for an affected party to compile the requisite filing.

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[80] *See*, *e.g.*, Proposed Rule 5203.

[81] This task is all the more onerous without sufficient requirements for detail in the order initiating proceedings. *See* Part III.C. above. Without such detail, respondents will have an every greater difficulty answering in this unreasonably short time period.

CONCLUSION

Due to the short time period within which the Board has requested comments and the complicated nature of the proposed rules, it may be useful to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579 or Philip R. Rotner at (212) 492-4012.

Very truly yours,

/s/ Deloitte & Touche LLP

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