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

PCAOB Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Release No. 2004-015, Rulemaking Docket Matter No. 017

Dear Mr./Madam Secretary:

Ernst & Young LLP ("E&Y") is pleased to provide these comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed ethics and independence rules concerning independence, tax services, and contingent fees.

Ernst & Young supports the rule proposal. In our view, the Board has taken a balanced approach, seeking to distinguish between tax services that may impair independence and those that do not.

Implicit in the proposal is the recognition that audit quality is often enhanced when auditors have knowledge of a client's tax accounting gained through the provision of certain tax services. Board Member Gillan addressed this issue directly at the Board's December 14, 2004 meeting approving the issuance of these Proposed Rules. She said it had become apparent during the Board's roundtable discussion of this issue last year that an "auditor's involvement in a company's decisions about the appropriate tax treatment of some transactions can actually play a significant role in assuring the accuracy not only of annual financial statements, but quarterly disclosures as well." Transcript of the PCAOB Open Meeting, December 14, 2004 ("Transcript") at 20.

This is a point of view with which we strongly agree. We believe that the provision of tax services by an audit firm to its audit client can improve audit quality because knowledge of a client's tax profile – and the tax and accounting implications of that profile – is shared with the audit engagement team by the firm's tax professionals. This occurs best when the auditor has access to tax professionals who have acquired an understanding of the activities affecting the client's tax liability and related accounting.

The ability of the auditor to benefit from the broad expertise of his or her tax colleagues has been long held and is widely acknowledged as essential to the performance of a high quality audit. The auditor must make important judgments concerning a client's tax matters which, in many

cases, are among the largest expenses the client incurs and which can have significant financial statement impact. A firm's tax professionals, by working with their audit colleagues, can understand the differences between financial accounting and tax accounting principles. By assisting in the audit process, these professionals can help in determining that these differences are properly reflected in the financial statements by company management.

In examining the tax accounts of large multinational organizations, the audit teams place a great deal of reliance on the specialized skills and knowledge of tax personnel in countries throughout the world in determining the nature, timing, and extent of the audit procedures that should be applied to these tax accounts. The greater the client's business complexity, the more critical it is for the audit firm to have the resources and expertise necessary to complete the audit in a high quality manner. Being allowed to provide tax services to audit clients is essential for the maintenance of a highly skilled tax practice.

In this regard, we suggest that the Board's final rulemaking release provide more explanation – along the lines offered by Board Member Gillan at the December 14 open meeting – of the reasons underlying its decision to take a balanced approach to this issue. This is an important issue, and if Board Members share this view as to the important relationship between tax work and audit quality, it would be helpful if the Board were to make that position clear in its final rule release.

Our more specific comments, largely addressing technical aspects of the rule proposal, are listed below.

1. The Board should modify Proposed Rule 3522 so that it focuses on prohibiting an audit firm from "advising in favor of, or otherwise promoting," listed, confidential, or aggressive transactions as defined in the rule.

Under Proposed Rule 3522, a registered public accounting firm would not be independent of an audit client if the firm or any of its affiliates provides during the audit and professional engagement period "any non-audit service to the audit client related to planning, or opining on the tax treatment of" a listed transaction, confidential transaction, or aggressive tax position. PCAOB Release No. 2004-015 (December 14, 2004) ("Release") at A-5. The Board should modify Proposed Rule 3522 so that it focuses the prohibition of services in those circumstances where an audit firm is advising in favor of, or otherwise promoting, "listed," "confidential," or "aggressive" transactions.

Neither the Proposed Rule nor the accompanying proposing Release explains what it means to "provide any non-audit service...related to planning, or opining on the tax treatment" of the identified transactions, and we are concerned that it may sweep too broadly. This portion of the Proposed Rule could be read to preclude firms from advising clients *against* engaging in a proscribed transaction or from assisting a client in determining whether the transaction is a listed transaction (or "substantially similar" to a listed transaction).

Similarly, because the proposal would prohibit "opining on the tax treatment" of specific transactions, it could prohibit a firm from evaluating a transaction brought by a third party for

purposes of providing the client with a "more likely than not" opinion on which it could rely solely to avoid understatement penalties.[1] The proposal could also be read to preclude the firm from assisting its audit client in explaining the transaction to the Internal Revenue Service ("IRS" or "Service") or another tax authority, even though the client hired the firm to provide that service long after the client executed the transaction. For example, a client might engage in a transaction at a level of confidence below "more likely than not" and in a subsequent year engage its audit firm to assist it in its IRS examination. Under the Proposed Rule, the firm might be viewed as providing a service "related to" or "opining" on the client's tax treatment in the presentation before the tax authority.

We do not believe that such applications of the rule reflect the Board's intent. At the Board's December 14, 2004 meeting approving the rule proposal, Chief Auditor Carmichael stated, "The rule is not intended to prevent an auditor from advising a client not to do a transaction. What's contemplated in the term planning or planning on a transaction is planning that transaction to fruition or providing a positive opinion on that transaction." Transcript at 31. In response to Mr. Carmichael's statement, Board Member Goelzer said, "I think that's an important point, because it seems to me in that kind of scenario, it's actually desirable that the client might consult its accountant about the transaction, and I would hope that if that's not clear from this little exchange we've had, then perhaps that the adopting release stage or to some interpretive stage we might make that clear." *Id*.

