

**Report on the Corporate Governance of the  
Public Company Accounting Oversight Board**



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**Report to the Securities and Exchange Commission  
on the Corporate Governance of the  
Public Company Accounting Oversight Board**

**Executive Summary**

In this Report, we identify, assess, and make recommendations regarding, the governance policies and practices of the Public Accounting Oversight Board (“PCAOB”) for the three-year period beginning January 2018 and ending December 2020. A number of events, combined with certain facets of the PCAOB’s operations that preceded our retention, figured significantly in our assessments.

**Events Preceding this Review**

Thus, the PCAOB had a reputation as a staff-driven organization with minimal staff turnover. It had been criticized by some for its inability to act on a number of significant projects, its failure to modernize and integrate sophisticated technology into its operations, and its difficulty monitoring and addressing the apparent misconduct of both its staff and a Board Member. These events and facets of the PCAOB’s operations were followed by the decision of the Securities and Exchange Commission (“SEC” or “Commission”) to replace the PCAOB’s entire Board at the end of 2017, the first time that had occurred since the Board’s formation in 2003.

The new Board began assuming their positions in early 2018, and committed to work collaboratively in rethinking the way the PCAOB’s efforts had been conducted for the fifteen years preceding their appointment. Part of that process resulted in the creation of more than forty Transformational Programs designed to modernize the PCAOB’s efforts, and to make the organization more efficient. Another part of the process involved the creation of a number of additional senior officer positions to facilitate the execution of these Transformational Programs. And, in addition, the new Board collectively decided that the employment of seven senior PCAOB officials (along with the employment of a number of mid-level supervisory personnel) should be terminated to assure that new personnel, unburdened by prior commitments to the way things had always been done, would be responsible for implementing the Board’s new approaches.

While the new Board's goals were salutary, and its plan bold, the manner in which some of these changes were implemented was problematic. There was no advance disclosure to the PCAOB's staff to explain the rationale for the employment terminations, no disclosure while these seven individuals (and others) left the PCAOB, and no disclosure after the major employment terminations had concluded. This had the effect of exacerbating what already had become an environment of fear and distrust, abetted by rampant speculation regarding the events actually taking place.

The cultural angst afflicting the PCAOB's staff culminated with the submission of two whistleblower complaints—one in May 2019 and a longer one in September 2019—which contained allegations regarding the Chairman and the Chairman's immediate staff, first for withholding critical information from the Chairman's Board colleagues, and second, for what were alleged to be malevolent motivations in arranging for the employment termination of seven senior PCAOB officials.

Upon the filing of the May Whistleblower Complaint, the PCAOB's Chairman recused himself from participation in any Board processes, deliberations or decisions, with respect to the consideration or disposition of the allegations of the whistleblower complaint. The four non-recused Board Members were confronted with a situation that the Board was neither prepared for, nor able to compare to historical Board precedents, since the PCAOB had only a year earlier installed the system on which the May Whistleblower Complaint had been filed.

Ultimately, the four Board Members reported the occurrence of these events to the staff of the SEC's Office of Chief Accountant, and these matters were brought to the attention of SEC Chairman Clayton. Chairman Clayton sought input from the SEC's General Counsel, and eventually the SEC's General Counsel retained Kalorama Legal Services, PLLC ("KLS") to conduct an internal review of the PCAOB's governance. The second—or September—whistleblower complaint stated it had been authored by the same individuals who had submitted the original May Whistleblower Complaint, and expanded the original allegations, all of which involved the Board's Chairman or members of his immediate staff.

## **The PCAOB**

Despite the more detailed allegations set forth in the September Whistleblowing Complaint, we sought to ensure that our review would objectively reflect a non-adversarial approach. We coordinated our activities with the four

non-recused Board Members, prepared a work plan for our internal review, provided copies of proposed communications to a list of PCAOB personnel we pre-cleared with the four Board Members. We solicited feedback from all five Board Members. Among other things, the four Board Members expressed concerns that 2019 PCAOB Employment Surveys reflected an untrusting culture on the part of PCAOB staff members, and we provided requested assurances that we would do our utmost to avoid causing the PCAOB's employees to feel intimidated.

### **KLS Mandate and Approach**

During our review we conducted sixty-five separate interviews of fifty-four individuals, together with several dozen telephone and/or email follow-up discussions. We interviewed both current and former PCAOB staff and Board Members, and interviewed most of the current Board Members twice—first, at the outset of our review and, second, at the end. We reviewed tens of thousands of pages of public and nonpublic PCAOB documents, prior studies of the PCAOB, reports prepared for the Board by outside consultants, reviews prepared by the Government Accountability Office, studies performed by the Project on Government Oversight, and numerous articles published about the PCAOB, including articles about the May and September Whistleblower Complaints.

While we had the full cooperation of the PCAOB staff and its Board Members, we confronted certain limitations as we attempted to complete our review. In the end, everyone we sought to interview agreed to allow us to do so, with the exception of two former PCAOB officials, the previous Chief Ethics Officer, and the prior Director of the Office of Human Resources. The former had retired from the Board without any severance agreement, while the latter was asked to leave, and entered into a severance agreement that provided her with six months' salary, and seven months of health benefits. The Board authorized severance agreements with all employees whose employment was terminated in 2018 on the same terms but it did not require those who entered into severance agreements to cooperate with internal reviews or other matters affecting the PCAOB about which the departed employee had relevant information.

### **The Interplay of Statutes Governing the PCAOB's Operations**

By virtue of the Sarbanes-Oxley Act ("S-Ox"), the PCAOB is a District of Columbia Nonprofit Corporation, subject to the D.C. Nonprofit Corporation Act ("DCNPCA"), except to the extent that the DCNPCA conflicts with S-Ox. The

PCAOB also obtained IRS recognition as a tax-exempt nonprofit organization, subject to the provisions of Internal Revenue Code §501(c)(3). This had the effect of obligating the Board to harmonize the provisions of those three statutes, and requiring Board Members to look to all three sources for a complete understanding of their fiduciary duties.

The interplay between S-Ox, the DCNPA and the IRS Code appears to have received scant attention from the Board or the PCAOB's staff, however. A number of current and former Board Members indicated that they lacked a clear understanding of the interplay between these three statutory provisions. Not only was there a lack of a clear understanding regarding these sources of Board Members' obligations, but the general concept of fiduciary obligations was not a topic of discussion among Board Members, nor was it explicitly referenced when discrete issues were presented to the Board for a vote.

### **PCAOB Bylaws**

The PCAOB is governed by a set of Bylaws approved by the SEC in mid-2003, and later modestly updated by the PCAOB in 2005. Apart from those changes, the PCAOB's Bylaws are the same today as when the SEC approved them in 2003. In effect, this means that the experiences garnered over almost two decades since its inception have not informed any changes in the way the Board governs itself or the PCAOB.

The PCAOB's Bylaws pattern its governance after that of the SEC, as set forth in Reorganization Plan No. 10 of 1950 ("Reorg Plan No. 10")—which transferred all executive and administrative functions originally vested in the full Commission to the SEC Chairman. Former Board Members consistently expressed the view that their roles were shaped by who the Board Chairman was. Consequently, there was confusion throughout the PCAOB about the Board's authority vis-à-vis the Chairman's.

Our interviews highlighted two principal weaknesses in the PCAOB's governance structure—first, the lack of clarity regarding the respective roles and authority of the Chairman and the four Board Members. The second principal weakness is the omission—in both the PCAOB's Bylaws and the onboarding training provided for new Board Members—of the impact of the tri-partite statutory scheme governing the Board, namely S-Ox, the DCNPCA, and IRS §501(c)(3). This has created two extreme behavior patterns on the part of Board Members—those who believe the Chairman possesses all the significant

governance power over the PCAOB, and therefore limit themselves to expressing their views on issues of substance, but deferring to the Chairman; and those who believe their fiduciary responsibilities give them the same authority as that vested in the Chairman.

Neither view is consistent with good governance, and that has created some dysfunctional behavior by Board Members. Board Members are obligated—statutorily and as a consequence of their fiduciary duties—to engage in a constructive partnership with one another and with the Chairman. This makes it imperative for the Board to foster clear expectations about the roles of the Chairman and the other Board Members.

That should typically be done in the onboarding process. But the PCAOB’s onboarding process does not provide meaningful guidance on the roles of, or expectations for, Board Members. It also highlights the need for the Board to engage in a process of self-assessment, both as a collective body, and with respect to each individual Board Member. Unfortunately, the Board has not engaged in self-assessment efforts; consequently, the precise role of Board Members other than the Chairman remains a subject of confusion.

This confusion was aptly demonstrated by the Chairman’s attempt to institute a worthwhile “Board Champions” initiative in early 2018. Under this initiative, individual Board Members were designated as “Champions” of a particular facet of the Board’s operations. The intent was to have Members identify policy matters of interest to the Chairman and the entire Board, as well as bringing those issues back to the Board for discussion and, if appropriate, formal Board decision making. But, this initiative commenced without a written description of its purpose or the manner in which individual Board Members should carry out their designated responsibilities. As a result, this program engendered further confusion on the part of some Board Members about the scope and reach of their authority, and created confusion for senior and mid-level PCAOB staff. The program, or something similar, should be a part of normal Board practices. Instead, the initiative was effectively discontinued in 2019.

As part of the Board’s commitment to structural change, since the beginning of 2018 the PCAOB has created eight additional senior level positions or, in one case, revised the scope of a pre-existing position. The PCAOB had a legitimate need to create these positions, and their creation has had a positive effect on its operations. But, the Board did not consider corporate governance issues regarding the manner in which these positions were created, the scope of

the authority vested in these positions, or the appropriateness of adding some of these new positions to the list of senior staff positions set forth in the PCAOB's Bylaws. Adding some of these positions to the list of senior staff officials set forth in the Bylaws would mean that future hires for these positions would need to receive the approval of at least three Board Members. Similarly, adding these positions to the Bylaws would mean that an effort to terminate the employment of someone in one of these positions would require the Chairman first to consult with the other four Board Members before proceeding.

### **PCAOB Recordkeeping Practices**

The PCAOB's governance records and recordkeeping practices have been centered in its Secretary's Office since the inception of its activities. The Secretary's Office is responsible for recording the minutes at official Board meetings as well as maintaining the PCAOB's various intranet libraries and document repositories. Significant Board *decisions* are also made at informal meetings, but if that occurs, records are not created regarding the decisions or the rationale for them. Thus, for example, there are no records reflecting the Board's decision, in early 2018, after a number of informal conversations, to terminate the employment of seven senior PCAOB officers, as well as additional mid-level officials. Nor are there records reflecting the reasons that all officials whose employment was terminated received severance pay of six months' salary and seven months of health care. Those severance payments apparently were arrived at after informal discussions, but are not reflected in any Board minutes or other documentation.

The PCAOB's tax-exempt status, however, obligates it to do an individual analysis of the severance payments offered to each departing staff member. To assist nonprofit corporations, the IRS has provided guidance on the types of information to be gathered, and the process to be followed, to establish the appropriateness of the compensation being offered. Following the IRS' guidance can result in the establishment of a safe harbor for compensation decisions. The Board, nonetheless, did not engage in the IRS-approved processes, and did not record either its decisions vis-à-vis severance pay, or the rationale for them.

This presents a governance problem, because the Board has not—either prior to 2018 or subsequently—focused on the types of records it is required to maintain as a result of its status as a tax-exempt nonprofit organization. Indeed, the PCAOB has not focused on many of its myriad other activities in which

appropriate records should be—but currently are not—maintained and preserved.

In 2014, the PCAOB’s Secretary and the IT Department began to digitize available PCAOB documents and implement a central document management platform. The improvements made since 2014 are considerable, but there does not appear to be an overall design, structure or plan for what now constitutes the PCAOB’s Enterprise Record Management system (“ERM”). Given the importance of its documentary libraries, and the obligation to safeguard the confidentiality of sensitive information, the PCAOB needs to develop and maintain sound ERM policies. At present, there is no single document that sets forth the entire system of enterprise records management currently maintained by the PCAOB.

Many on the PCAOB’s current staff appear unaware of the documents that are available to them, and where those documents can be found. In part, this stems from the existence of multiple databases (some of which *intentionally* duplicate the same documents held in other databases). The existence of multiple document repositories is confusing and inefficient. Indeed, when we first spoke with the five Board Members appointed in 2018, some were unfamiliar with these platforms and did not make use of them. PCAOB staff reflected a similar degree of confusion, and many said they had not used the main document repositories.

Access to various of the PCAOB’s document repositories is restricted, but there are no written descriptions of who has access to which documents. Individual staff members cannot seek or be granted access to certain repositories, and if an unauthorized individual attempts to open a restricted document, the system automatically sends the Secretary’s Office a “request to open” email, containing the individual’s identity and the document to which access is being sought. While this offers protection against the possible access to documents that should not be readily available, the PCAOB should develop specific rules regarding the ability to effect changes in system documentation, or delete information entirely.

As matters stand now, documents on most of the data bases are in PDF format and cannot readily be modified by anyone other than the Secretary’s Office. However, these documents can be deleted by staff who have administrative permission to manage the document repositories. In addition, the PCAOB does not, but should, have a system in place to prevent anyone with access from sending these documents outside the PCAOB by email. Moreover, there is no express policy prohibiting Board Members or staff from forwarding

nonpublic information to their personal emails. While access to various databases can be tracked through an audit trail, the PCAOB does not have anyone actively monitoring that information on a real time basis.

The PCAOB has made substantial progress in developing a meaningful ERM system. Nonetheless, a great deal of the foundational work necessary for an effective system remains to be performed. The Board should identify the information needed at each level of the PCAOB and develop a comprehensive set of policies to govern its complete control over the system.

### **The Board's Historical Functioning**

Although the PCAOB operated collaboratively at the outset of its existence, that dynamic began shifting as the PCAOB grew in size, and new Chairmen were appointed. By 2012, it appears that conflicts and tensions among Board Members were increasing, and collaboration had become much more difficult. This phenomenon was attributable to dysfunctional group dynamics, disengagement by certain Board Members who did not know what was going on at the Board, and a general sense of uncertainty on the part of Board Members about their roles and responsibilities.

In particular, it has not always been understood by Board Members that there is an essential difference between the Board as a whole, which has the legal authority to act, and individual Board Members, who do not possess the Board's legal standing, or the right to dictate a course of action to the Board. Nor has it always been possible for individual Board Members to confine their disagreements to nonpublic meetings while publicly highlighting their positive interactions as a means of reinforcing a culture of collaboration.

