**IN THE UNITED STATES DISTRICT COURT**
**FOR THE NORTHERN DISTRICT OF ILLINOIS**
**EASTERN DIVISION**

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| ERIC SILVERMAN, on behalf of himself and all others similarly situated, | ) | Case No. 1:07-CV-04507 (Consolidated) |
| Plaintiff, | ) | CLASS ACTION |
| v. | ) | Honorable Amy St. Eve |
| MOTOROLA, INC., et al., | ) | |
| Defendants. | ) | Magistrate Judge Michael T. Mason |

**BRIEF OF *AMICUS CURIAE* CENTER FOR AUDIT QUALITY IN SUPPORT OF KPMG LLP**

The Center for Audit Quality ("CAQ") respectfully submits this brief as *Amicus Curiae* in support of a motion filed by KPMG LLP to quash third-party subpoenas that seek to obtain documents and information relating to a confidential inspection by the Public Company Accounting Oversight Board ("PCAOB" or the "Board").

## STATEMENT OF INTEREST

The CAQ is a public policy organization that commenced operations in January 2007. The mission of the CAQ is to seek to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change that are rooted in the profession's core values of integrity, objectivity, honesty, and trust. The CAQ also seeks to improve the reliability of public company audits and to enhance their relevance for investors in this time of increasing financial complexity and globalization. The CAQ is led by a governing board that comprises leaders from public company auditing firms and the American Institute of Certified Public Accountants ("AICPA"), as well as public board members who bring an outside perspective to the CAQ's agenda and activities.

Since its founding the CAQ has undertaken research, offered recommendations to enhance investor confidence and the vitality of the capital markets, issued technical support for

public company auditing professionals, and helped facilitate the public discussion about modernizing business reporting. Any U.S. accounting firm registered with the PCAOB may join the CAQ. The CAQ is affiliated with the AICPA, and has approximately 750 U.S. public company auditing firms as members, representing tens of thousands of professionals dedicated to audit quality.[1] The CAQ has a strong interest in the issues raised by KPMG's Motion to Quash because of the potentially serious implications that failing to grant the motion could have for the effectiveness of the PCAOB in fostering audit quality and reliability.

## INTRODUCTION

In 2002, pursuant to the Sarbanes-Oxley Act (the "Act"), Congress created the PCAOB "to provide for more effective oversight of the part of the nation's accounting industry that audits public companies."[2] A key element of the PCAOB's oversight is its inspection program, pursuant to which it assesses the performance of audit firms against the laws, rules and standards promulgated by Congress, regulators and the accounting profession.

In establishing the PCAOB, Congress created a supervisory model of regulation designed to encourage a "constructive dialogue" between the PCAOB and the audit firms it regulates.[3] Congress recognized that the success of such a model depended on the confidentiality of the PCAOB's inspection process. That recognition is primarily embodied in Section 105(b)(5)(A) of the Act which shields PCAOB inspection-related material from civil discovery.

This is an important case of first impression in which the Plaintiffs are seeking to obtain, among other things, documents and information that constitutes and reflects KPMG's internal communications relating to, and reflecting the substance of, a PCAOB inspection. Plaintiffs will

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[1] KPMG is a member of the CAQ.

[2] S.Rep.No.107-205 at 4 (July 3, 2002).

[3] PCAOB Release 104-2006-077 (March 21, 2006) at 2.

undoubtedly argue that such materials fall outside the scope of the evidentiary privilege created by Section 105(b)(5)(A). The CAQ believes that the language and purpose of the statute are clear. The documents and information fall squarely within the language of the statute, just as Congress intended. A contrary interpretation would destroy the confidentiality that is a prerequisite to the open and constructive regulatory regime designed by Congress and implemented by the PCAOB. The CAQ urges this Court to quash the subpoenas, thereby preserving the integrity and confidentiality of the PCAOB inspection process.

## STATEMENT

In the wake of the collapse of Enron and other major Fortune 500 companies, Congress sought to address serious questions that had been raised regarding "the integrity of certified financial audits; appropriate accounting principles and auditing standards; the effectiveness of the accounting regulatory oversight system; [and] the impact of auditor independence on the quality of audits . . . ."[4] The result was the Sarbanes-Oxley Act of 2002, which comprehensively addressed these issues. In order to improve the quality of financial reporting, the Act addressed, among other things, auditor independence, corporate responsibility, and enhanced corporate disclosure, and provided greater resources to the SEC and other agencies.