We urge the Board to make this intent clear in the final rules by prohibiting an auditor's evaluation of an audit client's transactions – including "listed," "confidential," or "aggressive" transactions – only when the firm advises in favor of or otherwise promotes the transaction. Modifying the Proposed Rule's scope in this manner would permit audit firms to advise audit clients on the possible ramifications of the transaction, such as applicable penalties or disclosure requirements, while still barring them from assisting with the transaction's planning or implementation. Similarly, a modified rule would permit an audit firm to assist the client, after the transaction's execution and reporting in the tax return and financial statements, with respect to presentation to the IRS or other tax authority.

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[1] Congress recently amended IRC Section 6664 to provide that a taxpayer cannot rely on an opinion of a "disqualified tax advisor" to establish a defense to the assertion of a penalty under IRC Section 6662. A disqualified tax advisor includes material advisors who participate in the organization, management, promotion, or sale of the transaction. IRC Section 6664(d)(3)(B)(ii)(I). In Notice 2005-12, 2005-7 I.R.B. 494, 496 (February 14, 2005), the IRS provided interim guidance concerning its interpretation of these provisions, stating in relevant part, "Consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor's only involvement is rendering an opinion regarding the tax consequences of the transaction. In the course of preparing a tax opinion, a tax advisor is permitted to suggest modifications to the transaction, but the tax advisor may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits." Thus, the IRS distinguishes between advisors who merely evaluate the tax consequences of a transaction that has been developed by an unrelated third party and advisors who actually develop and promote the transaction. Our recommendation above would be consistent with the approach followed by the IRS in these situations.

2. The Board should clarify issues raised by the prohibitions on "listed" and "aggressive" transactions set forth in Proposed Rule 3522.

Proposed Rule 3522 would prohibit planning and opining on "listed transactions," "confidential transactions," and "aggressive tax positions." We urge the Board to clarify certain aspects of the prohibitions on "listed" and "aggressive" transactions.

2.1. *Listed transactions: The Board should make clear that an independence impairment does not arise when a transaction that was not listed at the time an audit firm advised the audit client later becomes listed.*

As an initial matter, the Board asks if Proposed Rule 3522(a) adequately describes a class of transactions that have an unacceptable risk of impairing an auditor's independence. We believe that the Proposed Rule does so. Given the attention that the IRS has given to abusive tax avoidance transactions and the Service's increasing use of listing as an indication of that class of transactions, it is appropriate to prohibit audit firms from assisting their audit clients in entering into such transactions.

We are concerned, however, about the statement in the Release that there might be a "potential impairment" of independence with regard to a transaction that is not listed at the time the accounting firm provides the advice but that later becomes listed. Release at 28-29. In our view, no independence impairment should arise when such a later listing occurs. The listing of a transaction is the notification by the IRS to taxpayers that the transaction may be potentially abusive. In fact the IRS has removed transactions from "listed" status on several occasions, thereby indicating the complexity of the factors considered in the application of the listing process. Assuming that the audit firm evaluated the tax engagement prior to pre-approval, discussed the nature of the transaction with the audit committee and received pre-approval, and was able to opine at a "more likely than not" level of confidence upon implementation of the transaction, the subsequent listing of the transaction should not be considered an impairment of the firm's independence.

The Board stated in the Release its concern that the later listing of the transaction may affect the auditor's independence for several reasons – the audit firm or the audit client (or both) might be required to pay penalties, the firm might have civil liability, or the firm might have an incentive to allow the transaction to be reflected inaccurately for financial accounting purposes so that the transaction's tax treatment appears correct. Release at 28-29. But these same or similar situations have long arisen in other contexts, without impairing independence. For example, an accounting firm's audit opinion might be called into question when the client is required to restate its financial statements, thereby giving rise to potential civil liability or penalties. That development does not, by itself, impair the auditor's independence. Existing auditor independence rules already address these situations. For example, ET Section 101.08 and the codification in FRR 606.02(f)(ii) provide that independence may be impaired by actual or threatened litigation between the client and its auditor and set forth factors for assessing independence in this situation. We believe that transactions that are listed by the IRS subsequent to implementation, and any controversies or disputes arising from such listing, could be addressed with these same

general independence rules. Further, the "more likely than not" standard in Proposed Rule 3522(c) is a high standard, and the PCAOB can use its inspection process to examine the basis for a firm's conclusion when a particular transaction later becomes listed. These are significant safeguards against the promotion by accounting firms of inappropriate tax transactions.

2.2. *Aggressive tax positions*

Under Proposed Rule 3522(c), a "transaction" that (1) is "initially recommended" to an audit client by a registered public accounting firm "or another tax advisor" and (2) has a significant tax avoidance purpose, would qualify as an "aggressive tax position" unless the proposed tax treatment is at least "more likely than not" to be allowed under applicable tax laws. *See* Release at A-5. There are several areas that need clarification.

A. The final rule should clarify the definition of the term "transaction" for purposes of assessing when a transaction has been initially recommended by the audit firm.

The definition of "transaction" is critical in applying the "initially recommended" provision of the rule. For example, suppose a client decides to acquire another company for business reasons and consults with its auditor for tax advice on how to efficiently execute the acquisition for tax purposes. If the "transaction" is the acquisition itself, then the audit firm would presumably be permitted to provide overall tax planning for the acquisition. If, however, the "transaction" is deemed to be the tax advice related to the acquisition, then the tax planning alternatives might each be viewed as "initially recommended" by the audit firm and therefore could be a prohibited service.