### **Historical Trends in the Staff's Functioning**

From the outset of the PCAOB's existence, its staff reflected considerable longevity and a low turnover rate. From a governance perspective, staff longevity has a number of positive aspects, most notably that, staff longevity can help preserve and protect a positive culture. At the PCAOB, the low rate of senior staff turnover led to the formation of many constructive relationships that helped propel the achievement of the early Board's goals. But senior staff longevity can also lead to burnout or fatigue, and a lack of receptiveness to new ways of achieving changing objectives. This is a phenomenon that occurs in companies as they mature, and some aspects of that pattern began to appear at the PCAOB.

In any event, the juxtaposition of the PCAOB's historic staff longevity against the discharge of seven senior staff members that occurred in 2018 by the collaborative action of the five newly designated Board Members could not have been more stark. Employees confronted with significant organizational changes tend to experience lower levels of job satisfaction and three times the amount of mistrust vis-à-vis their employers. Those general trends became a reality at the PCAOB in 2019, where the PCAOB's employee surveys evidenced considerable mistrust for the current Board. Those surveys were followed by the May and September Whistleblower Complaints. Because there was no general announcement of the Board's early decision to adopt a program of Transformational Change, and to replace seven senior staff members, the PCAOB's staff was confused about what was taking place and why, which fueled staff concerns and unfounded rumors.

### **PCAOB Office of General Counsel**

Entering 2018, the PCAOB had had two General Counsel ("GC") over the first fifteen years of its existence. Over that time, the position had grown increasingly important, starting with the need to get the PCAOB up and running, and continuing through the end of 2017. After the PCAOB's early years, the Office of General Counsel ("OGC") became more involved in policy matters, as opposed to strictly legal issues. A number of PCAOB employees were concerned that OGC had grown unduly powerful and was no longer operating within what many employees perceived as the appropriate parameters of the OGC's authority.

Although the new Board Members wanted to be certain that the OGC operated within an appropriate scope, some employees speculated that the Chairman, in particular, was intent on marginalizing the OGC. That speculation was incorrect, as demonstrated by extrinsic evidence: the GC's job description was *more* robust as revised in 2019 than it was in 2017. Nonetheless, the speculation was likely fostered by the forced departure of three of the most senior lawyers in OGC, without any explanation or discussion.

Two changes to OGC's portfolio were disconcerting, however. As originally structured, the Chief Ethics Officer was part of the OGC, and reported to the GC. In 2018, the Chairman moved this function under the Chief Risk Officer, which made the ethics function part of the Chairman's Office. Making the Chief Ethics and Compliance Officer ("CECO") a third-tier official, reporting to the Chief Risk Officer, who in turn reports to the Chairman, could be viewed as negatively

affecting the PCAOB staff's perception of the CECO's independence. At the outset of our interviews, we were told that the placement of the CECO within the Chairman's Office was temporary. But more than two years have passed since that structure was adopted, and no changes appear likely in the near term. For a variety of reasons, we believe it is better governance if the CECO is moved out of the Chairman's Office immediately. We believe that the CECO should report to the full Board, and that the discharge of the CECO should follow the same protocols in the PCAOB's Bylaws as apply to the IOPA Director—namely, that a majority of the Board agree to the discharge.

### **Onboarding New Board Members**

The process of onboarding new Board Members is a critical function for the PCAOB, especially since it establishes the perspective of each new Board Member for the duration of his/her Board tenure. Over the course of the last two years, the process of onboarding new Board Members has improved considerably. This effort, however, remains a work in progress, and requires a number of changes to achieve the objectives the process is intended to serve.

Thus, at the beginning of 2018, when the five new Board Members took their seats, onboarding efforts largely involved providing incoming Board Members with multiple thick binders, each containing relevant information from each principal office and division. Several new Board Members did not recall receiving any onboarding briefings, while others felt the process consisted of dispensing the entire library of records since the Board's inception, and claimed they were overwhelmed by the process.

A principal purpose of the onboarding process is to familiarize new Board Members with their duties and responsibilities. While the latest iteration of the PCAOB's onboarding materials does a much better job of identifying how the PCAOB operates mechanically and provides a useful memorandum from the GC setting forth an overview of PCAOB procedures, it does not set forth a discussion of the responsibilities, expectations, and roles, of individual Board Members other than the Chairman/CEO. While the memorandum covers the impact of S-Ox quite well, it does not mention anywhere the DCNPCA, the subject of fiduciary duties or requirements imposed on the PCAOB as an IRS-recognized tax-exempt corporation.

The memorandum also does not offer advice on how individual Board Members should work collaboratively with one another, as well as with the

Chairman. And there is no discussion regarding how Board Members should interact with the PCAOB's staff, a critical issue, especially in light of the two whistleblower complaints. As much as the onboarding process has improved over the past two years, there is still room for some substantial improvement.

## **PCAOB Ethics Code**

Shortly after the appointment of the five new Board Members was announced, and two of the five had commenced working, public disclosure was made of unlawful conduct by several members of KPMG's professional audit staff and several former (and, at the time, one current) PCAOB employee, who stole confidential information about forthcoming PCAOB inspections of KPMG audits. These problems arose on the watch of prior Board Members, predating the start of work by any of the five new Board Members, and occurred from 2015 to 2017.

Upon learning of this problem, the current Chairman publicly announced that the PCAOB would take steps to prevent a recurrence of these events and would investigate the Board's policies with respect to access to critical and sensitive PCAOB information. In addition to taking steps to secure the PCAOB's sensitive data, one of the main changes made by the current Board was the retention of a CECO, who was tasked with upgrading and updating the PCAOB's Code of Ethics. This was a salutary effort, but progress on the revisions has been extremely slow and no revisions have as yet been considered or approved by the Board. Given that the conduct in question occurred between 2015 and 2017, and became public in January 2018, it is regrettable that the Board did not hire a CECO and have her report on duty until May 2019.

Even considering the lapse of time solely from the late start date for the new CECO, more than nineteen months have passed since she began work on a revised Code of Ethics, without any formal action. Some of the lack of progress is attributable to the failure to assign any assistants to her on a full or part time basis. Even now, we understand that the CECO only has a single individual assisting her in producing a revised Ethics Code. The Board has not treated this project as a critical priority. It should have done so, and in any event should do so now.

An additional reason for the delayed progress stems from the CECO's concern that, under S-Ox, Ethics rules are PCAOB rules, making noncompliance with the Ethics Code subject to potential civil and criminal penalties. The CECO believes that possibility may be unconstitutional for violations of certain ethics

rules, such as those prohibiting the “appearance” of misconduct, rules related to gifts, and those addressing the misuse of an employee’s official position. Accordingly, the CECO has proposed a two-tier ethics code—a series of Ethics Rules that would carry clear penalties (including potential civil and criminal penalties), and a second formulation, in the form of a Code of Conduct, that would house those principles the CECO believes should not properly be subject to civil or criminal enforcement.

We disagree with this approach and recommend that the Board not adopt it. Whether or not a particular provision of the Ethics Code can be enforced criminally or civilly is not really a germane issue. What is important is to establish a set of firm principles and make clear to all employees that the violation of any of those principles will have significant consequences. Moreover, the very provisions the CECO would relegate to second-tier status have been the subject of criminal and civil prosecutions for decades.

Beyond this, we believe it is unwise to adopt a two-tier set of principles—employees typically expend limited efforts to study the ethical principles that apply to them when those principles are conveniently set out in a single place. Creating multiple locations for ethics rules means many employees may simply not invest the time to track down the rules to which they are subject. In any event, the CECO’s concern with the enforceability of some of these rules can be handled contractually, as a condition for obtaining or retaining employment.

### **2018 Terminations of, and Severance Agreements for, PCAOB Senior Staff Members**

Given the difficulties confronting the new Board Members, and their determination to engage in a program of Transformational Change, the Board decided to terminate the employment of seven senior PCAOB staff members. Prior to 2018, the Board had not adopted a defined and formally articulated severance policy, but there had been a process that was followed fairly consistently when senior employees had left the PCAOB or been discharged. In most cases, those employees were offered severance payments for a complete release, with severance amounting to the equivalent of two weeks’ pay plus an additional week of pay for each year that an individual was employed at the PCAOB. This resulted, typically in severance payments in the six-to-eight-weeks of salary range.

With the employment terminations in 2018, a number of changes were made to these prior practices. Among other things, there were no documents prepared

in connection with the terminations—either explaining why they were occurring or providing a rationale for the amount of severance pay being offered. In that latter regard, all departing employees were provided with severance pay equivalent to six months’ salary, an amount exponentially higher than the severance payments offered to departing employees prior to 2018, with no written explanation of the justification or rationale for these payments.

### **Communications about Board Policies, Perspectives, and Transformational Change**

In retrospect, a great deal of the impetus behind the May and September Whistleblower Complaints apparently was the lack of helpful communications from the Board to the PCAOB staff regarding the structural and personnel changes the Board Members had decided to pursue, or the rationale behind those changes. The Board has improved its processes of internal communications with the PCAOB staff, but there is still additional work to be done in that regard. The most important way the Board can achieve an accurate understanding of its initiatives is to ensure that timely and clear disclosure of those events—in the Board’s own terms—is given to the PCAOB staff. So-called town hall meetings can be an effective tool for communicating, as well as for avoiding the “Wizard of Oz” syndrome—that is, the impression that PCAOB leaders are hiding behind curtains, unwilling to interact with those subject to their leadership.

With respect to communications between Board Members beginning in 2018, there is a logical dividing point between the meeting protocols originally used, and those put in place since the onset of the COVID-19 pandemic. Prior to the onset of the pandemic, a variety of formal and informal meetings were organized by the Chairman as a means of fostering useful discussions. On an informal basis, the Chairman hosted a bi-weekly luncheon meeting, and vis-à-vis work-related issues, encouraged Board Members to take advantage of his open-door policy. The difficulty with those informal approaches is that some Board Members declined to engage in those types of interactions. Formal meetings also were available, and included opportunities for Board Members to interact with the PCAOB Staff (as well as with one another).

Subsequent to the onset of the pandemic, the Board convened one open meeting (the Board has not complied with its own Bylaws requirement that the Board hold at least one open meeting each calendar quarter), utilized the vehicle of Board Working Hours Meetings, held telephonically, to discuss pending projects, their progress and offer insights on how to address any difficulties that

may have arisen. In addition, there are now twice-weekly Board telephone calls. One of those calls is designed to replace the bi-weekly lunches but, unlike those lunches, these telephone calls consistently occur every Tuesday. The second call is with Division and Office leaders, and it is treated as an update call. During the pandemic, the Board has done a better job of regularly meeting, discussing important issues, and communicating better with one another.

### **PCAOB Structural Changes**

Since 2018, there have been a number of structural changes implemented, a number of which have been helpful in making the PCAOB more efficient and effective. Among the changes made are the institution of an EthicsPoint® Hotline, that allows individuals to file complaints, or raise concerns, anonymously; the creation of a new position of Chief of Staff (“COS”) for the PCAOB; creation of a new Office of External Affairs; creation of a new Office of Enterprise Risk Management; creation of a new position of Chief Data Officer, and the Board Champions Initiative.

The EthicsPoint® Hotline has been a useful idea but, as implemented, it does not permit two-way anonymous conversations. This prevents those submitting complaints from receiving updates on the PCAOB’s review of the complaints. There are also indications that at least some employees might not trust the Hotline and, as a result, may take their concerns outside the organization. The new COS position, as described, is much like a traditional corporate Chief Operating Officer (“COO”). In practice, neither the other Board Members nor the PCAOB’s senior staff adopted this enlarged role for the COS. Ultimately, if there is a need for such a position, it probably should result in creating a true COO position.

The new Office of External Affairs combined several prior PCAOB offices into one and enables the PCAOB to look at its communication strategy holistically. It appears to be improving the manner in which the Board communicates with the PCAOB staff and can assist the Board in ensuring that the PCAOB’s standards and efforts are better understood by the Board’s various constituencies. There is still a need for more contact between the Board and PCAOB staff, and more timely information, however.

### **Handling of Whistleblower Complaints**

When the May Whistleblower Complaint was filed, the new Board was confronted, for the first time, with a number of process issues requiring

immediate resolution. This was complicated by the fact that the Acting GC, and the entire OGC, had been recused from participating in the matter. The recusal of the Acting GC was inappropriate in our view, and left the Board to handle these issues without the benefit of the Board's in-house lawyer.

These events pointed up the lack of any Board standards governing conflicts of interest, other than generic admonitions about appearances and public confidence. Neither the concept of what is a conflict, nor how a potential conflict should be assessed and resolved, are covered in the PCAOB's Ethics Code. The Acting GC was advised to recuse himself because one of the signatories to the May Whistleblower Complaint purported to be employed in the OGC. This advice was provided by the head of the Office of Risk Management, in her temporary role as the acting Ethics Officer. Although she advised the Acting GC to recuse himself, she was part of the Chairman's Office but did not recuse herself from looking into the allegations.

The Board retained the Venable law firm as its outside counsel, largely because the firm was doing other work for the PCAOB, and this matter could be added to their existing retainer agreement. The Board did not request a statement of work, or fee estimate, from Venable. Until KLS inquired about the details of the arrangements, the four Board Members did not know the actual amount of fees the Board had expended for Venable's representation in a non-adversarial internal review. Rather, the billing statements were sent to the otherwise recused Acting GC, who reviewed and approved them. The Chairman's recusal also meant that no one involved in PCAOB administration coordinated the expenditure of nearly one-half million dollars with those managing the Board's budget plan.

### **The Bases for the Whistleblower Complaints**

The Whistleblower Complaints appear to have resulted due to the absence of Board disclosure identifying and explaining the rationale for the Board's significant programmatic decisions. The decision to undertake a large number of Transformational Projects was a principal reason that the Board adopted a strategy of replacing senior PCAOB staff. In effect, the Board created a new team committed to the success of these programs, rather than rely on those who might be wed to the old way of doing things. But this was never explained to the staff.

Similarly, both Whistleblower Complaints reflect an absence, on the Board's part, of an effort to anticipate likely staff reactions to the Board's

programmatic changes. Once projects were announced, or staff terminations had taken place, the Board could, and should, have tried to gauge staff reactions, and attempted to allay concerns about those events. Unfortunately, this was a process not undertaken, and the two whistleblower complaints reflect many misperceptions about what had occurred, and why.

