IS THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD CONSTITUTIONAL?

By

Erika C. Birg*

The Federalist Society
for Law and Public Policy Studies

*Erika C. Birg is an attorney practicing in Washington, D.C.

IS THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD CONSTITUTIONAL?

Introduction

In the highly publicized and recently enacted Public Company Accounting Reform and Investor Protection Act of 2002, S. 2673, 107th Cong., also known as the Sarbanes-Oxley Act of 2002 (the "Act"), Congress provides for the creation of a Public Company Accounting Oversight Board (the "Board"), to oversee public company audit functions and, it is hoped, to prevent further accounting scandals such as the "Enron" problem. The members of the five-person Board are to be appointed by the Securities and Exchange Commission ("SEC"),[1] with the idea that this Board will be "independent," and "will set clear standards to uphold the integrity of public audits, and have the authority to investigate abuses and discipline offenders." George W. Bush, July 30, 2002 speech, http://www.whitehouse.gov/news/release/2002/07/print/20020730.html (last visited Sept. 9, 2002). As shown more fully below, however, Congress's desire to create an "independent" Board under the auspices of the SEC actually may run afoul of the Appointments Clause, U.S. Const. Art. II, § 2, cl. 2, rendering the Board unconstitutionally created.

The Appointments Clause

The Appointments Clause of the Constitution provides:

> [The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public

[1] The Board is to be composed of "prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures." § 101(e)(1).

> Ministers and Consuls, Judges of the supreme Court, and *all other Officers of the United States*, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

U.S. Const. Art. II, § 2, cl. 2 (emphasis added). The United States Supreme Court has clarified the Clause, stating that

> The Constitution for purposes of appointment very clearly divides all its officers into two classes. The primary class requires a nomination by the President and confirmation by the Senate. But foreseeing that when offices became numerous, and sudden removals necessary, this mode might be inconvenient, it was provided that, in regard to officers inferior to those specially mentioned, Congress might by law vest their appointment in the President alone, in the courts of law, or in the heads of departments. That all persons who can be said to hold an office under the government about to be established under the Constitution were intended to be included within one or the other of these modes of appointment there can be but little doubt. This Constitution is the supreme law of the land, and no act of Congress is of any validity which does not rest on authority conferred by that instrument.

United States v. Germaine, 99 U.S. 508, 509-10 (1878).

Application of the Appointments Clause to the Board

Despite the admonition in *Germaine*, Congress attempted to ensure that the Appointments Clause, and perhaps other federal rules and regulations, would not apply to the newly created Board by providing that "[n]o member or person employed by, or agent for, the Board shall be deemed to be ***an officer*** or an employee of or agent for the Federal Government by reason of such service." Section 101(b) (emphasis added). Congress, however, may not be successful in keeping the Board outside of the reach of the Appointments Clause.

First, with respect to constitutional issues, Congress cannot, by its simple declaration, render the Board a non-governmental entity. *See Lebron v. Nat'l Rr. Pass. Corp.*, 513 U.S. 374, 392-93 (1995) ("But it is not for Congress to make the final determination of Amtrak's status as a Government entity for purposes of determining the constitutional rights of citizens affected by its actions."). Second, neither the President nor Congress can waive the protections guaranteed in the Appointments Clause. *Freytag v. Comm'n, Internal Rev. Serv.*, 501 U.S. 868, 880 (1991). "The Appointments Clause prevents Congress from dispensing power too freely; it limits the universe of eligible recipients of the power to appoint. . . . For example, the Clause forbids Congress to grant the appointment power to inappropriate members of the Executive Branch. Neither Congress nor the Executive Branch can agree to waive this structural protection." *Id.* The Clause protects all citizens, not just the interested branches of government. *Id.* Hence, for purposes of determining whether the Appointments Clause applies, it is likely that Congress's drafting did not except the Board from that analysis.[2]

The next question in determining whether the Appointments Clause applies is whether the individual will exercise "significant authority." "[A]ny appointee exercising significant authority pursuant to the laws of the United States is an 'Officer of the United States', and must, therefore, be appointed in the manner prescribed by § 2, cl. 2 of that Article." *Buckley v. Valeo*,

---

[2] The question of whether Congress can avoid the Appointments Clause altogether by delegating authority to a private rather than public body is contested. *Compare* John C. Yoo, "The New Sovereignty and the Old Constitution: the Chemical Weapons Convention and the Appointments Clause," 15 Const. Comment. 87, 111-16 (1998) (seeking to demonstrate that "[e]fforts to transfer federal authority to an entity outside the federal government undermine the principles of the unitary executive, of the non-delegation doctrine, and of the public accountability they both seek to promote"), *and* Walter Dellinger, Assistant Attorney General, Office of Legal Counsel, "The Constitutional Separation of Powers Between the President and Congress," http://www.usdoj.gov/olc/delly.htm, (May 7, 1996) ("The Appointments Clause simply is not implicated when significant authority is devolved upon non-federal actors.").