As another example, suppose a client proposes to sell a building and asks its audit firm for planning and advice. The sale might result in a taxable gain, and, as a result, the firm might suggest alternative means of disposing of the building. If the "transaction" is deemed to be the sale of the building, then the firm could provide a range of alternatives for disposition (*e.g.* selling it outright, entering into a like-kind exchange transaction or a joint venture) without each of these alternatives being treated as initially recommended transactions.

B. The final rule should clarify that the "more likely than not" standard applies to overall tax advice, rather than each separate element covered by the advice.

The Board should clarify how to assess transactions with multiple steps. For example, the standard could apply to each element of tax advice the client follows when acquiring another company (*e.g.* the formation of an acquisition entity, the consolidation of acquired subsidiaries, or other internal elements), or it could apply to the advice as a whole.

To eliminate this uncertainty, the final rule should clarify that the "more likely than not" standard applies to the overall tax advice, rather than each step or element of tax planning or advice. Such a clarification would be consistent with the recent IRS guidance on opinion standards for tax practitioners who provide advice on federal tax issues. *See Treasury Department Circular No. 230 (Rev. 7-2002)*, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the*

IRS or *Practice Before the Internal Revenue Service*, 31 C.F.R. Sections 10.0-10.97 (2004). Under those standards, federal tax practitioners who issue opinions on the confidence level of a transaction must consider all significant federal tax issues and reach an overall conclusion on the transaction. 31 C.F.R. Section 10.35. It would also be consistent with the Board's efforts to "incorporate an existing framework that auditors who serve as tax advisors already follow in their tax practices." Release at 28.

C. The final rule should accommodate non-U.S. jurisdictions by providing an alternative to the "more likely than not" standard.

Because the "more likely than not" standard is a U.S. tax term, it carries with it associations and meanings that have developed through U.S. case law and IRS guidance. These meanings and context may not be readily apparent outside the U.S. tax system. Rather than seek to apply a U.S. standard globally, we would recommend a different term that is easy to understand and apply in other taxing jurisdictions, such as "more than 50% chance of the position being upheld upon review by the relevant tax authorities."

D. The final rule should reconsider the inclusion of "another tax advisor" in Proposed Rule 3522.

Proposed Rule 3522 would prohibit the audit firm's involvement in aggressive tax positions initially recommended by another tax advisor. If the Board were to adopt our suggestion above that Proposed Rule 3522 only extend to advising in favor of or otherwise promoting listed, confidential or aggressive transactions, we would not be so concerned about the extension of the restriction to "another tax advisor." But without that limitation, the Board should consider deleting the phrase "another tax advisor" from the proposal, so that the proposal would only apply to transactions brought to the client by the audit firm itself. Otherwise, for the reasons discussed above, the rule would prevent a company's audit firm from advising its audit client against entering into a transaction proposed by another tax advisor. If the Board's concern is that firms might use third parties as their agents to promote improper tax strategies, the Board might address that concern by prohibiting firms from "directly or indirectly" recommending an aggressive tax strategy. Eliminating the reference to "another tax advisor" would also avoid the need to make difficult factual determinations as to whether a third party "initially recommended" the transaction (in which case the rule's prohibition would apply), or whether it was instead initiated by the client itself (where the prohibition would not apply).

E. The final rule should not require audit firms to obtain a third-party tax opinion to support a transaction's tax treatment if the potential effect of the treatment could materially affect the audit client's financial statements.

The Board seeks comments on whether it should require an audit firm to obtain a third-party tax opinion in support of the tax treatment if the potential effect of the treatment could have a material effect on the audit client's financial statement. Release at 35. We do not believe such a requirement would be necessary. The PCAOB's Proposed Rules would significantly raise the threshold regarding audit firm involvement in certain tax planning activities, and those rules should be allowed to take effect before determining whether additional requirements are

necessary. Moreover, obtaining the opinion of a third party would seem redundant and unnecessary, as the firm is already required to perform an analysis of the tax transaction. The Board itself notes that registered firms that provide tax services are in a position to perform this analysis and cannot rely on the opinion of a third party to satisfy the rule's standard. Release at 34 n.71. Also, requiring a firm to obtain the opinion of a third party would result in increased costs to both the firm and the audit client.

3. The Board should reiterate the SEC Staff's view that the independence principles do not generally prohibit the provision of permissible tax services to audit clients.

The PCAOB's Release notes that the Securities and Exchange Commission ("SEC"), in a Preliminary Note to its 2000 independence rules, set forth four principles of auditor independence.[2] Release at 13-14. Against the backdrop of those principles, the Release states that the Board "has determined at this time to propose restrictions only in two particular areas." Release at 14. It would appear, therefore, that other tax services are permissible, subject of course to audit committee pre-approval.

There has, however, been some confusion as to how the principles apply to permissible tax services, and we therefore urge the PCAOB to provide clarification in this area. The "auditing your own work" restriction has been a particular source of confusion. There are many instances in which a tax service that the Board considers permissible – such as "general tax planning and advice" (Release at 15) – might arguably result in the auditor "auditing its own work."