The September Complaint attributed improper motivations to the Chairman for what was alleged was *his* decision to compel the departure of seven senior staff members. Those claims were unsupported. The replacement of the seven senior staff members was a collaborative *Board* decision. Moreover, there was no indication of any intent to “politicize” the PCAOB, as asserted. Most individuals hired to replace departed senior staff were identified by a headhunter, had responded to online postings, or had been referred by someone already at the PCAOB. The allegation that the Chairman did not consult with the other Board Members before senior employees were asked to depart was also incorrect. Board Members were properly consulted. Although some mid-level PCAOB officials also were asked to leave without consultation, the PCAOB Bylaws did not require that.

Similarly, the September Complaint raised the concern that the Chairman allowed vacancies for GC and Director of Enforcement to go unfilled for over fifteen months. In fact, the Chairman’s effort to achieve a true Board consensus meant that one or two Board Members were responsible for delays in filling those positions. The September Complaint also alleged that, after four months, no action had been taken on the May Whistleblower Complaint, but work had begun on looking into those claims. Unfortunately, without being able to conduct a two-way anonymous dialogue, the Board would have had to disseminate a public announcement to the staff generically advising that a complaint had been made and that work had already begun. Given the absence of any procedures for situations involving the Chairman’s recusal, that never happened.

There were also allegations in the September Whistleblower Complaint that efforts were made by the Chairman’s Office to identify the identity of the signatories to the May Whistleblowing Complaint. There was an isolated incident where an individual employed in the Chairman’s Office made comments that were most likely the basis for that allegation. She stated that her statements were misconstrued because she did not intend to inquire who had signed the complaint. In any event, there was no indication of any effort on the Chairman’s part, or by his office, to learn who had been responsible for submitting the May Whistleblower Complaint.

The September Whistleblower Complaint also alleges that “significant hirings were made without board input.” Most were new positions created to enhance the PCAOB’s responsiveness to its mandatory functions and there appears to have been meaningful consultation between the Chairman and the other Board Members in the hiring of most personnel to fill those positions.

## **Recommendations**

Based upon our review of the PCAOB’s current and historical governance policies and practices, we set forth fifty-two recommendations, divided into six broad categories:

- Ethics, Whistleblower Complaints and Conflicts/Recusals
- Board Members’ Roles, Duties, Obligations and Interactions
- Recordkeeping
- Internal Communications
- PCAOB Bylaws; and
- Miscellaneous

\* \* \*

Over the past two years, the Board has made progress in developing a platform of good governance policies, procedures and practices. Many of our recommendations seek to build on that progress. In other areas, there is still a fair amount of work to be done, but we believe that our recommendations should help the Board upgrade its governance significantly.

## I. Introduction

### 1.1. Events Preceding this Review

Kalorama Legal Services, PLLC (“KLS”).<sup>1</sup> was retained by the General Counsel’s Office (“SEC OGC”) of the Securities and Exchange Commission (“SEC” or “Commission”) to identify and assess the governance policies and practices of the Public Company Accounting Oversight Board (“PCAOB”) for the period beginning January 2018.<sup>2</sup> In undertaking this review, KLS was asked to provide its independent analysis and advice vis-à-vis the alignment of the PCAOB’s current policies with applicable laws, regulations and standards, and to propose any additional policies, practices and structure that we believe could enhance the PCAOB’s current governance.<sup>3</sup>

Events at and affecting the PCAOB, and criticisms that had been raised vis-à-vis the PCAOB, that preceded our retention, were relevant in setting the context

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<sup>1</sup> KLS and its affiliated consulting firm, Kalorama Partners, LLC (“KP”; together, KLS and KP are referred to as “Kalorama Firms”), were formed in 2003 by former SEC Chairman and General Counsel, Harvey Pitt, and former SEC Chief Accountant, Robert Herdman. The Kalorama Firms provide guidance to domestic and foreign public and private, for-profit and nonprofit, companies, as well as domestic and foreign governmental bodies in the areas, among others, of corporate governance, compliance, disclosure, and risk and crisis management.

The principal personnel of the Kalorama Firms who prepared this Report, in addition to Mr. Pitt, were Nina Rodriguez, Esq., Managing Director, and Jacob Huston, Esq., Counsel. For further information about these individuals, and the Kalorama Firms, *see* the Kalorama Website, <https://www.kaloramapartners.com/>.

<sup>2</sup> *See* KP PCAOB Review Contract Agreement, annexed as Exhibit 1. Of necessity, this meant reviewing aspects of the history of the PCAOB’s governance from its inception. The contract with the SEC was entered into with KP, which was already an SEC-approved vendor, though the work under the contract was performed by KLS, KP’s affiliate.

Our last formal interview took place on December 31, 2020, and this Report speaks as of that date, except as otherwise noted. In the course of writing this Report, KLS learned of additional governance-related issues arising from the for-cause termination of the PCAOB’s former Chief Administrative Officer. Those issues were reviewed internally by the PCAOB. While those issues are not directly addressed in this Report, some of our recommendations relate to our understanding of the PCAOB’s internal review, and the events leading to that employment termination.

<sup>3</sup> *See* Ex. 1, *supra* n. 2, at p. 3. Although KLS worked closely with members of the SEC’s Staff, this Report sets forth only the views of KLS; nothing in this Report is intended to, or necessarily does, reflect the views of the Commission, individual Commissioners, or any member of the SEC’s Staff. The views expressed herein also should not be attributable to any present or former clients of the Kalorama Firms, or any Members of the PCAOB, or its staff.

for this Report.<sup>4</sup>

From its inception until the beginning of 2018, the PCAOB had largely been a staff-driven organization.<sup>5</sup> Some external and internal criticism centered on the PCAOB's minimal staff turnover,<sup>6</sup> and the PCAOB's reputation of being led, largely, by staff initiatives, rather than by top-down policy decisions.<sup>7</sup> Among other things, the PCAOB's General Counsel was said to actively influence significant policy decisions, and was instrumental in achieving changes in the direction, scope, content and implications of PCAOB policy pronouncements that many at the PCAOB perceived as extending beyond advising on concrete legal issues.<sup>8</sup>

In addition, throughout the years preceding our retention, the PCAOB had been criticized for its inability to

- Act on a number of significant projects, such as setting standards for auditing estimates, fair value measurements and the utilization of other auditors and specialists;<sup>9</sup>
- Modernize and integrate sophisticated technology tools to assist it in performing and tracking its multiple responsibilities, often relying on

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<sup>4</sup> Some of these criticisms emanated from SEC Commissioners or Staff. In setting them forth, they do not reflect our factual findings; we set these criticisms forth to reflect significant external perspectives about the PCAOB of which we were cognizant, but we did not perform an independent review to determine whether there was factual support for them.

<sup>5</sup> See, e.g., J. Moore, "Peekaboo! PCAOB More Powerful and Less Accountable than Government Claims," OPENMARKET.ORG (Dec. 4, 2009), available at <http://www.openmarket.org/2009/12/04/peekaboo-pcaob-more-powerful-and-less-accountable-than-government-claims> ("Peekaboo") (quoting former SEC Commissioner Paul Atkins indicating that many of the PCAOB's more significant efforts were "staff-driven").

<sup>6</sup> See nn. 72-82, *infra*, and accompanying text.

<sup>7</sup> See, e.g., *Peekaboo*, *supra* n. 5.

<sup>8</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 3-4; Witness X (1<sup>st</sup> Interview), at pp. 4-5.

A word about our Witness Interview citation methodology is in order here. We conducted sixty-five formal interviews and promised to maintain the confidentiality of witness' statements to us. We have created—for our own internal use—a list of interviewees, and we reference their interviews in this Report by reference to an arbitrary witness "number" we have assigned to each interview. The witness numbers do not necessarily correlate to the order in which we conducted our actual interviews. We do not reference all the interviews during which the same points were raised, but rather cite only a sample, to reflect that we had multiple sources for most of our factual statements.

<sup>9</sup> See, e.g., B. Croteau (then-Deputy Chief Accountant of the SEC), "Remarks before the 2014 AICPA Nat'l Conf. on Current SEC and PCAOB Developments," (Dec. 8, 2014), available at [https://www.sec.gov/news/speech/2014-spch120814btc#\\_ednref9](https://www.sec.gov/news/speech/2014-spch120814btc#_ednref9).

manual systems to track its activities and records;<sup>10</sup>

- Develop sophisticated and robust policies and procedures to cover the full range of both internal and external PCAOB activities;<sup>11</sup>
- Comprehensively review or update its ethics prescriptions since the time of their initial formulation, leaving the PCAOB and its personnel with a relatively terse set of standards that did not reflect current assessments of existing ethics rules;<sup>12</sup>
- Diligently oversee the improper conduct of its own personnel, most notably the conduct reflected by the successful criminal prosecutions and civil enforcement actions involving several former PCAOB employees in connection with the theft and use of confidential PCAOB information relating to planned inspections of various audits performed by KPMG LLP;<sup>13</sup> and
- Timely advise the Commission about other, significant, internal issues,

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<sup>10</sup> See, e.g., J. Kaiser, “A Board Member’s Perspective: PCAOB’s 5-Year Strategic Plan, Transformation Initiatives, and Current Developments,” (Nov. 1, 2018) (“Kaiser Perspectives”), available at <https://pcaobus.org/News/Speech/Pages/kaiser-board-members-perspective-PCAOB-5-year-strategic-plan-transformation-initiatives-current-developments.aspx>.

<sup>11</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 27; Witness X (1<sup>st</sup> Interview), at pp. 7-8; Witness X (1<sup>st</sup> Interview), at p. 31.

<sup>12</sup> The PCAOB’s Ethics Code contains fourteen sections, including one setting forth the application of the code and one containing definitions. See PCAOB, *Ethics Code*, available at <https://pcaobus.org/Rules/Pages/Ethics Code.aspx>. With the exception of a handful of amendments adopted in 2014, the Ethics Code currently reads as it did on its effective date of November 7, 2003.

The PCAOB’s Chief Compliance and Ethics Officer (“CECO”) has advised us that she has prepared a revised and renamed Ethics Code—to be called “Ethics Rules and Standards of Conduct,” which will be presented for formal Board rulemaking in early February. See E. Horton, Email to N. Rodriguez re Documents for Kalorama (Nov. 23, 2020); E. Horton, Email to H. Pitt (Jan. 6, 2021).

<sup>13</sup> See Dept. of Justice, “Former KPMG Executive and Former PCAOB Employee Convicted of Wire Fraud for Scheme to Steal and Use Confidential PCAOB Information,” (Mar. 11, 2019), available at <https://www.justice.gov/usao-sdny/pr/former-kpmg-executive-and-former-pcaob-employee-convicted-wire-fraud-scheme-steal-and>; SEC, “Six Accountants Charged with Using Leaked Confidential PCAOB Data in Quest to Improve Inspection Results for KPMG,” SEC Press Rel. No. 2018-6 (Jan. 22, 2018), available at <https://www.sec.gov/news/press-release/2018-6>; SEC, “KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training,” SEC Press Rel. No. 2019-95 (June 17, 2019), available at <https://www.sec.gov/news/press-release/2019-95>; see also, D. Michaels & M. Rappaport, “KPMG Fires Partners over Leak of Audit Regulator’s Confidential Plan,” WALL ST. J. (Apr. 11, 2017), available at <https://www.wsj.com/articles/u-s-audit-regulator-probing-leak-of-confidential-inspection-information-to-kpmg-1491922950>.

including one that ultimately led to a Board Member's resignation.<sup>14</sup>

By the end of 2017, the Board was comprised of four Members,<sup>15</sup> three of whose terms had expired.<sup>16</sup> In December 2017, the SEC ultimately appointed five new Board Members, the first time since the PCAOB's creation in 2002 that its entire membership had been appointed simultaneously.<sup>17</sup> In a public comment on the appointments, SEC Chairman Clayton noted that one of the Commission's goals was to bring diverse skills and perspectives to the PCAOB, "*along with a commitment to work for consensus.*"<sup>18</sup> The unusual appointment of a completely new Board apparently created anxieties on the part of some PCAOB employees, even beyond those concerns normally attending the appointment of a new Board Chair.<sup>19</sup>

Once each of the new Members had assumed his/her responsibilities,<sup>20</sup> the Board unanimously committed itself to rethinking its approach to governance and

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<sup>14</sup> See J. Clayton, Letter to Senators Brown and Reed (Nov. 12, 2019), at p. 2 ("*J. Clayton Letter*").

<sup>15</sup> The four Board Members were then-Chairman Doty and then-Board Members Harris, Ferguson and Franzel. Board Member Hanson had resigned at the end of 2016. See PCAOB, Press Release (Dec. 23, 2016), available at <https://pcaobus.org/News/Releases/Pages/PCAOB-released-the-following-statement.aspx>.

<sup>16</sup> See J. Clayton, "*James R. Doty, Chairman of the PCAOB, Agrees to Remain in Place for Search and Transition Period for New Board Members,*" (Aug. 11, 2017), available at <https://www.sec.gov/news/public-statement/clayton-statement-pcaob-2017-08-11> (Noting that, as of August 11<sup>th</sup>, of the five Board seats, "one is vacant, two are held by members whose terms have expired, and one is held by a member whose term will expire in two months").

Board Members can serve until their successor is appointed. See Sarbanes-Oxley Act, §101(e)(5)(A), Pub. L. 107-204, 116 Stat. 745 (Jul. 30, 2002) ("S-Ox"), codified at 15 U.S.C. §7211(e)(5)(A) ("The term of service of each Board member shall be 5 years, and until a successor is appointed . . .").

<sup>17</sup> See SEC, "*SEC Appoints New Chairman and Board Members to PCAOB,*" Press Rel. No. 2017-230 (Dec. 12, 2017), available at <https://www.sec.gov/news/press-release/2017-230>; *Kaiser Perspectives*, *supra* n. 10 ("For [the] first time since the PCAOB was created in 2003, we have an entirely new set of Board members"); D. Michaels, "*Government Cleans House at Audit Regulator,*" WALL ST. J.L. (Dec. 12, 2017), available at <https://www.wsj.com/articles/government-cleans-house-at-audit-regulator-1513110178>.

<sup>18</sup> See J. Clayton, "*Statement on Appointment of New PCAOB Board Members,*" (Dec. 12, 2017) (emphasis supplied), available at <https://www.sec.gov/news/public-statement/clayton-2017-12-12>.

