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WSGR ALERT

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SUPREME COURT HOLDS PCAOB MEMBER REMOVAL PROVISION OF SOX UNCONSTITUTIONAL

On June 28, 2010, the United States Supreme Court issued a long-awaited decision concerning the validity of the Sarbanes-Oxley Act of 2002 (SOX). The decision largely left SOX undisturbed. However, the ruling in *Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board* potentially will have a significant impact on both administrative and securities law. The decision addressed two constitutional questions: (1) whether the provision of SOX creating the Public Company Accounting Oversight Board (PCAOB) violated the Constitution's separation-of-powers provisions; and (2) whether the PCAOB violated the Constitution's Appointments Clause.

The Court unanimously rejected the challenge under the Appointments Clause, but held, 5-4, that the for-cause limitations on the removal of PCAOB members contravened the Constitution's separation-of-powers provisions. The Court found that PCAOB members, who are appointed by the Securities and Exchange Commission (SEC), were impermissibly insulated from presidential control by two layers of tenure protection: PCAOB members could only be removed by the SEC for cause, and the SEC commissioners could in turn only be removed by the President for cause. The Court severed the unconstitutional tenure provisions from SOX, but upheld the remainder of the statute.

Background

In enacting SOX, Congress created the PCAOB to regulate public accounting firms in the wake of the Enron and Worldcom accounting scandals. SOX granted the PCAOB extensive regulatory and enforcement authority over all accounting firms that audit publicly traded companies. Every such firm must register with the PCAOB, pay an annual fee, and comply with its rules and oversight. PCAOB also may inspect registered firms, initiate formal investigations, and issue severe sanctions in its disciplinary proceedings.

The PCAOB is composed of five members appointed by the SEC. The SEC, itself an independent agency, has broad supervisory authority over the PCAOB, including the power to approve or abrogate any rule that the PCAOB promulgates, review any sanction that the PCAOB imposes, and promulgate rules restricting or directing PCAOB investigations. As set forth in SOX, the SEC may remove a member of the PCAOB only if it found that the member willfully violated a provision of SOX, abused his authority, or failed to enforce SOX or its rules. The SEC commissioners, in turn, cannot be removed by the President except "for cause." This dual for-cause removal mechanism, coupled with the extensive regulatory and enforcement powers of the PCAOB, was at the heart of the separation-of-powers argument.

Petitioners were Beckstead and Watts, an accounting firm that was investigated by the PCAOB, and the Free Enterprise Fund, a nonprofit public interest organization of which Beckstead and Watts is a member. They brought suit in the U.S. District Court for the District of Columbia against the PCAOB and its members, seeking a declaratory judgment that the PCAOB is unconstitutional and an injunction preventing the PCAOB from exercising its powers.

The suit challenged the PCAOB as violating the Constitution's separation-of-powers principles and Appointments Clause. The district court found that it had jurisdiction and granted summary judgment to the PCAOB. The Second Circuit affirmed, and the Supreme Court granted certiorari.

The Decision

The 5-4 decision for the Court was written by Chief Justice Roberts, who was joined by Justices Scalia, Kennedy, Thomas, and Alito, with Justices Breyer, Stevens, Ginsburg, and Sotomayor dissenting. The issue that divided the Justices was the significance of the dual for-cause removal mechanism for the status and control of PCAOB members.

The majority agreed with the petitioners that the dual for-cause limitations on the removal of board members implemented by SOX contravened the Constitution's separation-of-powers provisions. Turning to Article II of the Constitution, the Court found that the ability to keep executive officers accountable, including by removing them from office if necessary, is a key and inalienable corollary of the presidential powers.

The Court acknowledged that since the 1920s, various impositions on the President's removal power have been permitted by the

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Court. Thus the Court held that Congress may, under certain circumstances, create independent agencies run by "principal officers" appointed by the President, whom the President may not remove at will, but only for good cause. The Court sustained similar restrictions on the power of the principal executive officers—themselves responsible to the President—to remove their own inferiors. The Court has never, however, considered or approved a dual level of removal restrictions. Such restrictions, in the Court's view, not only protected PCAOB members from removal except for good cause, but withdrew from the President any decision on whether the good cause existed. That decision was vested instead in the SEC commissioners who are themselves not subject to the President's direct control. The Court found that arrangement contrary to Article II's vesting of the executive power in the President.

Finding that the existence of the PCAOB itself does not violate the Constitution, the Court unilaterally severed the removal-for-cause clause from SOX, with the remainder of the statute continuing to be "fully operative as law." With the tenure provisions excised from the statute, PCAOB members became removable by the SEC for any reason.

The Court rejected the petitioners' second—and potentially more far-reaching—argument that the PCAOB's appointment by the commissioners was inconsistent with the Appointments Clause in Article II of the Constitution, which requires "Officers of the United States" to be appointed by the President (with the Senate's advice and consent), or in the case of "inferior officers," by the President alone, by the courts, or by the "Heads of Departments." The Court found that PCAOB members were inferior officers and that the SEC was a Head of Department within the meaning of the Appointments Clause. The Court observed that with for-cause restrictions removed, the SEC would possess the power to remove board members at will, in addition to its expansive oversight authority. PCAOB members thus satisfied the definition of inferior officers, i.e., officers who were directed and supervised by a superior officer appointed by the President with the Senate's consent. The Court also found that the SEC is a department because it is a free-standing component of the executive branch not subordinate to or contained within any other such component. Significantly, the Court found that a Head of Department could be a multimember body rather than a single person. Because the SEC's powers generally are vested in the commissioners jointly, and not the chairman alone, the commissioners could jointly be the Head of Department within the meaning of the Appointments Clause.

Justice Breyer's dissenting opinion found that the double for-cause removal arrangement did not violate the separation-of-powers principle. Justice Breyer opined that the SEC's extraordinary control over the PCAOB, as well as the other features of the relationship with the PCAOB, allowed the President sufficient, if not absolute, executive control. The dissent also criticized the majority opinion for *assuming* that the SEC commissioners are removable for cause when the statutory authority for the SEC is *silent* on the issue. Further, Justice Breyer stated that the majority's holding could call into question the legitimacy of numerous other government and military offices.

Implications

The Court's decision means that the SEC, charged with appointing the PCAOB's members, now legally can remove them for any reason. This holding in itself likely will have little practical impact, in light of the close working relationship between the SEC and the PCAOB. However, the majority's analysis concerning the separation of powers may have a significant impact on securities and administrative law. The decision clearly indicates a slow-down or even a reversal of the long-term trend in the Court's jurisprudence of expanding the scope of congressionally authorized independent actors within the executive branch. It also serves as an important signal about what kinds of constitutional limitations the Court will place on financial regulations. It remains to be seen whether the financial reform legislation pending in Congress has or has not crossed that line.

The court's ruling also will likely result in litigation challenging the rules and decisions issued by the PCAOB while it was under the unconstitutional structure. Actions taken by such bodies may, under certain circumstances, be challenged and sometimes invalidated.

Finally, the decision is a sign that SOX is here to stay, at least pending a new constitutional challenge. The opponents of SOX were hoping that in overturning the provision regarding PCAOB appointees, the Court would declare the entire PCAOB or the entirety of SOX, which does not have a severability clause, unconstitutional, but the Court declined to do so.

For more information on *Free Enterprise Fund* or other related issues, please contact any member of Wilson Sonsini Goodrich & Rosati's securities litigation practice.

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