For example, a company may engage its audit firm to conduct a research and development tax credit study. Such a study typically involves (1) reviewing the company's activities to determine the potential for claiming an R&D credit on its tax return; and (2) identifying the expenditures that would "qualify" for the credit under Sections 174 and 41 of the Internal Revenue Code. After receiving the study from the audit firm, the company's management would take responsibility for it, including reflecting the credit amount on the tax return filed with the IRS. Management would also need to account properly for the amount of the R&D credit in the company's financial statements, including the assessment of any potential tax contingencies required under FAS 5.

Management's determinations with respect to the impact of the R&D analysis will be reflected in the company's financial statements. In making its determinations, management would likely consider any report, opinion, or analysis provided by the auditor through the tax services engagement. As such, one might possibly conclude that an audit firm was "auditing its own work" and should be precluded from providing this service, even though the company's

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[2] Under the four principles, a firm may not perform for audit clients any service that (1) creates a mutual or conflicting interest between the firm and the audit client; (2) places the firm in the position of auditing its own work; (3) results in the firm acting as management or an employee of the audit client; or (4) places the firm in a position of being an advocate for the audit client. 17 C.F.R. Section 210.2-01, Preliminary Note (2001).

management is solely responsible for determining the proper financial statement accounting treatment as part of its income tax provision process.

Similar concerns would also be present in other tax advisory engagements. For example, a company may inquire about the tax treatment of a gain from the sale of an asset. The audit firm's tax advice will be evaluated by management, which will detrmine the effects of the transaction on the company's financial statements. Based on the Proposed Rule and the Release, it would appear that this is a type of service that a company should be able to obtain from its audit firm in the capacity of a tax services provider. Applying the principle that a firm should not be auditing its own work, however, could lead audit committees to conclude that this service poses an independence concern. Similar questions can arise for other tax work, such as cost segregation studies, tax accounting method support, tax basis computations, general tax advisory engagements, and tax return preparation engagements.

Because the company is responsible for the accounting determination, recording, and disclosure of the effects of general tax planning and advice, we do not believe that the services described above violate the "audit your own work" principle. This has also been the SEC Staff's view: the principles "have not been strictly applied to traditional tax services, such as tax compliance and preparation, tax planning, and the provision of tax advice. For example, when an auditor prepares a company's tax return, the fact that the amount of tax owed may impact the accrued tax liability reflected in the company's financial statements has not been deemed to impair the auditor's independence." Memorandum from Scott A. Taub, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission 5-6 (June 24, 2003).

Accordingly, the final rules should clarify that the principles generally do not preclude an audit firm from providing otherwise permissible tax services to audit clients. In clarifying this point, the Board should note that the audit client's consideration of information obtained from the audit firm's provision of permissible tax services does not violate the "auditing your own work" principle, provided those services do not represent the creation of journal entries or similar source documentation.

As a final note in this regard, the Release lists several tax services (*e.g.*, "routine tax return preparation and tax compliance" and "general tax planning and advice") that are permitted under the proposal and asks whether "there are other types of tax services that could appropriately be included in this discussion." Release at 15-17. We do not believe that such a list would be necessary. Indeed, any such list might infer that tax services omitted from the list are not permitted, which we do not believe would be an appropriate result. A recommended approach is one described above, namely, to reiterate the SEC Staff's position regarding application of the principles to tax services. Further, if the PCAOB were to set forth such a list, the Board should consider incorporating by reference those services described by the SEC as permissible tax services in its rulemaking release. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, 68 Fed. Reg. 6006, 6012, 6031 (Feb. 5, 2003) ("SEC Release") ["Our rules do not prohibit an accounting firm from providing such services for non-financial reporting (*e.g.*, transfer pricing studies, cost segregation studies, and other tax-only valuations) purposes."]; [noting that "[t]ax planning and tax advice encompass a diverse range of

services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans, and requests for rulings or technical advice from tax authorities"].

4. The Board should clarify additional aspects of the rule proscribing the provision of tax services to officers in a financial reporting oversight role.

4.1. *The Board should consider specifying the persons to whom the restrictions apply as opposed to using the term "financial reporting oversight role."*

While we support the Board's decision to limit the services an audit firm can provide to an officer in a financial reporting oversight role, we are concerned that some confusion will result from the use of the term "financial reporting oversight role" in Proposed Rule 3523. That definition includes a person who "is a member of the board of directors or similar management or governing body." Release at A-5. However, it seems clear that the Board did not intend to include board members in the restriction. This is because the Proposed Rule itself only extends "to *an officer* in a financial reporting oversight role." *Id*. (emphasis added). Likewise, the Proposing Release states that the rule "would apply only to tax services provided to officers in a financial reporting oversight role at an audit client." Release at 36. To avoid confusion, we think it would be helpful to include this statement in the text of the rule itself.

Alternatively, the Board should consider specifying the persons to whom the restrictions apply as opposed to using the term "financial reporting oversight role." This approach might also avoid the difficulties that arise from use of the defined term "audit client" in Proposed Rule 3523. Proposed Rule 3501 would adopt certain definitions that are used in the SEC's independence rules, including a definition of "audit client" that includes "affiliates" of the audit client and a definition of "affiliates" that includes (among other things) "[a]n entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries." Release at A-1. Accordingly, the Proposed Rule's prohibitory reach would be very broad.

Effective compliance with such a broad rule would be difficult. Many of our foreign affiliates have tax practices with several thousand individual clients. The fees these clients pay for routine tax return preparation and advice is minimal on a per return basis, and the non-U.S. affiliates have very limited contact with these tax clients during the year.