<sup>19</sup> See, e.g., Witness X Interview, at pp. 10, 25-28; Witness X Interview, at p. 12; Witness X Interview, at p. 20.

<sup>20</sup> The five new Board Members announced at the end of December 2017 commenced duty at differing times. Initially, Board Chairman Duhnke and Board Member Hamm started in January 2018. Board Member Brown joined in February, Board Member Kaiser joined in March, and Board

the best ways of fulfilling its mission.<sup>21</sup> Among other things, in rethinking its approach, the Board *collectively* adopted several operational policies:

- The development of an extensive program of transformational change at the PCAOB;<sup>22</sup>
- An assessment of senior PCAOB staff to determine which members of the existing staff were committed to, and likely whole-heartedly to support, the program of transformational change;<sup>23</sup>
- Greater reliance on technology to improve the PCAOB’s performance;<sup>24</sup> and
- Revisiting the PCAOB’s governance structure, among other things to add new positions to fulfill important responsibilities and ensure that the PCAOB’s transformational change efforts received appropriate resources.<sup>25</sup>

As part of its efforts, the new Board reviewed the performance of its senior staff and, ultimately, a total of seven senior staff members were either asked to depart or voluntarily retired.<sup>26</sup> After these employment terminations, some of these key positions remained vacant for months and, for some positions, over a

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Member DesParte joined in April. See W. Duhnke, “*PCAOB Transitions for the Future*,” (May 17, 2018), available at [https://pcaobus.org/News/Speech/Pages/PCAOB-Transition.aspx?utm\\_source=PCAOB+Email+Subscriptions&utm\\_campaign=5737c06839-EMAIL\\_CAMPAIGN\\_2018\\_05\\_08&utm\\_medium=email&utm\\_term=0\\_c97e2ba223-5737c06839-125360501](https://pcaobus.org/News/Speech/Pages/PCAOB-Transition.aspx?utm_source=PCAOB+Email+Subscriptions&utm_campaign=5737c06839-EMAIL_CAMPAIGN_2018_05_08&utm_medium=email&utm_term=0_c97e2ba223-5737c06839-125360501) (“*PCAOB Transitions*”).

<sup>21</sup> See, e.g., *Kaiser Perspectives*, *supra* n. 10; see also, *PCAOB Transitions*, *supra* n. 20 (“Organizational Assessment”).

<sup>22</sup> See, e.g., *Kaiser Perspectives*, *supra* n. 10; see also, *PCAOB Transitions*, *supra* n. 20 (“Organizational Assessment”).

<sup>23</sup> See, e.g., *PCAOB Transitions*, *supra* n. 20 (“Organizational Assessment”).

<sup>24</sup> See, e.g., *Kaiser Perspectives*, *supra* n. 10.

<sup>25</sup> *Id.*

<sup>26</sup> See nn. 84-90, *infra*, and accompanying text. See also, e.g., D. Michaels & J. Eaglesham, “*Audit Watchdog Plagued by Internal Strife, Whistleblower Claims*,” *WALL ST. J.L.* (Oct. 15, 2019), available at <https://www.wsj.com/articles/audit-watchdog-plagued-by-internal-strife-whistleblower-claims-11571152206> (“*Plagued by Internal Strife*”).

This article reported claims by some PCAOB staff members that the departing senior PCAOB officials were “push[ed] out” by Board Chairman Duhnke. As noted, *see supra*, n. 23, and accompanying text, the departures of senior PCAOB staff members were the result of a Board consensus or voluntary retirements, and not the result solely of the Chairman’s predilections.

year,<sup>27</sup> although vacancies in Division and Office Head positions were filled by existing senior staff members, designated as “Acting” Head of their various units.<sup>28</sup>

In the midst of these significant changes, there were indications that some PCAOB employees believed they had been restrained in their ability freely to share information with other employees and/or Board Members. Thus, a Culture Survey of PCAOB personnel reflected a general sense of unease among the five hundred seventy participating PCAOB staff members.<sup>29</sup> The Culture Survey included eighty-seven questions, covering an array of topics, including the cultivation of a high-performance workforce, fostering teamwork, as well as creating a culture of inclusion, collaboration, and diversity.<sup>30</sup>

In response to the questionnaire, the PCAOB received only middling scores<sup>31</sup> on questions exploring whether the Board was transparent when communicating with its employees, or whether the Board shared relevant information in a timely manner.<sup>32</sup> The PCAOB received even lower ratings vis-à-vis questions regarding the comfort level of employees with respect to their ability to engage directly with the Chairman or other Board Members.<sup>33</sup>

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<sup>27</sup> See, e.g., *Plagued by Internal Strife*, *supra* n. 26.

<sup>28</sup> See, e.g., PCAOB, Press Rel., “Former Acting Director of the Division of Enforcement and Investigations Mark A. Adler to Leave the PCAOB,” (Mar. 23, 2020), available at <https://pcaobus.org/News/Releases/Pages/Former-Acting-Director-of-the-Division-of-Enforcement-and-Investigations-Mark-A--Adler-to-Leave-the-PCAOB.aspx>.

As noted below, *see* nn. 390-392, *infra*, and accompanying text, we found no evidence that the PCAOB’s functioning was incapacitated during the periods when senior staff positions remained vacant.

<sup>29</sup> See S. Trotman (PCAOB Chief HR Officer), “2019 Culture Survey Approach and Response,” (Dec. 6, 2019), reporting on the results of the PCAOB’s Culture Survey (May 2019) (“There is a fundamental lack of trust between key internal stakeholder groups (staff, managers, senior leaders and the Board) that permeates the entire organization and has developed and festered over time”), annexed as Exhibit 2.

<sup>30</sup> See 2019 Culture Survey Questions (May 2019), annexed as Exhibit 3; 2019 PCAOB Culture Survey, annexed as Exhibit 4. Together, these surveys are referred to as “2019 PCAOB Employee Surveys.”

<sup>31</sup> The questions required response on a scale of one to five, with one meaning the respondent “strongly disagree[s]” with the statements, and five indicating the respondent “strongly agree[s]” with the statements. See 2019 PCAOB Employee Surveys, *supra* n. 30.

<sup>32</sup> *Id.* For the two questions set forth in the text, the PCAOB’s score was approximately three. *Id.*

<sup>33</sup> *Id.* Both topics generated ratings below three.

In May 2019, the PCAOB received an anonymous whistleblower complaint through its anonymous “EthicsPoint”<sup>®</sup> Hotline,<sup>34</sup> the complaint represented that it had been posted by an unspecified number of (but at a minimum at least four) current employees “in various divisions of the organization.”<sup>35</sup> The Complaint stated that these employees

[H]ave been directed by the Chairman’s office to undertake significant programmatic projects with the specification that we not divulge to any other board members or their staff what we have been tasked to do.<sup>36</sup>

The persons specified in the Complaint were Chairman Duhnke, his then Chief of Staff, Francis “Abe” Dymond, and the Chairman’s Office as a whole.<sup>37</sup> The document raised the complainants’ concern that, through the direction to withhold information, the other four Board Members would be impeded from “fulfilling their statutory duties of care,”<sup>38</sup> and that, as a result, the complainants were “extremely uncomfortable,” as well as concerned they could lose their positions at the PCAOB “were the other board members to learn what [these employees] have been directed to do.”<sup>39</sup>

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<sup>34</sup> See EthicsPoint<sup>®</sup> “*Incident Management Report*,” (May 6, 2019), annexed as Exhibit 5 (“May Whistleblower Complaint”). EthicsPoint<sup>®</sup> is a product of NAVEX Global, Inc., and provides organizations with software to receive and track employee complaints. See NAVEX, “*Superior Hotline & Issue Management*,” available at <https://www.navexglobal.com/en-us/campaigns/ethicspoint-hotline-incident-management-software-ppc?gclid=EAlalQobChMlZJrmsl x7AIVCkmGCh3f9gRJEAAAYAiAAEgKXt D BwE>; see also Witness X Interview, at p. 4 (At the time the whistleblower complaint was filed, three PCAOB staff members had access to the EthicsPoint hotline, former Chief Risk Officer, Sue Lee, (b)(6), (b)(6), and (b)(6)); and see Witness X (1<sup>st</sup> Interview), at p. 16.

<sup>35</sup> May Whistleblower Complaint, Ex. 5, *supra* n. 34, at p. 2. The operating units expressly mentioned were the Division of Registration and Inspection (“DRI”), Office of the Chief Auditor (“OCA”), Office of General Counsel (“OGC”), and Division of Enforcement and Investigations (“DEI”). *Id.*

By reference solely to the language of the Complaint, the employees who posted it presumably were all *current* employees, since the document stated that “We *are* employees in various divisions of the organization . . . .” *Id.* (emphasis supplied).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* At that time, the Chairman’s Office consisted of the Chairman, the Chief of Staff, a Special Counsel and a Special Adviser. See PCAOB Website, *Senior Staff/Board Staff*, <https://pcaobus.org/About/Staff/Pages/default.aspx>.

<sup>38</sup> See May Whistleblower Complaint, Ex. 5, *supra* n. 34.

<sup>39</sup> *Id.* The manner in which this concern—about potential job loss—was articulated is confusing. Presumably, if the other Board Members learned of alleged “directions” from the

The May Whistleblower Complaint did not state whether the employees who posted it were actually complying with these asserted directives. We were unable to find support for this allegation, and each of the Board Members in place at the time this Complaint was filed stated to us that they believed they had access to the information they needed to do their jobs, in a manner consistent with their fiduciary and statutory duties.

Upon its submission, this Complaint was initially retrieved by former Chief Risk Officer and then-Acting Ethics Director, Sue Lee,<sup>40</sup> and discussed with Acting General Counsel John Cook, as well as Director of Internal Oversight and Performance Assurance (“IOPA”), Ryan Sack.<sup>41</sup> This handling of the Complaint raises independence issues, since the then newly-created Chief Risk Officer position had been made part of the Chairman’s Office and, at the time, Ms. Lee was also functioning as Acting Ethics Officer.<sup>42</sup> Thereafter, the Complaint was shared with the four other Board Members,<sup>43</sup> and Chairman Duhnke recused

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Chairman’s Office to these employees to keep confidential the details of their assignments, that likely would have prompted a discussion among the five Board Members, and the existence of such a “direction” would not, by itself, have created a likelihood of job loss for those allegedly directed not to share information with others. It would have been less confusing if the authors of the Complaint had indicated they were concerned that they would lose their jobs if they complied with this directive (presumably, if they complied one might question their willingness to adhere to a directive obviously at odds with other Board Members’ fiduciary duties). For purposes of our review, we assumed that that was what the Complaint’s authors intended to state.

As we discuss below, *see infra*, Section 2.15.2.2., we were unable to find support for this allegation, and each of the Board Members at the time of the filing of this Complaint stated to us that they believed they had access to the information they needed to do their jobs in a manner consistent with their fiduciary and statutory duties.

<sup>40</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 12; Witness X (2<sup>nd</sup> Interview), at p. 1.

<sup>41</sup> See, e.g., Witness X Interview, at p. 4; Witness X (1<sup>st</sup> Interview), at p. 12; Witness X (2<sup>nd</sup> Interview), at p. 1.

<sup>42</sup> See PCAOB, “PCAOB Announces New Office of Enterprise Risk Management, Names Chief Risk Officer,” (Feb. 25, 2019) available at <https://pcaobus.org/News/Releases/Pages/PCAOB-announces-new-office-enterprise-risk-management-names-chief-risk-officer.aspx>; see also, Witness X (1<sup>st</sup> Interview), at pp. 26-27; Witness X (1<sup>st</sup> Interview), at p. 8 (Ms. Lee was the designated Ethics Officer from April 1 to May 13, 2019. The period between the former Ethics Officer’s, Barbara Hannigan’s, departure, and her replacement as Chief Compliance and Ethics Officer, Elizabeth Horton’s, onboarding).

We recommend a number of changes in the manner in which employee complaints are handled. See *infra*, Sections 3.1.8.-3.1.11.

<sup>43</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 12; Witness X Interview, at p. 4.

himself from any participation in the consideration or review of those allegations.<sup>44</sup>

Ultimately, the four Board Members advised the SEC's Office of Chief Accountant ("SEC OCA") of the Complaint,<sup>45</sup> and the SEC OCA alerted SEC Chairman Clayton of the allegations, who then sought input from the Commission's Office of General Counsel ("SEC OGC").<sup>46</sup> After conducting a review of potential firms, the SEC OGC retained KLS to conduct an independent review and assessment of the PCAOB's internal corporate governance policies and practices, and prepare a Report delineating our factual conclusions and recommendations.<sup>47</sup>

In September 2019, a second whistleblower complaint regarding the PCAOB was submitted. Rather than posting this Complaint on the PCAOB's EthicsPoint® Hotline, as had been done with the May Whistleblower Complaint, this Complaint was sent directly to SEC Commissioner Roisman.<sup>48</sup> This September Whistleblower Complaint stated it was prepared by the same individuals that had submitted the May Whistleblower Complaint.<sup>49</sup> Among other

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<sup>44</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 33-34; Witness X Interview, at p. 22; Witness X (2<sup>nd</sup> Interview), at p. 27; see also Witness X (1<sup>st</sup> Interview), at p. 32; see also, KLS, Notes of Call with R. Humes (SEC Assoc. General Counsel) and (b)(6), SEC OCA), at pp. 2-3.

<sup>45</sup> The Board Members contacted the SEC on May 14, 2019. See, e.g., Witness X (1<sup>st</sup> Interview), at p. 39; see also Witness X (1<sup>st</sup> Interview), at p. 34.

<sup>46</sup> See *J. Clayton Letter*, supra n. 14, at p. 5.

<sup>47</sup> Among other things, the Kalorama Firms specialize in corporate governance, corporate compliance, as well as risk and crisis management. See Kalorama Firms Website, <https://www.kaloramapartners.com/>. Kalorama's CEO, former SEC Chairman and General Counsel, Harvey Pitt, has been recognized for his corporate governance expertise. See, e.g., NACD, "Announcement of Inductees into the Corporate Governance Hall of Fame," (Sept. 19, 2011), available at <https://www.prnewswire.com/news-releases/nacd-announces-the-2011-directorship-100-honorees-include-jpmorgan-chases-jamie-dimon-netflix-reed-hastings-and-starbucks-corporations-melody-hobson-130112353.html>.

The SEC OGC conducted a review of firms it might retain to provide guidance vis-à-vis the PCAOB's corporate governance, the result of which was the retention of KLS. A description of the SEC OGC's process is set forth in the *J. Clayton Letter*, supra n. 14.