**Auditor Oversight and the Need for Confidentiality**

Congress was particularly concerned about the weaknesses of the then-current system of regulation of audit firms that audited public companies, a system that was subject to "a bewildering array of monitoring groups."[5] The Public Oversight Board ("POB"), one of the several entities that provided oversight to auditors, was subject to particular criticism for being

[4] *See Accounting Reform and Investor Protection: Hearing on S. 2763 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 723 (2002) (Opening Statement of Senator Sarbanes).

[5] S. Rep. No. 107-205 at 4 (July 3, 2002).

"slow and ineffective."[6] The POB itself recognized its deficiencies and agreed with the criticism of a former SEC Commissioner that its system "results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances."[7] According to the POB, its inability to protect information from litigants was a significant reason for its ineffectiveness:

> One reason for the delay in the current system stems from the fact that those charged with administering the system lack privilege to ascertain facts. Privilege would give the investigative entity the authority to protect information it uncovers from outside demands until any enforcement action is concluded. At present, firms will not disclose documents or other information that is likely to wind up in the hands of litigants in legal proceedings.[8]

The POB's inability to protect information affected not only its disciplinary functions but its ability to provide broader regulatory oversight. When asked by the SEC to review issues relating to auditor independence, the POB's efforts were stymied because it could not enter into satisfactory confidentiality agreements with the audit firms from which it was seeking information.[9]

The necessity for confidentiality was a recurrent theme in the testimony of witnesses at Congressional hearings investigating the prior system. Shaun F. O'Malley, former Chairman of the Panel on Audit Effectiveness, testified that the oversight of the POB was "hampered by distrust and by concerns that the materials developed were not protected."[10] He went on to state

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[6] *Id.* at 5.

[7] "The Road to Reform" A White Paper from the Public Oversight Board on Legislation to Create a New Private Sector Regulatory Structure for the Accounting Profession (March 19, 2002).

[8] *Id.*

[9] *Id.*

[10] *Accounting Reform and Investor Protection: Hearing on S. 2763 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 723 (February 2002).

that "[p]roviding confidentiality will expedite and vastly improve the review, investigatory, and disciplinary processes."[11] Joel Seligman, then Dean of the Washington University School of Law in St. Louis and a member of the AICPA Professional Ethics Executive Committee, testified that he recommended "a privilege from discovery of investigative files to facilitate auditing discipline during the pendency of other Government or private litigation."[12] John Biggs, the CEO of TIAA-CREF, a major user of financial statements who also served on the POB testified that:

> the investigative authority of a new accounting regulatory body needs to be clear-cut and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from cooperating with this new agency. *Of course, it must have the ability to keep the information gathered out of the hands of the litigating lawyers.*[13]

**Congress Created the PCAOB to Engage in a Supervisory, Non-Adversarial Regulatory Scheme Protected by a Civil Discovery Exemption for Inspection-Related Documents and Information**

Congress created the PCAOB in 2002 to "establish, adopt, or modify auditing, quality control, ethics, and independence standards for public company audits, inspect accounting firms, investigate potential violations of applicable rules relating to audits, and impose sanctions if those violations are established."[14]

In designing the structure of the PCAOB's investigative and inspection functions, Congress took care to address the confidentiality concerns that had plagued the POB by enacting, among other provisions, Section 105(b)(5)(A) of the Act, which reads as follow:.

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[11] *Id.*

[12] *Id.*

[13] *Id.* (emphasis added).

[14] S. Rep. No. 107-205 at 4 (July 3, 2002).

> CONFIDENTIALITY—Except as provided in subparagraph (B), all documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, in connection with an inspection under section 104 or with an investigation under this section, shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, and 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, unless and until presented in connection with a public proceeding or released in accordance with subsection (c).