With such a broad application, uncertainty regarding who is considered an officer in a financial reporting oversight role will cause organizations to spend a great deal of time identifying and monitoring the individuals moving into and out of these roles. Audit committees, in an attempt to avoid the risk of an inadvertently violating the rule, may conclude that many individuals will fall into the restricted class and will be faced with the decision to have multiple tax service providers or to change to a tax service provider that is not the auditor. Some "investment company complex" organizations that engage a number of audit firms may not be able to identify any firm that would be permitted to provide service to all the individuals in their expatriate program. This

result would be inconsistent with the intent of the rules, which allows expatriate tax services to be provided to attest clients. Release at 16.

Accordingly, we believe that this prohibition should be redefined. One possible description of persons who should be covered by the rule is included in the SEC's rules governing insider transactions under Section 16 of the Securities Exchange Act, which contains a definition of "officer," assuming the definition is limited to persons in a financial oversight reporting role.[3] Limiting the rule to this well-defined set of officers provides clarity as to the individuals covered by the rule, making the rule easier both to administer and to comply with. This would also be consistent with the Board's statement in the Release that the proposal is "narrowly tailored to include only those tax services that a registered public accounting firm provides to individuals in a position to play a significant role in an audit client's financial reporting." Release at 36.

4.2. *The Board should provide transitional relief under Proposed Rule 3523.*

The Board should address certain transitional issues arising under Proposed Rule 3523. The rule should provide that a firm's independence is not affected if tax services are provided before the executive becomes a covered officer. The Release describes the restriction on the provision of tax services for officers in a financial reporting oversight role as designed to preclude the appearance of a "mutual interest" between the auditor and individuals in a position to play a significant role in an audit client's financial reporting. Release at 35 n.72. If the executive did not have the ability to exert this influence before taking on the financial oversight role, then the prior provision of tax services should not affect the firm's independence going forward.

Transitional issues will also arise in the context of a merger or other business combination. If an audit client merges with or is acquired by another entity for which the firm is providing executive tax services, the executive could then become a person in a financial reporting oversight role of the combined entity being audited by the firm. So long as the firm ceases providing tax services to the executive, the final rule should clarify that the firm's independence will not be affected. The SEC provides a similar exception for mergers with regard to the "cooling off period" for employment at a former issuer. SEC Release at 6009.

We would suggest modifying the rule to provide a transition period that would allow a firm to complete the engagement related to the year the individual becomes a covered officer, perhaps

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[3] 17 C.F.R. Section 240.16a-1(f) states: "The term 'officer' shall mean an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other person who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust."

with a final deadline of 12 months. We would also ask that the transition rule include a statement that future tax services, such as assisting the individual with responses to inquiries by the IRS or other governmental agencies related to the year, for which the tax return relates, are permitted. Without such a transition rule, the individual, as well as a successor tax service provider, would be denied access to the firm with the knowledge needed to respond to such inquires.

4.3. *The Board should clarify the effective date of Proposed Rule 3523.*

The Release states that a firm's independence is not impaired as long as the newly proscribed services "were provided by the registered public accounting firm in connection with original returns filed no later than October 20, 2005, or 10 days after SEC approval of the rule, whichever is later." Release at 43. Read literally, this means that our firm (and we assume others as well) may already have independence impairments with respect to some audit clients. This is because we have in some instances assisted officers in financial oversight roles at audit clients in determining their estimated taxes for the first quarter of 2005, and the original return for 2005 will of course be filed after October 20, 2005. A similar issue is raised with respect to non-U.S. tax returns. In the United Kingdom, for example, the tax year runs to April 5 and returns are filed by January 31 of the following year. The rule as drafted would impair our independence with respect to work on those returns. We do not believe that the Board intended such a retroactive application of its rule. Accordingly, we suggest that firms be permitted to complete individual tax returns covering periods that fall wholly or partly prior to December 31, 2004, with perhaps a final deadline of 12 months after the final rule is issued.

5. We do not believe that Proposed Rule 3524(a)(i) is necessary in order to accomplish the Board's objectives, and it would be highly burdensome to audit committees if adopted.

Proposed Rule 3524(a)(i) would require that, as part of the audit committee pre-approval process for non-audit services, the audit firm must provide the audit committee with "the engagement letter relating to the service, which shall include descriptions of the scope of the service and the fee structure, any amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service." Release at A-6. We do not believe that this rule is necessary in order to accomplish the Board's objectives and in fact could undermine audit committee effectiveness.

As the Release notes, the SEC has addressed the pre-approval process, both in its 2003 independence rulemaking and in informal guidance from the Office of the Chief Accountant. *See* SEC Release at 6022; Memorandum from Scott A. Taub, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission (June 24, 2003); *Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions, FAQ No. 22-24* (August 13, 2003), http://www.sec.gov/info/accountants/ocafaqaudind080703.htm.

We are not aware of any evidence that the SEC's requirements have been ineffective in ensuring that audit committees give adequate consideration to tax and other non-audit services. Nor does

the PCAOB's Release indicate that experience under the SEC's requirements warrants the adoption of new or incremental pre-approval rules. Our experience has been that audit committees and audit firms take the existing procedures and the pre-approval process seriously and that they have been working well.