<sup>48</sup> See KLS, Notes of Call with R. Stebbins (General Counsel, SEC) (Sept. 9, 2019), at p. 2; see also, R. Stebbins, Email to H. Pitt re Provenance of the Latest PCAOB Complaint Memorandum (Sept. 10, 2019). For the substance of the allegations set forth in this September Whistleblower Complaint, see KLS, Summary of Second Whistleblower Allegations, annexed as Exhibit 6.

<sup>49</sup> See Ex. 6, supra n. 48. By the time of the September Whistleblower Complaint, it appears that some of the signatories to the May Whistleblower Complaint had left the PCAOB, since the

things, this September Complaint expanded the allegations set forth in the May Whistleblower Complaint, and asserted additional criticisms of PCAOB governance practices in general and, more specifically, criticized the policies and practices of the PCAOB Chairman and his Office.<sup>50</sup>

With respect to governance-related issues, the September Whistleblower Complaint effectively alleged that:

- Under Chairman Duhnke, the PCAOB had been politicized;
- For eighteen months, efforts had been made to deprive the PCAOB of its institutional knowledge, largely through the dismissal of senior PCAOB staff personnel;
- There had been efforts to dilute the PCAOB’s receipt of input from its primary constituencies;
- Efforts had been made to have the PCAOB become closer with the groups the PCAOB had been established to regulate, as part of the Chairman’s program of terminating the PCAOB’s senior staff leadership;
- Efforts had been made to prevent Board Members from exercising their fiduciary duties by withholding information from them, or providing them with incomplete information;
- Staff members were instructed not to advise Board Members of activities and assigned tasks;
- Issues and complaints raised via the PCAOB’s EthicsPoint® hotline had not been addressed;
- Efforts had been expended by the Chairman’s Office to learn the identities of those individuals who had submitted the earlier complaint;
- Some individuals who had been wrongly identified by the Chairman’s Office as complainants were threatened with retaliation;
- Staff specifically were directed not to divulge the Chairman’s Office policy initiatives to Board Members, including:
  - The re-organization of statutory advisory groups;
  - Rulemaking/guidance on auditor independence;
  - Inspection audits in China; and

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September Complaint indicates it was prepared by current *and former* PCAOB employees, whereas the May Complaint simply states that its authors “are” PCAOB employees.

<sup>50</sup> *Id.*

- Plans for developing a permanent inspection program for audits of broker-dealers.
- The Chairman’s Office unilaterally directed or prevented inspections of member firms without requesting or obtaining input from other Board Members;
- The Chairman’s office unilaterally made personnel decisions without input from other Board Members;
- When key personnel were terminated, certain of their positions remained vacant for extended periods of time;
- Some of the 2018 terminations of the employment of senior PCAOB staff were driven by retaliation; and
- The Chairman purported to have absolute discretion and relegated other Board Members to second-class status.<sup>51</sup>

These events formed the backdrop to KLS’ retention, and our efforts were mindful of their existence and significance. Initially, our review was focused upon information sharing within the PCAOB, particularly how information is communicated between the Board and its senior staff, between the Chairman and individual Board Members, and among the PCAOB’s staff. In light of the receipt of the more-detailed September Whistleblower Complaint, however, we included in our efforts a holistic review of the PCAOB’s governance policies, procedures and practices, within the context of S-Ox, the D.C. Nonprofit Corporations Act,<sup>52</sup> IRS provisions relating to nonprofit tax-exempt entities, and best practices for nonprofit corporations.

## 1.2. The PCAOB

The PCAOB is a private-sector, DC nonprofit corporation, established by Congress under S-Ox.<sup>53</sup> It oversees the auditors of U.S. public companies and SEC-registered securities broker-dealers, and its responsibilities include:

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<sup>51</sup> This listing represents KLS’ summary of the lengthier textual assertions contained in the September Whistleblower complaint; it is not a verbatim recitation of the issues raised.

<sup>52</sup> Code of the District of Columbia, Ch. 4, Nonprofit Corporations, §§29-401.01, *et seq.* (“DCNPCA”).

<sup>53</sup> *See* S-Ox §101, 15 U.S.C. §7211.

- Registering public accounting firms;<sup>54</sup>
- Establishing auditing, quality controls, ethics, independence, and other standards relating to audits of public companies and securities broker-dealers;<sup>55</sup>
- Conducting inspections, investigations, and disciplinary proceedings of accounting firms registered with the PCAOB,<sup>56</sup> and
- Enforcing compliance with S-Ox.<sup>57</sup>

Congress vested the SEC with broad authority to oversee the PCAOB's operations, including appointing and removing Board Members,<sup>58</sup> approving the PCAOB's budget,<sup>59</sup> approving all PCAOB rules,<sup>60</sup> and entertaining appeals from PCAOB inspection reports<sup>61</sup> and disciplinary actions.<sup>62</sup> Every domestic or foreign accounting firm that participates in auditing public companies or SEC-regulated

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The PCAOB's initial bylaws contained placeholders regarding the powers of the PCAOB Chairman until the PCAOB's Chairman was appointed. *See* PCAOB, "Proposed Bylaws," File No. PCAOB-2003-01, available at <https://www.sec.gov/rules/pcaob/pcaob200301.htm#exhibita>. After the PCAOB's Chairman, William J. McDonough, was appointed, the initial bylaws were revised, and those bylaws were approved by the SEC. *See* Securities Exchange Act Rel. No. 48212 (Jul. 23, 2003), available at <https://www.sec.gov/rules/pcaob/34-48212.htm>. Subsequently, the PCAOB further amended its bylaws, among other things "to make the bylaw provisions more consistent with District of Columbia and Internal Revenue Service provisions for nonprofit corporations," and the Commission approved those changes as well. *See* Securities Exchange Act Rel. No. 51155 (Feb. 8, 2005), available at <https://www.sec.gov/rules/pcaob/34-51155.htm>.

<sup>54</sup> *See* S-Ox §101(c)(1), 15 U.S.C. §7211(c)(1); *see also*, PCAOB Rule 2100, available at [https://pcaobus.org/Rules/Pages/Section\\_2.aspx](https://pcaobus.org/Rules/Pages/Section_2.aspx).

<sup>55</sup> *See* S-Ox §101(c)(2), 15 U.S.C. §7211(c)(2).

<sup>56</sup> *Id.*, at §§101(c)(3) and (4), 15 U.S.C. §7211(c)(3) and (4).

<sup>57</sup> *Id.*, at §101(c)(6), 15 U.S.C. §7211(c)(6).

<sup>58</sup> *Id.*, at §§101(e)(6) and 107(d)(3), 15 U.S.C. §§7211(e)(6) and 7217(d)(3).

<sup>59</sup> *Id.*, at §109(b), 15 U.S.C. §7219(b).

<sup>60</sup> *Id.*, at §107(b), 15 U.S.C. §7217(b).

<sup>61</sup> *Id.*, at §§104(g) and (h), 15 U.S.C. §§7214(g) and (h).

<sup>62</sup> *See* PCAOB Website, "About the PCAOB," <https://pcaobus.org/About/Pages/default.aspx>; *see also*, SEC Website, "PCAOB," <https://www.sec.gov/fast-answers/answerspcaobhtm.html>; and *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010) ("*Free Enterprise Fund*").

securities broker-dealers must register with the PCAOB, pay it an annual fee, and comply with its rules and oversight.<sup>63</sup>

The PCAOB is charged with enforcing relevant aspects of S-Ox, applicable provisions of the federal securities laws, applicable SEC rules, the PCAOB's own rules, as well as professional auditing standards.<sup>64</sup> The PCAOB regulates many aspects of an auditing firm's practice pertaining to engagements with issuers and SEC-registered securities broker-dealers, including hiring and professional development, promotion, supervision of audit work, the acceptance of new business and the continuation of old, internal inspection procedures, professional ethics rules, and "such other requirements as the PCAOB may prescribe,"<sup>65</sup> subject to approval by the SEC.<sup>66</sup>

The PCAOB is responsible for promulgating auditing and ethics standards for registered accounting firms, performing inspections of all accounting firms registered with it, compelling the production of documents and testimony in furtherance of its exploration of potential violations of its standards, federal statutes, or SEC rules, and initiating formal investigations and disciplinary proceedings where believed appropriate.<sup>67</sup> Willful violation of any PCAOB rule is deemed a willful violation of the Securities Exchange Act of 1934, a federal crime punishable by up to twenty years' imprisonment or \$25 million in fines, and the PCAOB can issue significant sanctions in its disciplinary proceedings, up to and including the permanent revocation of an accounting firm's PCAOB registration, a permanent ban precluding any person from associating with any PCAOB-registered accounting firm, and significant monetary penalties.<sup>68</sup>

Since its inception in 2003, through the date of this Report, there have been a total of eighteen Board Members, including six Members who served as Board

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<sup>63</sup> *Free Enterprise Fund, supra* n. 62, 561 U.S. at 485.

<sup>64</sup> *Id.*, citing 15 U.S.C. §§7215(b)(1) and 7215(c)(4).

<sup>65</sup> *Free Enterprise Fund, supra* n. 62, citing 15 U.S.C. §7213(a)(2)(B).

<sup>66</sup> *See supra*, n. 61, and accompanying text.

<sup>67</sup> *See Free Enterprise Fund, supra* n. 62, citing 15 U.S.C. §§7213-7215.

<sup>68</sup> *See Free Enterprise Fund, supra* n. 62, citing 15 U.S.C. §§78ff(a), 7202(b)(1) and 7215(c)(4).

Chair or Acting Chair,<sup>69</sup> each appointed by formal SEC action, after consultation with the Secretary of the Treasury and the Chairman of the Federal Reserve Board.<sup>70</sup> In contrast, since the PCAOB's inception in 2003, up through the end of 2017, there had been relatively low turnover of senior members of the PCAOB's staff. Thus, after its initial start-up period, the PCAOB was comprised of eight major senior staff positions:

- General Counsel;
- Director of the Division of Enforcement and Investigations;
- Director of the Division of Registration and Inspections;
- Chief Auditor and Director of Professional Standards;
- Chief Hearing Officer;
- PCAOB Secretary;
- Director of Economic and Risk Analysis (“DERA”); and
- Director of IOPA.<sup>71</sup>

As of year-end 2017, despite the fact that six different Board Chairs or Acting Chairs had already served, the PCAOB's then incumbent General Counsel

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<sup>69</sup> See PCAOB Website, “About the PCAOB,” <https://pcaobus.org/About/Board/Pages/default.aspx>. Former Board Member Kaiser's resignation became effective at the expiration of his term, in October 2020. See SEC, Press Rel. No. 2020-257 (Oct. 15, 2020), available at <https://www.sec.gov/news/press-release/2020-257>. He was replaced by PCAOB Chief Auditor, Megan Zietsman. See SEC, Press Rel. No. 2020-256 (Oct. 15, 2020), available at <https://www.sec.gov/news/press-release/2020-256>.

<sup>70</sup> See SEC Website, “Procedures for Appointment of a Member or Chairperson of the PCAOB,” <https://www.sec.gov/about/offices/oca/pcaob-appointments.htm> (as of Aug. 9, 2010).

Under S-Ox, consultation with the Treasury Secretary and Federal Reserve Chairman was required solely for the SEC's initial Board appointments. See S-Ox §101(e)(4)(A), 15 U.S.C. §7211(e)(4)(A). The Commission's procedures, cited above, however, provide for consultation with Treasury and the Federal Reserve for *all* Board Member appointments, even those subsequent to the initial Board appointments. Board Members are appointed for five-year terms, with one permissible renewal period for up to an additional five years. See S-Ox §101(e), 15 U.S.C. §7101(e). The terms of Board Members are staggered, so that, in the ordinary course, only one new Board Member would be appointed in a given year. *Id.*

<sup>71</sup> See PCAOB Website, *Senior Staff*, <https://pcaobus.org/About/Staff/Pages/default.aspx>.

had served in that position for eleven years,<sup>72</sup> its Enforcement Director had served in that position for fourteen years,<sup>73</sup> its Registration and Inspections Director had served in that position for seven years,<sup>74</sup> its Chief Auditor had served in that position for nine years,<sup>75</sup> its Economic and Risk Analysis Director had served in that position for eleven years,<sup>76</sup> and its Director of IOPA had served in that position for thirteen years.<sup>77</sup>

The relatively lengthy tenure for PCAOB senior staff<sup>78</sup> also characterized a number of intermediate and lower level staff positions during the same period of

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<sup>72</sup> See PCAOB Website, Press Rel. (May 1, 2018), available at <https://pcaobus.org/News/Releases/Pages/General-Counsel-Seymour-to-Leave-PCAOB.aspx>.

<sup>73</sup> See PCAOB Website, Press Rel. (May 29, 2018), available at <https://pcaobus.org/News/Releases/Pages/Claudius-Modesti.-Enforcement-to-Leave-PCAOB.aspx>.

<sup>74</sup> See PCAOB Website, Press Rel. (May 18, 2018), available at <https://pcaobus.org/News/Releases/Pages/Helen-Munter-to-Leave-PCAOB.aspx>

<sup>75</sup> PCAOB Website, Press Rel. (May 22, 2018), available at <https://pcaobus.org/News/Releases/Pages/PCAOB-Chief-Auditor-Baumann-to-Leave-the-Board.aspx>.

<sup>76</sup> See Andres Vinelli, LinkedIn Profiles, available at (b)(6).

<sup>77</sup> The first head of IOPA was Peter Schleck. He was appointed in March 2004, see PCAOB Press Rel., “*Board Creates Office of Internal Oversight and Performance Assurance*,” (Mar. 17, 2004), available at [https://pcaobus.org/News/Releases/Pages/03172004 InternalOversight.aspx](https://pcaobus.org/News/Releases/Pages/03172004%20InternalOversight.aspx), and he resigned from the PCAOB in June 2017. See AI Hit Ltd., The Company Database: “*PCAOB—History of Changes*” (2017-06-29), available at <https://www.aihitdata.com/company/00D60308/pcaob/history>.

<sup>78</sup> As set forth below, see *infra*, nn. 190-195, and accompanying text, the PCAOB’s governance structure was largely patterned after that of the SEC, as set forth in Reorganization Plan No. 10 of 1950, 15 Fed. Reg. 3175, 64 Stat. 1265 (Eff. May 24, 1950), available at <https://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node84-leaf114&num=0&edition=prelim> (“Reorg Plan 10”).