The legislative history of this provision shows that it was the intent of Congress to protect the confidentiality of documents and information relating to Board inspections in order to create a supervisory model of regulation that encourages cooperation and dialogue and discourages adversarial confrontation.[15] Section 105(b)(5)(A) explicitly keeps Board information "out of the hands of litigating lawyers"[16] unless and until, in the case of investigations, the Board brings a public disciplinary proceeding.[17] The provision creates an evidentiary privilege for investigative and inspection materials and it exempts such materials from discovery in civil proceedings. Moreover, Section 105(b)(5)(A) goes even further to preserve confidentiality by providing an explicit exemption from the Freedom of Information Act should the PCAOB decide to share such materials with a federal agency.

Through the enactment of the confidentiality provisions of the Act, Congress eschewed an adversarial regulatory model that would rely solely on the power to coerce the production of information through a combination of subpoenas and sanctions. Instead, it sought to encourage a cooperative relationship between the Board and the audit firms that it regulates in which firms

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[15] S. Rep. No. 107-205 at 10 (July 3, 2002).

[16] *Accounting Reform and Investor Protection: Hearings on S. 2763 Before the S. Comm. on Banking, Housing and Urban Affairs,* 107th Cong. 723 (February 2002)(Testimony of John H. Biggs).

[17] But even in such cases, hearings are public only with the consent of the parties. *See* 15 U.S.C. § 7215(c)(2).

have an incentive to work hand-in-hand with the Board to identify potential areas of improvement in audit processes. Absent the confidentiality provisions of the Act, audit firms would likely be incentivized to respond narrowly to Board information requests, being mindful of the enhanced liability risks that a broader, more cooperative approach would likely entail. With the benefit of the confidentiality built into the Act, the PCAOB has implemented a cooperative, supervisory approach. As the Board has stated:

> [T]he Act reflects a legislative policy choice favoring the correction of quality control problems over the exposure of them. Accordingly, the Board takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures.[18]

The supervisory model of regulation created by Sarbanes-Oxley and implemented by the PCAOB has thus far worked well and has improved the quality and reliability of audits of public companies. It has worked to the satisfaction of both the Board and the regulated community. In March 2006, the Board published a release containing its initial observations with respect to success of the supervisory model:

> The Board's initial experience with the 12-month remediation process generally validates the premise of the approach set out by Congress in Section 104(g)(2) of the Act.[19] That legislative approach rested on the hypothesis that firms could be genuinely motivated by the prospect of keeping the Board's quality control criticisms confidential. The Board's initial experience with the larger firms supports that hypothesis. Moreover, the firms were responsive to the Board's supervisory model, taking the initiative to engage constructively with the staff in an ongoing dialogue toward a result satisfactory to the Board, rather than emphasizing points of disagreement and taking an adversarial approach.
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> As a result of the process, the Board believes that those firms have crafted and undertaken important steps that, if conscientiously implemented, will have beneficial effects on audit quality.[20]

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[18] PCAOB Release 104-2006-077.

[19] Section 104(g)(2) of the Act provides for the confidentiality of PCAOB inspection reports. Although that provision is not directly at issue in this matter, it further reflects the importance of confidentiality to the regulatory structure created by the Act. 15 U.S.C. § 7214(g)(2).

[20] Note 18, *supra.*

In the PCAOB's 2007 Annual Report, its Chairman, Mark W. Olson stated:

> Our primary goal is to promote investor confidence in audited financial statements of public companies through effective use of a supervisory model of oversight of registered public accounting firms. Other goals speak to ensuring robust two-way communication with the audit profession, market participants and other interested parties, and to further strengthen the effectiveness and coordination of auditor oversight efforts in the United States and abroad.[21]
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> We increasingly are finding that the PCAOB can foster improvement in audit quality through the on-site dialogue the inspection process allows for, in addition to more formal findings in inspection reports and other oversight actions. The PCAOB employs several channels of communication with registered firms, which range from outreach and informal briefings on relevant issues, to inspections and issuance of inspection reports, to investigations and formal disciplinary actions.[22]

## ARGUMENT

In the present litigation, Plaintiffs have issued subpoenas to an audit firm and its employees, none of whom are defendants in the lawsuit. The subpoenas seek audit workpapers and other information relating to professional services performed by the audit firm for its client, which is a defendant in the lawsuit. As we understand it, the audit firm is prepared to produce such documents – created in the ordinary course of providing professional services to the client and independent of the PCAOB's inspection process – and has not interposed any claim of privilege to such material. This matter is before the Court because the subpoenas are not limited to work done by the audit firm for its client, but also seek documents and information relating to the PCAOB's annual inspection of the audit firm. The CAQ is concerned that if the Plaintiffs in this matter are granted the requested discovery, the Act's carefully constructed supervisory model will be adversely affected.