In addition, the Proposed Rule would add a layer of complexity to the pre-approval process. It would mean that audit committees would be required to follow one set of pre-approval rules – adopted by the SEC – for most non-audit services, and another set of rules – adopted by the PCAOB – for tax services. This could lead to confusion and frustration by audit committees, and could lead to inadvertent mistakes in the pre-approval process.

Moreover, the rule as proposed would be highly burdensome. Large multi-national corporations often have hundreds of tax projects that require audit committee pre-approval. Taking into account all the countries where the company has operations, there may be hundreds of relevant engagement letters (almost certainly at least one per country). Some letters may be in languages other than English and would be required to be translated. Much of the text of a typical engagement letter is irrelevant to independence concerns, relating to matters other than the scope or nature of the services or the fee arrangements. Audit committee members, in order to fulfill both the letter and the spirit of their responsibilities, would presumably feel obligated to read the entirety of such letters or engage outside counsel to the audit committee to do so. As a result, committee members or others working on their behalf would be required to read hundreds or even thousands of pages of documentation. This would be time-consuming and burdensome and would potentially reduce the level of oversight on other more significant issues. Given this level of detail, the Proposed Rule would effectively require audit committees to assume functions of management.

Some audit committees might decide that these requirements are so burdensome, and so likely to result in inadvertent violations, that it would be easier simply not to hire the audit firm to perform tax services. For the reasons noted above, such a result would be inconsistent with the Board's objectives.

It might be thought that audit firms could avoid some of these problems if they were to provide a global engagement letter or services arrangement, providing a detailed description of the allowable services. But tax regimes and tax authorities operate on a national and local basis and, hence, engagement terms are most often dealt with on a country-by-country basis. The client's local country management will be providing information, reviewing returns, and so on, all in direct contact with local country tax advisers. Thus, even where there is an overarching contractual arrangement, there will normally be a local service level agreement stating, for example, the obligations on management to provide necessary tax information or to sign and submit returns by specified local filing deadlines, and the obligations on the tax adviser to complete returns by specified deadlines. The agreement might also contain various explanations about the operation of the local tax system and the application of local professional and ethical obligations. Multiplying this information by, say, sixty times for a company that operates in sixty countries would create a huge burden for the audit committee.

Given the numerous burdens Proposed Rule 3524(a)(i) would impose on audit committees, we believe that the PCAOB should not adopt it. The pre-approval requirements established by the SEC and its Staff provide ample rigor for audit committees to determine that the provision of permitted tax services will not impair the auditor's independence.

We should note that we have no concerns about the other portions of Proposed Rule 3524. In fact, we think it would helpful if accounting firms were required to "discuss with the audit committee the potential effects of the services on the independence of the firm," as would be required by Proposed Rule 3524(b), and to "document the substance of its discussion with the audit committee," as would be required by Proposed Rule 3524(c). We think, however, that these requirements should apply to all non-audit services, not solely tax services, and accordingly believe they might be better addressed in other guidance that could be issued by the PCAOB or the SEC.

6. The Board should modify Proposed Rule 3502, "Responsibility Not to Cause Violations."

Proposed Rule 3502 provides:

> A person associated with a registered public accounting firm shall not cause that registered public accounting firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation.

Release at A-4. The Board stated that "[w]hile certain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm, the firm's associated persons bear an ethical obligation not to be a cause of any violations by the firm." Release at 18. The Release makes clear that the rule would establish a negligence standard for "causing" violations: "When an associated person negligently causes the registered firm to not be independent, Rule 3502 would allow the Board to discipline that associated person for that action." Release at 19.

The Board specifically invited public comment on two issues. First, whether there are "categories of circumstances encompassed by the rule as proposed that should not be encompassed by the rule for some reason" and, second, where a firm is found to have committed a violation that requires proof of scienter, "would it be appropriate to find a Rule 3502 violation by an associated person who negligently contributed to the violation." Release at 19.

We have several comments on the proposal.

1. Although neither the text of the Proposed Rule nor the accompanying explanatory statement expressly refer to secondary liability, the effect of the rule is to create a new species of secondary liability for associated persons – to authorize the imposition of disciplinary sanctions upon an associated person even though the associated person himself or herself does not violate

the applicable legal standard. The Sarbanes-Oxley Act does not expressly authorize the Board to take disciplinary action on this basis; rather, the statute refers only to the imposition of sanctions for engaging in "any act or practice, or omission to act, *in violation of*" the Sarbanes-Oxley Act, the securities laws, the rules of the Board or Commission, or professional standards. Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4) (2002) (emphasis added).

It is not at all clear that the Board's rulemaking power extends to creating a form of liability not authorized by Congress. The Supreme Court in *Central Bank* drew a clear distinction between primary and secondary liability, holding that Congress knew how to impose secondary liability when it wanted to and that the absence of any express authorization for such liability barred courts from implying it. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S.164, 182-184 (1994). Similarly, Congress in similar circumstances has expressly authorized the imposition of administrative sanctions on a secondary liability theory. *See*, *e.g.*, Securities and Exchange Act of 1934, Section 21C, 15 U.S.C. § 78u-3.

During the PCAOB meeting at which the Proposed Rule was approved, the Board's General Counsel stated that Rule 3502 "is essentially an ethical rule. It sets an ethical standard for accounting firms and for their associated persons, and we believe that...it's an appropriate exercise of the Board's ethics standard setting authority." Transcript at 35-36. But the typical ethical standard delineates particular impermissible conduct. The Board's rule, by contrast, makes any conduct potentially sanctionable, depending upon whether it somehow contributes to a violation by a firm.