424 U.S. 1, 126 (1976); *see also Edmond v. United States*, 520 U.S. 651, 662 (1997) (holding that the exercise of "significant authority" marks the line between officer and non-officer).

The Board indeed has significant authority over the governance of all public accounting firms. For example, the Board is charged with inspecting annually each and every registered accounting firm that provides audits to more than 100 publicly traded companies in a given year and with inspecting at least once every three years those registered accounting firms that provide audits to less than 100 publicly traded companies each year. The Board has the authority to enact rules governing the accounting firms and rules governing investigations of those firms, to investigate the firms, to report the entities to other federal and state regulatory authorities, to force entities to provide documents or testimony to the Board, and to impose sanctions to non-complying accounting firms ranging from suspension to multi-million dollar awards. Common-sense dictates that this activity rises to the level of "significant." As a result, it would seem that appointment of the Board members is governed by the Appointments Clause.

The Appointment Method Chosen By Congress Likely Does Not Pass Constitutional Muster

Assuming that the Appointments Clause applies, then the next question is whether the method of appointment in this instance is constitutional. To survive, the method of appointment must comport with the requirements of the Clause, as written. The primary question to be answered, to assess what type of appointment is required, is what status do Board members attain: inferior officer or superior officer? The Supreme Court has declined to create identifiable boundaries rendering a bright line distinguishing between inferior and primary officers. *See Morrison v. Olson*, 487 U.S. 654, 671-72 (1988). However, the delineation has been cast as follows: "[W]hether one is an 'inferior' officer depends on whether he has a superior. . .

.'[I]nferior officers' are officers whose work is directed and supervised *at some level* by others who were appointed by presidential nomination with the advice and consent of the Senate." *Edmond*, 520 U.S. at 662-63 (emphasis added). If the officers are superior officers, then they must be appointed by the President and confirmed by the Senate. If the officers are inferior, then Congress may decide to have the appointment be by the President, the courts or by the "Heads of Departments." U.S. Const. Art. II, § 2, cl. 2.

Under *Edmond*, the members of the Board likely are inferior officers rather than superior officers. For example, although the members have significant authority, the SEC must exercise direct supervision over the Board, and the SEC may censure or remove members from the Board. *See* Section 107 ("Commission Oversight of the Board"); *see also Edmond*, 520 U.S. at 661. Everything that the Board does is subject to the scrutiny of the Commission. Section 107. Thus, although the Board wields a mighty sword, its master (the SEC) can take it away easily, nullifying the Board's actions. As a result, the Board members should be considered inferior officers. If the Board members are inferior officers, then they must be appointed by the President, the courts, or the head of a department.

The appointment of the Board members by the SEC may not comport with the requirements of the Clause because they are appointed by the SEC as a whole. The Act provides that "the Commission, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, shall appoint the chairperson and other initial members of the Board, and shall designate a term of service for each." Section 101(e)(4). Appointment by the entire SEC, rather than by the Chairman, likely violates the Appointments Clause as the SEC is not composed of a body of equals. Instead, it is governed by the Chairman, who by even the SEC's own website, is the "SEC's top executive."

Http://www.sec.gov/about/commissioner.shtml, (last visited Sept. 10, 2002). Thus, as a simple matter of logic, the commissioners cannot collectively "head" the agency. The Chairman is ultimately, constitutionally responsible for appointment of inferior officers. As a result, it is likely that, if the Board members are inferior officers, then the method of appointment provided for by Congress in the Act does not comport with the Appointments Clause.[3]

Conclusion

For the brief reasons set forth above, there is considerable question as to whether the appointment method for members of the newly created Public Accounting Oversight Board, as provided by Congress in the Act, comports with the Appointments Clause. If the Board members are in fact inferior officers, then their appointment is constitutionally flawed and may jeopardize the Act.

[3] The analysis of the majority in *Silver v. United States Postal Serv.*, 951 F. 2d 1033, 1040 (9th Cir. 1991), does not alter this conclusion. In *Silver*, the Ninth Circuit concluded that appointment by the Governors of the Postal Service of an inferior officer, the Postmaster General, was constitutionally sound because the Governors collectively were the "head" of the department. *But see id.* at 1044 (O'Scannlain, J., dissenting) ("Congress could not have intended nine members of the Board to be the head of the department for Appointments Clause purposes while intending all eleven members to be head of department for purposes of running the Postal Service."). Unlike the Postal Service, as noted above, the SEC has a Chairman who is responsible for appointments. Accordingly, *Silver* is inapposite, and there is a substantial likelihood that, if challenged, the appointments process for the Board members will be deemed unconstitutional.