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[21] 2007 PCAOB Annual Report at p. 2.

[22] *Id.* at 3.

The Plaintiffs' subpoenas seek the production of all documents and information regarding the PCAOB's inspection of KPMG's audit and review of a client's financial statements as they relate to a segment of its client's business. This is precisely the kind of information that Congress determined should be protected from civil discovery when it designed the PCAOB regulatory process.

Section 105(b)(5)(A) states that "all documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, in connection with an inspection . . . shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency." There are only two exceptions to the strict confidentiality imposed by the Act. The PCAOB may share such information with certain other governmental agencies, as long as those agencies agree to keep the information confidential. In addition, following an investigation, the PCAOB may make such information public in connection with public disciplinary hearings and the imposition of sanctions. But even those exceptions are circumscribed with further safeguards. As to disciplinary hearings, Section 105(c)(2) of the Act provides that such hearings may be made public only with the consent of the parties. In situations where the PCAOB elects to share protected materials with other governmental agencies, Section 105(b)(5)(B) of the Act explicitly provides that such information remains privileged and confidential in the hands of receiving agencies. Further, the Act specifically creates a FOIA exception for any federal agency that receives such information from the PCAOB.

The Plaintiffs will no doubt urge the Court to narrowly interpret the language of Section 105(b)(5)(A) to exclude from its scope documents created by KPMG in connection with the

PCAOB inspection but that were not provided to the PCAOB, arguing that such documents were not specifically "prepared or received by or specifically for the Board" or that they do not specifically constitute or reflect "deliberations of the Board and its employees and agents." But that is not what the statute says. Internal KPMG documents relating to the inspection process are "prepared . . . specifically for the Board" because, absent the inspection, they would never have been created in the first place. They exist, and were prepared, solely because of the Board's inspection.[23]

In addition, the internal documents will, in many cases, certainly refer to "information prepared or received by the Board" and reflect "deliberations of the Board and its employees and agents." Such documents will contain the very information that the statute was designed to protect. For the statute to make sense those documents must be protected by the privilege. Moreover, there are certainly some documents related to every inspection where it is not known at the time of their creation whether the documents ultimately will go to the Board – *e.g.*, draft or proposed responses to inspector comments. For the privilege created by Section 105(b)(5)(A) to have meaning, all such materials must be covered. In short, an uncertain and weak privilege would undermine Congress's intent in creating the PCAOB by hindering the efficiency of the PCAOB's inspection process and delaying improvements to audit quality. As the Supreme Court has noted in an analogous situation, "[a]n uncertain privilege, or one which purports to be certain

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[23] This interpretation fits the way the statute is constructed. Section 105(b)(5)(A) protects documents and information "prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents." The language "specifically for the Board" has to mean something different from the language "received by the Board" and must cover a different category of documents. The documents and information at issue in this case fit within that category, and the purpose of the Act is furthered by including such documents and information within the statutory privilege.

but results in widely varying applications by the courts, is little better than no privilege at all." *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981).

The CAQ believes that the legislative history and clear purpose of the Act, provide compelling support to the interpretation that the documents and information sought by the Plaintiffs are subject to the Section 105 privilege. An examination of the way the PCAOB and audit firms typically interact during an inspection makes this evident.

A PCAOB inspection is an iterative process. Typically, an inspection will commence with PCAOB staff reviewing materials and engaging in a substantive dialogue with members of the audit firm engagement team and firm professional practice and/or management personnel, with respect to questions or issues the staff has identified regarding specific engagements. Additionally, the PCAOB inspection team will often interact with the audit firm's national office personnel regarding the audit firm's internal quality systems and controls. In responding to inquiries from the PCAOB inspectors, the audit firm engagement personnel may consult internally with professional practice or other experts within the firm to formulate responses to the inspection team -- communications that necessarily involve discussion of the inspectors' observations and statements, and thus reflect deliberations of the Board employees. As a result of such discussions, matters that may have initially been raised as questions or concerns on the part of the PCAOB inspection staff can be clarified and may cease to be issues, thus making the rest of the inspection process more efficient and more effective, and enabling the PCAOB inspection staff to complete inspections more readily and to complete more inspections annually.