We are not opposed to the Board's goal of imposing disciplinary sanctions on associated persons who violate relevant laws and regulations. The Board has previously adopted rules for this purpose, and we have supported the adoption of those rules. *See*, *e.g.*, PCAOB Rule 3100 (providing that associated persons of a registered public accounting firm "shall comply with all applicable auditing and related professional practice standards"). We support the establishment of an effective enforcement regime by the PCAOB, with respect to both registered firms and their associated persons. But the extent to which the Board has authority to adopt a rule like this is not certain, for the reasons just discussed. That fact counsels in favor of adopting a traditional standard for secondary liability. The Board, however, has proposed an unusually broad standard that is inconsistent with long-settled principles of secondary liability.

2. Secondary liability by definition addresses situations in which an actor does not violate a legal norm, but instead is involved in some way in the violation of that norm by another individual or entity. The secondary actor's conduct by itself is lawful; it provides the basis for imposing a sanction because of its relationship to the wrongful conduct of another. In these circumstances, courts and commentators have emphasized the need to configure secondary liability standards to provide reasonable notice to the secondary actor of the potential wrongfulness of his actions.

The Restatement (Second) of Torts addresses this issue by identifying three situations in which liability is appropriate:

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he
>
> (a) does a tortious act in concert with the other or pursuant to a common design with him, or
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

See § 876 (Persons Acting in Concert) (1979). Thus, liability is permissible only if the secondary actor has himself violated a legal norm (subsections (a) and (c)) or if the secondary actor *knows* that the actions of the other party constitute a violation (subsection (b)).

Neither of these protections is incorporated in the Proposed Rule. An associated person may be disciplined even if his or her conduct does not violate another legal norm and even if the person does not know that his actions are facilitating a violation by the entity. The Proposed Rule therefore creates the very situation that the Restatement standards are designed to prevent: imposition of liability in circumstances in which it would be difficult, if not impossible, for a diligent associated person to know in advance how to act in order to protect against the imposition of disciplinary sanctions.

The D.C. Circuit addressed this issue in the context of an SEC enforcement action under the provision of the Investment Company Act that prohibits payments creating conflicts of interest. *See Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980). The court upheld the Commission's determination that proof of knowledge of the wrongdoing was not required to impose sanctions upon those sanctioned for violating the provision. It reached a different conclusion with respect to the individual held liable on an aiding and abetting theory:

> The awareness of wrong-doing requirement for aiding and abetting liability is designed to insure that innocent, incidental participation in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties. This policy is especially germane where the prescribed conduct of the principal may not always appear to be wrongful...
>
> To the extent the Commission concedes a need for any state of mind requirement at all, it argues that a negligence standard meets the concerns mentioned above. The Commission contends that an accused aider and abettor can be censured whenever he "should have been able to conclude that his act was likely to be used in furtherance of illegal conduct." We do not agree. This standard has previously been used only in civil injunctive actions where the paramount concern is terminating the illegal conduct, not sanctioning the wrongdoers. It creates a duty to investigate potential violations of law which "in essence would amount to eliminating (any awareness of wrong-doing) as a necessary element in

> imposing aiding and abetting liability." Where sanctions can be imposed, the negligence standard provides insufficient protection for those persons whose involvement in securities law violations is in one respect substantial, yet wholly innocent.

Investors Research Corp. v. SEC, 628 F.2d at 177-178 (footnotes omitted); *see generally* David S. Ruder, *Multiple Defendants in Securities Fraud Cases: Aiding and Abetting, Conspiracy*, In Pari Delicto, *Indemnification and Contribution*, 120 U. PA. L. REV. 597, 638 (1972) ("[K]nowledge of the primary illegal course of conduct should be required for aiding and abetting or conspiracy liability.").

The statutory provision governing disciplinary actions against broker-dealers and their associated persons embodies these fundamental principles. Section 15(b)(4)(E) of the Securities Exchange Act, 15 U.S.C. § 78o(b)(4)(E), states that the Commission may impose sanctions upon proof that a person "has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of" the securities laws. The requirement of proof of "willfull[ness]" is consistent with the fundamental rule that proof of knowledge of the wrongdoing is necessary to avoid the imposition of sanctions upon innocent persons.

Most importantly, Congress itself adopted a knowledge standard when it addressed this very issue. Section 20(f) of the Securities Exchange Act, 15 U.S.C. § 78t, authorizes the SEC to bring enforcement actions against a person who aids and abets violations of the securities laws only upon proof that the person "*knowingly* provides substantial assistance to another person in violation of" the securities laws or regulations issued thereunder (emphasis added).

It might be argued that analogizing to aiding and abetting standards is inappropriate because the focus of Rule 3502 is the situation in which an individual "causes" a firm to violate a PCAOB rule. To begin with, although it is true an entity can act only through individuals, it is not always – or even most of the time – true that a single individual causes the entity to act in a particular manner. Most often, the entity's actions are the result of the confluence of decisions and actions by a number of different individuals. Therefore, determining who caused a firm to violate a rule could be a difficult enterprise.

Moreover, the Proposed Rule imposes liability upon anyone whose negligent act or omission "contribute[s]" to the firm's violation. As we discuss in greater detail below, this standard moves well beyond actions or omissions that are the direct cause of the violation to encompass actions or omissions that aid in its occurrence. It is classic aiding and abetting language.