Typically, when a new SEC Chairman is appointed, a fair amount of turnover at the SEC’s Senior Staff level generally follows. See, e.g., S. Lynch, “*SEC Hit with Wave of Departures Ahead of Trump Transition*,” REUTERS (Dec. 6, 2016), available at <https://fr.reuters.com/article/us-sec-departures-idUSKBN13V2PK> (“Turnover of high-ranking agency officials [at the SEC] after a Presidential election is common”). As noted in the text above, that was not the pattern at the PCAOB through the end of 2017.

time,<sup>79</sup> including Deputy and Associate General Counsels,<sup>80</sup> deputies of the other major Divisions,<sup>81</sup> and the PCAOB’s Ethics Counsel.<sup>82</sup> This tradition—of lengthy staff tenures—formed an important backdrop to the governance study we were asked to perform, since the announcement of the appointment of five new Board Members in December 2017<sup>83</sup> was followed shortly thereafter by the departure of, among others, the PCAOB’s

- Chief Auditor,<sup>84</sup>
- Chief Human Resources Officer,<sup>85</sup>
- Director of Registration and Inspections,<sup>86</sup>
- Director of Enforcement and Investigations,<sup>87</sup>

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<sup>79</sup> See, e.g., R. Cox, “What to Expect from PCAOB’s Ongoing Transition,” BrigliaHundley (June 14, 2018), at p. 1, available at <https://www.brighiahundley.com/wp-content/uploads/pdf/06-15-18-BH-What-To-Expect-From-PCAOBs-Ongoing-Transition.pdf> (“PCAOB’s Ongoing Transition”):

For years, the PCAOB was known for having some of the longest-tenured senior management among regulators. Many PCAOB directors and deputy directors of divisions have been with the PCAOB from its earliest days and have served more than five years in their current positions.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> See LinkedIn, *Barbara Bulger Hannigan*, (b)(6) (indicating Ms. Hannigan had served at the PCAOB for 15 years and 2 months).

<sup>83</sup> See SEC Press Rel. No. 2017-230 (Dec. 12, 2017), available at <https://www.sec.gov/news/press-release/2017-230>.

<sup>84</sup> See *PCAOB’s Ongoing Transition*, *supra* n. 79, at p.1 and nn. 2 & 3.

<sup>85</sup> See Mortgage Bankers Assoc., Press Rel., “MBA Hires Holly Cannon as Vice President of Human Resources,” (Jul. 3, 2018), available at <https://www.mba.org/2018-press-releases/june/mba-hires-holly-cannon-as-vice-president-of-human-resources> (Noting that Ms. Cannon “comes to MBA from the PCAOB”).

<sup>86</sup> See *PCAOB’s Ongoing Transition*, *supra* n. 79, at p.1 and nn. 2 & 3.

<sup>87</sup> See PCAOB Website, Press Rel. (May 29, 2019), available at <https://pcaobus.org/News/Releases/Pages/Claudius-Modesti.-Enforcement-to-Leave-PCAOB.aspx>.

- General Counsel;<sup>88</sup>
- Ethics Counselor;<sup>89</sup> and
- Director of Information Technology.<sup>90</sup>

(b)(6)

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### 1.3. KLS Mandate and Approach

As noted, our mandate was to inventory the PCAOB’s current governance policies and practices, and present any *constructive* recommendations we might make to the SEC (and ultimately to the PCAOB) for improvements in that governance structure and accompanying policies and practices.<sup>92</sup> Originally, we were asked, as a guidepost for our review, to emphasize the nature and manner of information sharing within the PCAOB, and in particular how information was communicated between the Board and its senior staff, between the Chairman and individual Board members, and among the PCAOB’s Staff.<sup>93</sup>

The SEC’s receipt of the more detailed September Whistleblower Complaint prompted the expansion of the scope of KLS’ review into the PCAOB’s corporate governance model, policies and practices in the context of S-Ox, the DCNPCA, IRS requirements for recognized tax-exempt entities, and best practices for nonprofit corporations. It was within the scope of our review to ensure that our factual reporting addressed the various allegations set forth in

<sup>88</sup> See PCAOB Website, Press Rel. (May 1, 2018), available at <https://pcaobus.org/News/Releases/Pages/General-Counsel-Seymour-to-Leave-PCAOB.aspx>.

<sup>89</sup> See *supra*, n. 82, and accompanying text; see also, IOPA, “Performance Review: Ethics Program Redesign” (Nov. 2019), available at <https://pcaobus.org/InternalOversight/Documents/2020-04-09-Ethics-Program-Redesign.pdf>.

<sup>90</sup> See *PCAOB’s Ongoing Transition*, *supra* n. 79, at p. 1 & n. 3.

<sup>91</sup> The PCAOB’s Ethics Counselor, Barbara Hannigan, technically retired, but apparently did so after learning that her reporting line had been changed from the General Counsel’s Office to the newly created position of Chief Risk Officer, directly in the Chairman’s Office. See, e.g., Witness X Interview, at p. 2; Witness X Interview, at p. 8.

<sup>92</sup> See *supra*, n. 2, and accompanying text.

<sup>93</sup> See KLS, Notes of call with R. Humes (June 30, 2019), at p. 1.

the two Whistleblower Complaints, notwithstanding that the *disposition* of the Whistleblower Complaints was not our direct responsibility.<sup>94</sup>

Despite the more detailed allegations set forth in the September Complaint, and our mandate to understand whether there were factual indications reflecting the validity of those allegations, we assiduously took measures to ensure that our efforts would not be perceived as an adversarial exercise, and would objectively reflect a non-adversarial approach. Thus, among other things, we

- Worked with PCAOB Counsel to draft a memorandum providing each interviewee with an indication of the purpose of the interview and its voluntary nature, and stressed at the beginning of each interview that our inquiry was a factual review, not one intended to uncover past or current misconduct;<sup>95</sup>
- Informed interviewees, in advance of their interviews, of the topics we wished to discuss, and any documents we thought might be relevant to the questions we intended to pose;<sup>96</sup>
- Stressed that interviews were entirely voluntary, and that interviewees could decline to answer any question posed—for any reason, or no reason at all—and could terminate the interview at any time;<sup>97</sup>
- Assured interviewees that we did not expect to attribute information in our Report, or statements made during our interviews, to specific individuals;<sup>98</sup>

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<sup>94</sup> *Id.*

<sup>95</sup> We discuss the Board's retention of counsel below, *see* nn. 137-138, *infra*, and accompanying text. *See* Venable, Memorandum to PCAOB Employees re: SEC Governance Review, annexed as Exhibit 7. *See also*, KLS, Witness Interview Sheets. We did, of course, advise interviewees that if anything they stated to us might reveal possible problematic conduct, we would report that information to appropriate members of the SEC's Staff. *Id.*

<sup>96</sup> *See, e.g.*, H. Pitt, Email to Witness X re Update (Dec. 17, 2019); N. Rodriguez, Email to Witness X re Meeting (Feb. 13, 2020); N. Rodriguez, Email to Witness X re Meeting for PCAOB Review (Jan. 14, 2020). We also provided copies of those documents to those interviewees who might not have had ready access to them, in particular former Board Members and former PCAOB staff. *See, e.g.*, N. Rodriguez, Email to Witness X re Copies of WB Complaint & Summary (Dec. 17, 2019); N. Rodriguez, Email to Witness X re Update (Mar. 19, 2020); N. Rodriguez, Email to Witness X re WB Summary (Apr. 23, 2020).

<sup>97</sup> *See supra*, n. 95, and accompanying text.

<sup>98</sup> *Id.* We also apprised interviewees that, if we did want to attribute anything they might say to them by name (as opposed to a reference to their generic status), we would first seek their consent. *Id.*

- Committed to, and did, prepare a draft memorandum, reflecting the substance of the interview, giving each interviewee an opportunity to modify, amend, delete or add additional information (or context) to our memorandum;<sup>99</sup> and
- Advised interviewees that, if they felt more comfortable, they could have counsel of their own choosing present.<sup>100</sup>

Once KLS had been retained, we were advised to coordinate our information requests through the PCAOB’s CECO.<sup>101</sup> We did so, and had requested a number of documents essential to beginning our efforts,<sup>102</sup> but experienced difficulties in obtaining appropriate documents that were not already public.<sup>103</sup> It was our intention to, and our expectation that we would, review

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<sup>99</sup> *Id.* Every interviewee was provided this opportunity, and we received suggested edits from most interviewees. We made whatever changes were requested, irrespective of what our notes indicated had been stated during the interview, to ensure that each interviewee had passed upon the accuracy of our notes of their interviews.

<sup>100</sup> *Id.* As discussed below, despite the non-adversarial nature of our review, the Board decided to retain its own counsel to interface with us and attend interviews of PCAOB employees. *See* nn. 136-138, *infra*.

<sup>101</sup> *See* (b)(6) Email to H. Pitt (Jul. 1, 2019) (noting KLS’ “primary point of contact,” and providing relevant contact information). The Chief Compliance Officer, Elizabeth Horton, is also the PCAOB’s Chief Ethics Officer. *See* LinkedIn, PCAOB Chief Compliance Officer, (b)(6)

This position will serve as the PCAOB’s top corporate governance and regulatory support position. This key role is the Ethics Officer of the PCAOB, reports to the Chief Risk Officer, and is primarily responsible for overseeing the development, implementation, and enforcement of the ethics and compliance program.

<sup>102</sup> These documents included the PCAOB’s incorporation documents, the May Whistleblower Complaint and the PCAOB’s Culture Surveys. *See* KLS, Notes of Meeting with PCAOB Board Members (Jul. 16, 2019); and KLS, Notes of Meeting with PCAOB Chairman Duhnke (Jul. 16, 2019).

<sup>103</sup> The PCAOB’s *Ethics Code* provides, among other things, that,

Unless authorized by the Board, no Board member or staff shall disseminate or otherwise disclose any information obtained in the course and scope of his or her employment, and which has not been released, announced, or otherwise made available publicly.

PCAOB, *Ethics Code*, Rule EC9, “Nonpublic Information,” available at [https://pcaobus.org/Rules/Pages/Ethics Code.aspx](https://pcaobus.org/Rules/Pages/Ethics_Code.aspx).

The PCAOB interprets this provision to apply to information requests by, or on behalf of, the SEC, as well as telephonic or in-person meetings (which therefore included KLS), and necessitates a Board resolution, signed by at least a quorum of the Board, authorizing specific documents or information to be disclosed. *See* E. Horton, Email to KLS (Jul. 14, 2019). It took

relevant documents first, and then schedule appropriate interviews, a standard practice in internal corporate reviews of this nature, to make our interviews as efficient as possible, and eliminate the need for multiple interviews wherever possible.<sup>104</sup>

In July 2019, before beginning our efforts, KLS held two preliminary meetings—one with then-Board Members Kathleen Hamm, Duane DesParte, J. Robert Brown, Jr. and James Kaiser, and a separate meeting with PCAOB Chairman Duhnke—to discuss our review and, in particular, the scope of the review, the methodology we intended to employ, and our intended processes; we also used these meetings to solicit feedback from the Board, to ensure that they understood, and had the opportunity to provide us with any appropriate suggestions regarding, our intended approach.<sup>105</sup>

During these discussions, among other things, we discussed with, and received feedback from, the Board our plans to:

- Conduct a non-adversarial review of the PCAOB’s governance;
- Develop a draft work-plan and provide Board Members with a copy, soliciting their comments, suggestions or additions;

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several weeks for such a resolution to be adopted and ratified, apparently due to one Board Member’s travel schedule. *Id.* Given the SEC’s important oversight role, we have specific recommendations regarding the need to facilitate and expedite appropriate responses to SEC information requests, and ongoing dialogues about issues of importance. *See* Section 3.1.6., *infra*.

<sup>104</sup> *See, e.g.*, B. Brian, B. McNeil & L. Demsky (eds.), INTERNAL CORPORATE INVESTIGATIONS (4<sup>th</sup> ed., ABA Section of Litigation, 2017), at p. 104 (“conduct the witness interviews after the document collection and review are complete”).

<sup>105</sup> *See* KLS, Notes of Meeting with PCAOB Board Members (Jul. 16, 2019); and KLS, Notes of Meeting with PCAOB Chairman Duhnke (Jul. 16, 2019). Members of the SEC Staff attended both meetings. Prior to our retention, Chairman Duhnke had been recused from any participation in, or consideration of, matters relating to the May Whistleblower Complaint. *See, e.g.*, Witness X Interview, at p. 22; Witness X (1<sup>st</sup> Interview), at p. 34; Witness X (2<sup>nd</sup> Interview), at p. 27; *see also* Witness X (1<sup>st</sup> Interview), at p. 32. After the September Whistleblower Complaint was lodged, Chairman Duhnke recused himself from any matters pertaining to those allegations, as well. *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 34; Witness X (2<sup>nd</sup> Interview), at p. 27; Witness X (1<sup>st</sup> Interview), at p. 32.

We discuss this conclusion—that Chairman Duhnke should have been recused from any decision-making regarding the two Whistleblower Complaints and our review—below and offer specific recommendations to govern such occurrences in the future. *See* Section 3.1.15., *infra*. In light of that recusal, KLS thought it was appropriate to meet separately with the four Board Members, apart from Chairman Duhnke. Both meetings covered the same topics, however.

- Assemble a list of proposed interviewees, and solicit their views;
- Provide all interviewees with a document identifying who we are, and what KLS' processes would be;
- Assure interviewees that anything they might say to us was confidential, nothing they might say would be attributed to them directly, and that there would be no retaliation for anything said to KLS;
- Commence our interviews with the five Board Members;
- Prepare memoranda summarizing each interview, and offer each interviewee the opportunity to edit the memorandum before finalizing;
- Address the May Whistleblower Complaint<sup>106</sup> in the context of applicable corporate governance implications;
- Develop a factual report and a draft list of recommendations; and
- Review the document with the Board for its feedback.<sup>107</sup>

Among other things, the Board Members expressed concerns<sup>108</sup> that the PCAOB's 2019 Employment Surveys reflected a culture that was not trusting,<sup>109</sup> and wanted assurances—which were provided—that KLS would do its utmost to avoid PCAOB employees from feeling intimidated.<sup>110</sup>

As noted, thereafter the SEC received the September Whistleblower Complaint.<sup>111</sup> The OIG was tasked with investigating two issues independently from KLS' review; KLS and OIG discussed how the two independent efforts would proceed.<sup>112</sup> It was agreed that KLS would disclose the existence of the separate OIG investigation during its interviews, and would prepare a summary of the September Whistleblower Complaint—absent the issues under review by OIG—

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<sup>106</sup> At that time, only the initial May Whistleblower Complaint existed. *See* n. 34, *supra*, and accompanying text; *see also*, Witness X (1<sup>st</sup> Interview), at p. 44.

