

Supreme Court Strikes Down “Good Cause” Removal Restrictions on PCAOB, But Leaves Sarbanes-Oxley Intact

In a sharply divided 5-4 ruling released on the last day of its term, the Supreme Court held that a provision of the Sarbanes-Oxley Act of 2002 that restricts the SEC's power to remove members of the Public Company Accounting Oversight Board (PCAOB) only “for good cause” violates the separations of powers principles of the Constitution. But the Court declined the opportunity to further limit the reach of Sarbanes-Oxley (SOX). According to the Court, SOX “remains fully operative as a law” and the PCAOB “may continue to function as before,” subject only to removal of members “at will” by the Commission. As a result, although this decision is a significant reaffirmation of the President’s constitutional role in supervising administrative agencies by preserving some power to fire executive officers, the Supreme Court’s refusal to more broadly enjoin the PCAOB’s activities will mean that the board will continue to exercise broad regulatory power over accountants that audit public companies.

The PCAOB was created in the wake of the Enron and WorldCom scandals as part of the Sarbanes-Oxley Act of 2002. Under SOX, its five members are appointed by the Commissioners of the Securities Exchange Commission (SEC). Every accounting firm that audits public companies must register with the PCAOB, pay an annual fee, and comply with its rules and oversight. The duties entrusted to the PCAOB are broad. Among other functions, the PCAOB may inspect auditing firms, initiate formal investigations, and issue sanctions as part of its disciplinary proceedings. Although the SEC maintains some degree of oversight over the PCAOB’s functions, under the statute the Commissioners of the SEC have the power to remove the members of the PCAOB only for “good cause.” In the case of *Free Enterprise Fund*, the PCAOB inspected a small Nevada accounting firm, released a report critical of its procedures and initiated a formal investigation. Free Enterprise Fund (an industry group) and the accounting firm thereafter filed suit seeking a declaration that the PCAOB was unconstitutional and an injunction preventing it from exercising its powers.

The Court began its constitutional analysis of the PCAOB’s structure by noting that unlike other independent agencies like the SEC, the PCAOB was insulated from the President’s control by *two* layers of “for cause” removal restrictions: PCAOB members could only be removed “for good cause” by the SEC *and* SEC Commissioners in turn could only be removed by the President for “inefficiency, neglect of duty or malfeasance of duty.” According to the Court, that diffusion of power meant that the President could not hold the PCAOB fully accountable for its conduct, and thus “subverts the President’s ability to ensure that the laws are faithfully executed—as well as the public’s ability to pass judgment on his efforts.”

Although the Court’s ruling found the removal authority over PCAOB members to be unconstitutional, it refused to strike down the PCAOB in its entirety. Rather, it applied normal principles of severability and found that the “for good cause” removal restriction could be excised from the statute and that the PCAOB can continue to perform its statutory functions so long as its members are “removable” at will by the SEC. Further, the Court rejected Free Enterprise Fund’s constitutional challenge to the appointment of the PCAOB’s members (the members are appointed by the Commissioners of the SEC), holding that the members are “inferior officers” under the Constitution who may properly be appointed by the “Hea[d]s” of a “Department” such as the SEC. Accordingly, the Court declined to issue a broad injunction against the operation of the PCAOB, instead holding that the Free Enterprise Fund was entitled only to a declaration that the PCAOB’s functions must be enforced “by a constitutional agency accountable to the Executive.”

The Court's decision is a significant win for auditing firms that felt the PCAOB was insufficiently responsible (and responsive) to the political process, but ultimately the Court's ruling may not have a significant practical effect. The Board will continue to operate as before; its powers remain as broad as ever; and its regulatory authority continue intact. Other than putting PCAOB members at risk of removal "at will" by the SEC, Sarbanes-Oxley Act emerged from the case unscathed. Indeed, in a perhaps perverse sense, the ruling may only serve to make the PCAOB less market-driven and more bureaucratic by making it more beholden to the SEC.

If you have questions about this alert, please contact [Douglas Hallward-Driemeier](#) or the Ropes & Gray attorney that usually advises you.

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