Thereafter, the PCAOB staff will prepare specific written comments which must be reviewed, analyzed and assessed by the inspected firm. Written responses are then prepared by the audit firm, and reviewed internally, before the firm's response is communicated to the

inspection team – a process which also reflects the observations, comments or criticisms prepared by, and received from, the PCAOB inspectors. Subsequently, the PCAOB provides a draft of its inspection report to the audit firm. The firm then has an opportunity to review the draft report and address the draft findings in writing with a view to satisfying any issues or concerns, a process that involves additional internal communications reflecting the inspectors' deliberations.

After considering the responses of the audit firm, the PCAOB will make public portions of the report that do not deal with the firm's quality control systems.[24] Under this regulatory structure audit firms understand that they can interact with their regulator confidentially and make appropriate enhancements to audit methodology, procedures and internal practices without subjecting all of the documents and information created during the process to discovery. That process is exactly the process contemplated by the Act.

Absent robust and candid internal communication at the audit firm, the process described above would be thoroughly undermined. Firm managers at various levels are often informed and consulted with respect to the inspection and questions raised by the inspectors. Many audit firms rely on specifically assigned quality control personnel to interact with and respond to PCAOB inspections. The function of such personnel is to assess the issues raised by the PCAOB inspection team; to evaluate the issues and assist the engagement personnel in providing a complete response to the PCAOB inquiries; to assess the audit firm's practices and procedures in relation to the PCAOB inspection team observations, suggestions or criticisms; and to determine whether the firm will perform additional audit procedures in response to observations relating to a specific engagement or modify existing firm audit practices in response to such comments or to

[24] Even with respect to those portions of the inspection reports that are made public, the identities of audit clients are kept confidential.

enhance audit quality. Congress recognized that in order for such work to be done properly, there must be complete and candid internal communication about the work that was done on the engagements inspected and the firm quality control systems inspected, the questions and issues raised by the inspectors, and positions that the firm should take in response, including whether it will undertake remedial actions or process improvements. Such communications are a necessary component of the supervisory model Congress created in the Act.

The discovery requested in this matter attacks this process at its very core. If internal communications related to the PCAOB inspection process are open to litigants, if the authors of documents must fear that their candid assessments and communications will end up as courtroom exhibits or as sound bites in a court pleading, the result is obvious: the open and candid inspection process will likely be replaced with a more cautious liability-avoidance dynamic in audit firm interaction with the PCAOB inspectors. Although audit firms undoubtedly will continue to seek to improve audit quality, the process of doing so in the context of an inspection model which can be routinely scrutinized by the securities class action bar with contrary interests will necessarily be less efficient and less robust, thus undermining the intent of the Act.

Accordingly, the CAQ believes that Section 105(b)(5)(A) is properly interpreted to apply to all documents and information pertaining to the PCAOB inspection process which are in the possession of the inspected audit firm, and thus precludes the production of the documents that the Plaintiffs seek in their subpoenas. Any other interpretation would render illusory the confidentiality so carefully built into the Act. Without the assurance of confidentiality, audit firms will feel constrained to take a defensive posture with the PCAOB and less able to accept and voluntarily implement audit quality enhancements in reaction to PCAOB observations and informal suggestions. Such a result would be contrary to the very purpose of the Act.

## CONCLUSION

Congress created the PCAOB to improve and strengthen the previous regulatory structure. As the PCAOB has stated, its goal is to ensure a "robust two-way communication with the audit profession, market participants and other interested parties, and to further strengthen the effectiveness and coordination of auditor oversight efforts in the United States and abroad.[25] That goal is primarily possible because Congress explicitly protected such "two-way communication" through the enactment of the strict confidentiality provisions set forth in the Sarbanes-Oxley Act. The CAQ respectfully submits that this Court should honor Congress' intention by granting KPMG's motion to quash the subpoenas.

Respectfully submitted,

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[25] 2007 PCAOB Annual Report at p. 2