<sup>107</sup> *See* KLS, Talking Points for Meeting with PCAOB Members (Jul. 16, 2019); KLS, Notes of KLS & SEC Meeting with PCAOB Board Members (Jul. 16, 2019).

<sup>108</sup> *See* KLS, Notes of KLS & SEC Meeting with PCAOB Members (Jul. 16, 2019).

<sup>109</sup> *See* 2019 PCAOB Employee Surveys, *supra* n. 30.

<sup>110</sup> Presumably, these concerns were the impetus for the four Board Members' insistence that Board counsel hired specifically for this purpose be present for interviews (subject to the desires of individual interviewees), and that KLS not record any interviews. *See* R. Humes, Email to KLS re Draft Materials (Sept. 2, 2019). We discuss this below, *see* n. 139, *infra*.

<sup>111</sup> *See* n. 48, *supra*, and accompanying text.

<sup>112</sup> *See* KLS, Notes of Call with C. Hoecker (Sept. 26, 2019); KLS, Notes of Call with C. Hoecker (Oct. 9, 2019).

to share with interviewees during its review.<sup>113</sup> Following these discussions KLS and OIG did not have any substantive communications about their respective inquiries.

#### **1.4. KLS Processes**

During the course of our review, KLS conducted sixty-five separate interviews of fifty-three individual interviewees.<sup>114</sup> In addition, there were dozens of telephone and/or email follow-up discussions, in which we sought supplementary information, clarification of prior discussions, or a reconciliation of conflicting factual observations. At the outset of our review, we conducted in-person interviews,<sup>115</sup> which were largely conducted at KLS' offices. However, due to the Covid-19 pandemic, we conducted a number of interviews by telephone or using the video services WebEx<sup>®</sup> and Zoom<sup>®</sup>.

KLS began the interview process by interviewing PCAOB Chairman Duhnke, followed by the other four Board Members. In addition, KLS identified a number of former current and past employees, as well as former Board Members, we believed—based upon their status within the organization—would likely have information helpful to our review. These current and past employees included<sup>116</sup>:

- **Prior Board Members (including former Chairmen and Acting Chairs);**

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<sup>113</sup> See KLS, Notes of Call with C. Hoecker (Sept. 26, 2019). Because we deemed the institution of a separate OIG investigation to be material, KLS believed it was essential to alert interviewees—at the outset of each interview—that such an inquiry was underway, and that the OIG and KLS reviews were separate and independent.

<sup>114</sup> See KLS, Interviews Chart. We had always planned to interview each Board Member twice—once at the outset of our review, and then after we had completed all our other interviews. We discovered that other interviewees had significant information relevant to our review and, in order not to extend interviews beyond four hours, or to ask about subsequently acquired information and understandings, we requested multiple interviews with those individuals, as well.

<sup>115</sup> These interviews were largely conducted at KLS' offices, at 1130 Connecticut Ave., NW, Suite 701, in Washington, D.C. In order to accommodate the work of Board Members, however, we were willing to conduct those interviews at the PCAOB's headquarters, at 1666 K St., NW in Washington, D.C. We decided to interview PCAOB staff only at our offices, to avoid the potential of any discomfort or inquiries to those individuals.

<sup>116</sup> A number of PCAOB employees switched positions during the course of our review. The positions listed in the text above are those held by interviewees at the time KLS conducted its interviews.

- Current Senior Staff;
- Division Heads;
- Mid-level Managers;
- Current Board Counsel;
- Special Advisors to the current Board Members;
- Director of Internal Oversight and Performance Assurance;
- Chief Compliance and Ethics Officer;
- Transformational Change Project Manager;
- General Counsel;
- Former Chief of Staff
- Former Senior Staff,<sup>117</sup>
- Former mid-level staff
- Former PCAOB General Counsel Office staff members;
- Outside PCAOB consultants and counsel;
- Former Senior SEC Staff; and
- Current SEC Commissioner Liaison with the PCAOB.

After conducting the aforementioned interviews, KLS interviewed two Board Members and Chairman Duhnke a second time before completing our review.<sup>118</sup>

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<sup>117</sup> This includes all but two of those individuals who either retired or had their employment terminated since January 2018, the PCAOB's former Ethics Counsel and its former Director of Human Resources.

Notwithstanding the PCAOB's provision of very robust separation payments to retiring or departing senior staff, *see* nn. 681-683, *infra*, and accompanying text, the PCAOB's separation agreements did not require those individuals to cooperate in future inquiries, such as this one. We believe this is an oversight that should be corrected, and we offer a recommendation to that effect. *See* Section 3.6.3., *infra*.

<sup>118</sup> We did not conduct second interviews with former Board Member Hamm, who departed from the PCAOB Board in November 2019, or then-newly appointed Board Member Jurata. Since then, Board Member Kaiser resigned, and his resignation became effective at the expiration of his term, in October 2020. *See* SEC, Press Rel. No. 2020-257 (Oct. 15, 2020), available at <https://www.sec.gov/news/press-release/2020-257>. He was succeeded by PCAOB Chief Auditor, Megan Zietsman. *See* SEC, Press Rel. No. 2020-256 (Oct. 15, 2020), available at <https://www.sec.gov/news/press-release/2020-256>. We did not interview Megan Zietsman—while serving as a Board Member. Board Member Zietsman had previously been the PCAOB's Chief Auditor and Director of Professional Standards, and we interviewed her in that capacity. Her perspectives as a senior PCAOB staff member were not necessarily the same as her perspectives would be as a Board Member, but her appointment came after we had concluded our formal

In preparation for each interview, KLS created a witness sheet, with tailored questions for each individual interviewee.<sup>119</sup> Each interviewee was given the option of having the interview recorded, or having KLS attorneys take detailed notes.<sup>120</sup> We began each interview by assuring the interviewee that our review was not focused on uncovering past or current misconduct, nor should it be viewed as if it were an SEC or PCAOB inquiry.<sup>121</sup> Instead, we stressed that ours was an independent review intended to assist the SEC in its oversight of the PCAOB, and assist the PCAOB in improving its corporate governance.<sup>122</sup>

During the interviews, KLS also provided interviewees with a Summary that we prepared of the September Whistleblower Complaint.<sup>123</sup> Using either the iPhone recording, or the detailed interview notes prepared, we drafted an interview memorandum summarizing the salient points discussed for each individual interview.<sup>124</sup> Interviewees were provided the opportunity to edit and review drafts of their memorandum before KLS finalized the documents. Because KLS' mission is to assist in improving the PCAOB's governance, we largely accepted constructive changes an interviewee suggested. Interviewees were asked to approve the final memorandum as reflecting accurately the statements attributed to him or her.

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interviews, and also did not provide her with enough time in her new role to make a meaningful contribution based on that role.

<sup>119</sup> See, e.g., M. Bloch, "Guide to Conducting Workplace Investigations," Corporate Compliance (2008), at p. 8, available at [https://assets.corporatecompliance.org/Portals/1/Users/169/29/60329/Workplace Investigations Guide.pdf](https://assets.corporatecompliance.org/Portals/1/Users/169/29/60329/Workplace%20Investigations%20Guide.pdf).

<sup>120</sup> Our normal practice, in conducting thousands of interviews in connection with internal reviews, is to record the discussion, to ensure accuracy. The four Board Members insisted that we not record interviews, and we were advised to acquiesce in that request by the SEC OGC. As a result, we advised employees of our preference to record, and provided them with the option to decline to be recorded. Most employees declined to be recorded.

<sup>121</sup> See generally, KLS Witness Interview Sheets, *supra* n. 95.

<sup>122</sup> *Id.*

<sup>123</sup> See Ex. 6, *supra* n. 48, KP Summary of Second WB Complaint Allegations.

<sup>124</sup> These memoranda did not purport to be, and were not, verbatim presentations of everything that had been said during the interviews. In a limited number of cases, given the nature of the interview, or the subject matter it encompassed, we did not solicit comments on our memoranda. Once we finalized our final memoranda of interviews, we disposed of earlier drafts and our contemporaneous notes of the interviews.

In conjunction with our interviews, we reviewed tens of thousands of pages of public and nonpublic documents,<sup>125</sup> prior studies of the PCAOB, reports prepared by outside consultants to the PCAOB, reviews of the PCAOB (or various facets of its selection and operation) prepared by the Government Accountability Office, as well as reviews prepared by the Project on Government Oversight (“POGO”), and numerous articles published by or about the PCAOB, including those about the May and September Whistleblower Complaints. We reviewed the PCAOB’s policies—to the extent they were codified<sup>126</sup>—and we also inquired about informal PCAOB policies affecting the PCAOB’s governance. We also received demonstrations of the various current PCAOB information systems and were provided with printouts and screenshots that demonstrated the capacities of these systems.<sup>127</sup>

## 1.5. Limitations

In any endeavor of this nature, it is appropriate to point out the existence of certain limitations that could have had an effect on the reviewer’s findings and recommendations.<sup>128</sup> Limitations that accompany reviews of this nature fall into two categories—those that generally inhere in these types of efforts, and others related to the specific entity under review, personnel with whom we interfaced, and the specific scope of our review. We do not know how this Report would have differed had we not been subject to these limitations, but we are confident this Report fairly characterizes the observations and conclusions set forth.

- ***Lack of Subpoena Power.*** KLS did not have subpoena power, nor could we compel persons no longer employed at the PCAOB to participate in interviews or produce documents. Without subpoena power, we also had limited ability to verify statements made to us by interviewees. In investigations accompanied by subpoena power, that authority

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<sup>125</sup> A list of the documents provided to us by the PCAOB are listed in Exhibit 8.

<sup>126</sup> At our first meeting with the Board Members, we were advised that the PCAOB had relatively few codified policies and procedures. *See* KLS, Notes of Meeting with PCAOB Board Members (Jul. 16, 2019).

<sup>127</sup> *See* PCAOB, OGC RC Contents; PCAOB, OS RC Permission Structure; PCAOB, Tracking Tool Export; PCAOB, List of Libraries on Office of Secretary Records Center 2019-12-20; PCAOB, List of Libraries on Board Portal.

<sup>128</sup> *See, e.g.,* M. Funk, S. Landefeld & C. Curfman, “*A Most Delicate Task: Investigating Allegations of Company-Internal Misconduct*,” (Aug. 2018), at p. 12, available at <https://www.perkinscoie.com/images/content/2/1/v3/218246/Investigations.pdf>.

frequently creates an *in terrorem* effect that promotes truthfulness.<sup>129</sup> Conversely, the informal review process in which KLS engaged frequently allows interviewees to speculate, or provide useful background context, that might not be possible in a more formal, on-the-record, sworn, investigative setting. Here, we relied upon the integrity of the individuals with whom we spoke. We believe most interviewees were honest, but a lack of subpoena power encumbered our resolution of conflicts.<sup>130</sup> Nonetheless, our professional and ethical obligations require us to set forth an accurate account,<sup>131</sup> and we are satisfied that we have done so.<sup>132</sup>

- ***Voluntary Nature of our Review.*** The voluntary nature of our review allowed individuals to decline to participate in our interviews. Two former PCAOB employees, who occupied significant roles and were knowledgeable about the May and September Whistleblower Complaints, refused to permit us to interview them, or even speak with us.<sup>133</sup> We were, of course, unable to ascertain the information we might have learned from these interviews. There were thus issues surrounding the departure of these two individuals, and certain events in which they were directly involved, that we were unable fully to explore or about which we were prevented from forming a detailed understanding.<sup>134</sup>
- ***Board Retention of Outside Counsel.*** An additional limitation we confronted was the decision of the four Board Members at the outset of

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<sup>129</sup> See, e.g., K. Michels, “*Internal Corporate Investigations and the Truth*,” 40 Seton Hall L. Rev. 83, 118 (2010), available at <https://core.ac.uk/download/pdf/303928625.pdf> (Noting that the adversary process and the existence of governmental subpoena powers are tools that enhance accuracy).

<sup>130</sup> Conflicts in recollections were resolved by us on the basis of our observation of interviewees, the proximity of interviewees to the events as to which conflicts arose, and the existence of other support for specific recollections. Where conflicts in recollections existed, we attempted to note those.

<sup>131</sup> See, e.g., *Internal Corporate Investigations and the Truth*, *supra* n. 129, at p. 102 (“An investigator who conducts a reliance or duty investigation is required to develop an accurate account”).

<sup>132</sup> We have attempted to annotate all factual statements in this Report with references to witness interviews and/or formal documents.

<sup>133</sup> See *supra*, n. 117, and accompanying text.

<sup>134</sup> One of the individuals, having left the PCAOB with a large severance payment, should have been subject to contractual obligations to cooperate with our review, but the PCAOB’s severance agreements did not include such a provision. See n. 117, *supra*, and accompanying text. We make recommendations to correct this situation. See Section 3.6.3., *infra*.

our review to retain outside counsel for the PCAOB. KLS was retained by the SEC OGC in June 2019,<sup>135</sup> and we presented a proposed Work-Plan to the SEC Staff with an intended Report submission date of October 2019.<sup>136</sup> However, shortly after presenting our Work-Plan and initiating our review, we were indirectly informed by the SEC OGC that the four Board Members were in the process of retaining outside counsel.<sup>137</sup> KLS was unable to confer with the PCAOB’s outside counsel—Venable LLP—until September 3, 2019.<sup>138</sup> The retention of “PCAOB Counsel” was surprising;<sup>139</sup> it was also confusing.<sup>140</sup> Given the limitation upon Venable’s representation, it also created costly

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<sup>135</sup> See KP PCAOB Governance Retainer Letter, Ex. 1, *supra* n. 2.

<sup>136</sup> See KLS, Work-Plan Chart for PCAOB Governance Review (Jul. 11, 2019).

<sup>137</sup> See R. Humes, Email to KLS re Draft Materials (Sept. 2, 2019) (Informing KLS that a lawyer from Venable LLP would attend all interviews). The Board’s liaison, Elizabeth Horton (*see* n. 101, *supra*), should have informed us of this decision, but she did not do so.