During the PCAOB session at which the Proposed Rule was approved, Mr. Carmichael acknowledged that the Board's proposal "does not require the proof of all the elements of aiding and abetting." Transcript at 37. He indicated that the proposal was based in part on Section 21C of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-3, which authorizes the issuance of civil cease-and-desist orders. For the very reasons identified by the D.C. Circuit in *Investors Research Corp.*, it is inappropriate to analogize the imposition of disciplinary sanctions to prospective injunctive relief.

Indeed, the negligence standard proposed by the Board would lead to the same unfair results described by the court in *Investors Research Corp*. For example, in the audit context, one member of an audit team could conform his or her conduct to all applicable professional standards – unaware that a particular action he or she had undertaken would make it harder to detect the failure to adhere to professional standards by an individual in an entirely different component of the audit team. Under the Proposed Rule, the first individual would be subject to sanctions if an after-the-fact analysis concluded that he or she was negligent in failing to anticipate the inadequate performance of his or her colleague.

In the independence context, a design decision with respect to a firm's independence monitoring system might, in retrospect, be found to have been inadequate in ensuring compliance with the rules, or might be found to have made the discovery of violations by associated persons more difficult than should have been the case. With negligence as the standard applied in hindsight to the extremely complex operations of audit firms, and without any objective limitations on the conduct that could give rise to liability, the Proposed Rule opens the door to extraordinarily expansive disciplinary liability.

And it is important to note that, even though the Board's sanction authority is limited to individual fines of $100,000 – still a very significant amount of money – the Board's sanctions could have significant collateral consequences. Section 3(b) of the Act provides that "[a] violation by any person of...any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78q et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act..." Although Section 105's limitations with respect to direct sanctions presumably override this provision, there may be federal collateral consequences to securities law violations that would still attach.

More significantly, many state boards of accountancy have the authority to impose follow-on sanctions in the event the licensee has been the subject of any disciplinary sanction by the PCAOB or has been found to have violated the federal securities laws. *See*, *e.g.*, CAL. BUS. & PROF. CODE § 5100(l) (2004). Action by the PCAOB therefore could produce a domino effect of additional, harsher sanctions by state boards.

We are very sympathetic to the goal underlying the Board's proposal; no one has a greater interest in promoting compliance with the Board's rules than a firm that is subject to disciplinary action if it is found to have violated them. For that reason, we have implemented very detailed control systems to promote compliance with the Board's independence rules and other standards to the greatest degree possible. We believe, however, that the Proposed Rule creates a trap for the unwary that threatens the imposition of sanctions on an unfair basis.

3. Apart from the flaw in the Board's general approach, it would be especially inappropriate and unfair to impose secondary liability based upon negligence when the primary violation requires proof of scienter. Such a result would be inconsistent with the intent of the Congress that enacted those primary violation standards by in effect overriding its decision with respect to the appropriate state-of-mind standard. A secondary violator should not be held to a lesser state-of-mind requirement than a primary violator.

4. If the Board revises the rule to adopt the well-established standards governing the state of mind required to impose secondary liability, there would be no need to revise the portions of the rule describing the necessary connection between the secondary violator's conduct and the primary violation. The current description – that the secondary violator's conduct must "contribute" to the primary violation – is entirely consistent with an aiding and abetting standard. On the other hand, if the Board retains the negligence standard, it should require a much closer connection between the secondary violator's conduct and the primary violation.

Presumably, the Board's justification for adhering to the negligence standard would be its observation that an entity acts only through individuals, and the individuals responsible for an entity's violation should also be subject to disciplinary sanctions. The current language of the rule, however, would sweep in individuals who innocently engaged in conduct that later was deemed to have contributed to the entity's violation.

To calibrate the rule's scope to the Board's intention, it would be necessary to replace the terms "cause" in the first clause and "contribute" in the last clause. These terms are too broad, permitting the imposition of sanctions on individuals who were not the moving force behind the entity's violation but rather merely contributed to it. "Cause" can encompass any factor that produces a particular result – that is why tort law distinguishes between but-for causes and proximate cases.

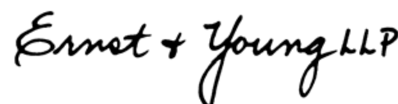
In other contexts, courts have recognized that "contribute" has an even broader meaning. *See*, *e.g.*, *Old Ben Coal Co. v. Director, OWCP*, 62 F.3d 1003, 1008 (7th Cir. 1995) (stating that a "contributing cause" under coal dust exposure regulation "means coal dust exposure was a necessary, though not necessarily sufficient, cause of the miner's disability"); *Cox v. City of Dallas*, 256 F.3d 281, 295 (5th Cir. 2001) (interpreting "contribute" in the Resource Conservation and Recovery Act "to mean 'have a part or share in producing an effect'"); *see generally* Black's Law Dictionary 234 (8th ed. 2004) (defining "contributing cause" as "[a] factor that – though not the primary cause – plays a part in producing a result").

If the Board retains the negligence standard, it should replace these two terms with "proximately cause." Although we believe that the resulting standard still would threaten to include innocent behavior for the reasons discussed in point 2 above, it at least would be focused on individuals who are the principal force behind the entity's violation.

* * *

We would be pleased to discuss our comments with members of the PCAOB or its staff.

Very truly yours,



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