<sup>138</sup> See G. Kostolampros, Email to KLS re PCAOB (Sept. 3, 2019) (Informing KLS that the PCAOB had retained Venable to represent the organization *and employees* in connection with our review).

<sup>139</sup> As noted above, *see supra*, nn. 2-3, and accompanying text, our review was directed at the PCAOB’s governance policies and practices, and was not focused on finding potential misconduct. Moreover, it was designed to be wholly non-adversarial, including processes we adopted at the request of the four Board Members. As a result, it was not apparent why the Board itself felt it needed its own counsel.

Particularly given the appropriate sensitivity of the four Board Members to the PCAOB staff’s lack of trust vis-à-vis the Board, the decision to hire outside counsel effectively required employees to declare—to the Board’s counsel—whether they would permit Board counsel to attend their interviews, and this created its own form of intimidation. This was compounded by the fact that, initially, all interviews of all PCAOB employees were required to be coordinated through the Board’s designated KLS liaison, Elizabeth Horton. *See* n. 101, *supra*. Given the lack of trust felt by some PCAOB staff, these decisions conceivably could have caused some employees to be less than fully forthcoming.

<sup>140</sup> At the outset, there appeared to be some confusion about the role Board Counsel could, and would, perform. Venable assumed, initially, that it would attend all interviews that KLS conducted, but some individuals might have preferred to be interviewed without the presence of Board counsel. And some individuals might have had information that reflected on deficiencies in the PCAOB’s governance. After lengthy discussions, and the intercession of the SEC OGC, both the Board and Venable agreed that, as Board counsel, Venable could not, and would not, “represent” any individual Board Member or any individual employee of the PCAOB. *See* KLS, Notes of Meeting with R. Stebbins, (b)(6), and E. McFadden (Deputy General Counsel, SEC) (Sept. 4, 2019); *see also* H. Pitt Email to G. Kostolampros (Oct. 1, 2019) (Stating the potential conflict of interests arising from Venable’s representation of individual PCAOB Board Members and staff); *and see*, G. Kostolampros, Email to KLS (Oct. 2, 2019) (Clarifying that Venable had decided it would not represent any individual). It was also agreed that individuals KLS sought to interview would be told the Board had its own counsel, and they could be briefed and prepared by Venable, and have Venable accompany them to their interviews. *See* Ex. 7, *supra* n. 95.

inefficiencies.<sup>141</sup>

- ***Document Production.*** Although we ultimately accumulated a sizeable amount of PCAOB materials, the process of producing documents was not always efficient. To obtain documents, we were required to detail, with specificity, what information we wished to receive, rather than providing generic categories of materials.<sup>142</sup> In a number of cases, we became aware of relevant documents *during* various interviews, and were required to seek that information after the conclusion of those interviews. This necessitated multiple interviews, on occasion, to clarify our understanding of the contents of certain documents. In addition, the approval of a PCAOB Resolution was required before *any* nonpublic documents were provided to KLS. The travel schedules of various Board Members (whose approval of a PCAOB Resolution was required before any nonpublic documents were turned over to KLS) caused an initial delay.<sup>143</sup> In addition, absences of the CECO (through whom the Board required all documents personally to be produced), contributed to additional delays.<sup>144</sup>
- ***Document Production Restraints.*** At the incipient stages of our efforts, the PCAOB executed a Resolution, partially waiving the application of its Rule EC9<sup>145</sup> to permit information to be given to KLS.<sup>146</sup> This initial

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<sup>141</sup> As counsel for the Board—*qua* Board—Venable could not simultaneously represent the PCAOB and any individuals (including Board Members in their individual capacities) in connection with our review. Those Board Members who desired their own individual counsel thus needed to hire additional counsel. Two Board Members—Ms. Hamm and Mr. Brown—did so. The fees and expenses of both Venable and the separate lawyers for Board Members Hamm and Brown were reimbursed by the PCAOB. *See, e.g.*, Witness X Interview, at pp. 1-2; Witness X Interview, at pp. 1-2. As we discuss below, *see infra*, n. 856, and accompanying text, Venable’s fees alone amounted to \$400,000.

<sup>142</sup> In our experience, it is customary for the entities for which we undertake a review to prepare packages of materials deemed most relevant to our inquiry. That was not the approach the Board followed here. However, pursuant to each of our requests, the PCAOB ultimately produced all the documents necessary to cooperate with our review.

<sup>143</sup> *See* PCAOB, Rule EC9, n. 103, *supra*.

<sup>144</sup> These absences were due to legitimate personal reasons. The Board, however, did not appoint any additional individuals to facilitate—or expedite—document production.

<sup>145</sup> PCAOB Ethics Code Rule EC9, *supra* n. 103, provides, in relevant part that, unless expressly authorized by the Board, no Board Member or staff member can disclose to any person any information obtained in the course of his/her employment, unless it already has been released, announced, or otherwise made available publicly.

<sup>146</sup> *See* PCAOB Resolution (Jul. 15, 2019), annexed as Exhibit 9. KLS had no role in the preparation or wording of this resolution.

PCAOB Resolution was inadequate, however,<sup>147</sup> especially vis-à-vis the production of documents from, and unfettered interviews of, former PCAOB personnel. Each of the senior employees whose employment was terminated or retired in 2018 executed a separation agreement with the PCAOB, as a result of which they were contractually precluded from discussing with KLS (or anyone else) their prior employment.<sup>148</sup> In addition, a number of these former employees were attorneys, and thus subject to ethical proscriptions regarding the disclosure of client information to third parties.<sup>149</sup> This necessitated the drafting of a new PCAOB Resolution, which we undertook, at the cost of additional time while we negotiated the terms of this Resolution with Venable.<sup>150</sup>

- ***Deviation from KLS' Standard Internal Corporate Review Practice.*** One standard practice we employ in internal corporate reviews is recording interviews informally.<sup>151</sup> We do so, among other things, to avoid factual errors in preparing our interview memoranda.<sup>152</sup> Venable informed us at the onset of their representation that the four Board Members objected to KLS recording individual interviews.<sup>153</sup> Accordingly, KLS offered interviewees the option of having their interviews recorded or having KLS personnel take detailed notes of the interviews. And, to assure accuracy, we provided interviewees with draft summaries of their interviews. In a few cases, we received significant changes to our

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<sup>147</sup> Among other things, the resolution limited KLS' access to "the Board's bylaws, policies, practices and the [May Whistleblower] Complaint and related matters." It also precluded release of information "for which attorney-client privilege may be asserted." *Id.*, at p. 2.

<sup>148</sup> We discuss these separation agreements below. *See* Section 2.11., *infra*.

<sup>149</sup> *See* DC, Rules of Professional Conduct, Rule 1.6.(e)(1), "Confidentiality of Information," available at <https://www.dcbarr.org/For-Lawyers/Legal-Ethics/Rules-of-Professional-Conduct/Client-Lawyer-Relationship/Confidentiality-of-Information> ("A lawyer may use or reveal client confidences or secrets: with the informed consent of the client").

<sup>150</sup> *See* PCAOB Resolution (Dec. 16, 2019), annexed as Exhibit 10. We ultimately were required to seek the intercession of the SEC OGC to ensure that the Resolution would permit us to proceed with our interviews effectively. *See* H. Pitt, Email to R. Humes re PCAOB Waiver Resolution (Dec. 16, 2019).

<sup>151</sup> We use smart phones for this purpose, in order to avoid having the recording process be intrusive. This is a recommended procedure. *See, e.g., Whistleblowing at Your Not-for-Profit: A Leader's Guide*, YOUR-CALL PTY LTD., (June 2017), at p. 25, available at <https://www.ourcommunity.com.au/files/whistleblowingbook.pdf> (Recommending that, "[w]here possible, interviews will be taped").

<sup>152</sup> Recording interviews also permits us to ascertain whether certain interviewee's responses appear to have been coordinated. In addition, recording interviews precludes *post hoc* claims that certain factual understandings were inaccurate.

<sup>153</sup> *See* R. Humes, Email to KLS re: Draft Materials (Sept. 2, 2019).

summaries; others required some discussions to reach an agreed-upon product. Those efforts extended the time it took us to the preparation of these summaries.

## II. Discussion

### 2.1. Governance of Nonprofit Corporations

Assessing PCAOB governance starts by recognizing it is a nonprofit corporation, with statutorily defined duties and responsibilities. Since the passage of S-Ox, federal law has codified many important principles of corporate governance which were formerly the province of state law.<sup>154</sup> The most critical is adherence to fiduciary obligations. At their core, fiduciary duties reflect officers' and directors' obligations to act in their corporations' best interests. In the nonprofit context, the components of these fiduciary duties are the Duties of Care, Loyalty, and Obedience.<sup>155</sup>

The Duty of Care requires corporate directors to act as reasonably prudent persons would in a similar situations.<sup>156</sup> The Duty of Loyalty requires directors to make decisions in good faith, in a manner they reasonably believe is in the

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<sup>154</sup> See, e.g., C. Glassman, "Sarbanes-Oxley and the Idea of 'Good' Governance," Speech to the Am. Soc. of Corp. Secy's (Sept. 27, 2002), at Part II, available at <https://www.sec.gov/news/speech/spch586.htm> (Noting that "the common thread" of the SEC's reforms is that "governance matters"—that is, "'good' governance tends to channel corporate decisions in the right direction"); R. Clark, "Corporate Governance Changes in the Wake of S-Ox," Harvard John M. Olin Discussion Paper Series Paper No. 525 (Sept. 2005), available at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Clark\\_525.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Clark_525.pdf); B. Civiletti, "Confidence, Courage and Leadership in Corporate Governance," Venable Insights (Dec. 2002), at p. 1, available at <https://www.venable.com/-/media/files/publications/2002/12/the-new-standards-of-corporate-governanceassessin/files/952pdf/fileattachment/952.pdf>.

<sup>155</sup> See, e.g., Weil, Gotshal & Manges LLP, GUIDE TO NONPROFIT GOVERNANCE (2019), at Tab 1, p. 2, available at <https://www.weil.com/~media/guide-to-nonprofit-governance-2019.pdf> ("*Nonprofit Governance*"). In the for-profit context, the basic components of fiduciary duties are the Duties of Care and Loyalty. *Id.*

<sup>156</sup> See, e.g., A. Eckstein & G. Parchomovsky, "Toward a Horizontal Fiduciary Duty in Corporate Law," 104 CORNELL L. REV. 803, 804 (2018), available at <https://poseidon01.ssrn.com/delivery.php?ID=571066117002112070010067111082118090125008047064079009011007085029118004000093026064096057055058008048005069001126002104007086105052000035040121127095002001028110086026000114069104090108114024093026079119122110099088112101089125066015084083021068072&EXT=pdf> ("*Horizontal Fiduciary Duty*").

company's best interest.<sup>157</sup> The Duty of Obedience requires directors to act within the scope of the company's stated purposes, and ensure that the company's mission is pursued lawfully.<sup>158</sup> These duties apply to all the nonprofit corporation's officers and directors, individually and collectively.<sup>159</sup>

The *intent*—or stated purpose and mission—underlying the creation of a nonprofit company largely dictates the principles and structure of corporate governance applicable to it.<sup>160</sup> Nonprofit corporations are distinguishable from their for-profit counterparts in that the creation of a profit is the chief concern of a for-profit corporation, while the purpose of a nonprofit corporation is the fulfillment of its specific mission.<sup>161</sup> A nonprofit's mission is the stated purpose for which it is formed, which serves as the basis for its grant of legal not-for-profit status.<sup>162</sup> A nonprofit corporation's mission delineates the services it may provide and structures its decision-making.<sup>163</sup> Unlike for-profit corporations, “developing a mission and measuring progress against it” is a critical task for nonprofits.<sup>164</sup> The mission must shape the nonprofit's activities, and the board must carry out the mission in strict conformity with applicable legal and regulatory requirements.<sup>165</sup>

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<sup>157</sup> *Id.*, 104 CORNELL L. REV. at 813.

<sup>158</sup> *See, e.g., Nonprofit Governance, supra* n. 155, at Tab 1, p. 2.

<sup>159</sup> *See, e.g., Horizontal Fiduciary Duty, supra* n. 156, 104 CORNELL L. REV. at 808-809.

<sup>160</sup> *See, e.g., Nonprofit Governance, supra* n. 155, at Tab 1, p. 1.

<sup>161</sup> *See, e.g., Horizontal Fiduciary Duty, supra* n. 156, 104 CORNELL L. REV. at 804.

<sup>162</sup> *See, e.g., Nonprofit Governance, supra* n. 155, at Tab 1, pp. 3-4.

<sup>163</sup> *See, e.g., M. Epstein and F. McFarlan, “Nonprofit vs. For-Profit Boards, Critical Differences,” STRATEGIC FINANCE MAGAZINE (Mar. 2011), at p. 31, available at <https://sfmagazine.com/wp-content/uploads/sfarchive/2011/03/Nonprofit-vs.-For-Profit-Boards-Critical-Differences.pdf> (“Nonprofit vs. For-Profit”).*

<sup>164</sup> *Id.*, at p. 30. It is widely recognized that, in the case of for-profit corporations, any lawful activity is within its authorized activities. *See, e.g., Del. Code, Ch. 8, Corporations, Ch. 1, General Corporation Law, §101(b)* (“A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes”); *Burwell v. Hobby Lobby Stores, Inc.*, 573 U.S. 682, 710-712 (2014) (Noting that modern corporate law permits corporations to pursue “any lawful purpose or business”).

<sup>165</sup> *Nonprofit vs. For-Profit, supra* n. 163, at p. 4 (Nonprofits must adhere to, and may not materially deviate from, their stated missions).

In many respects, the role of a nonprofit’s board of directors is similar to that of a for-profit board—the board is tasked with overseeing the organization and must carry out its duties in accordance with its fiduciary responsibilities.<sup>166</sup> A key difference, however, arises in the event there is a breach of those duties by the nonprofit’s board, officers, or employees. While for-profit shareholders can hold corporate directors and officers accountable for such breaches, there is no comparable private shareholder accountability mechanism for nonprofits.<sup>167</sup>

In the case of the PCAOB, the role normally played by shareholders of for-profit corporations—holding directors and officers accountable, and ensuring they are responsive to their fiduciary duties—is fulfilled, in part, by the SEC, which has plenary power over the PCAOB, and can disapprove many *proposed* acts of the PCAOB—in the form of rulemaking, Bylaw changes, budget, etc.—in advance of their effectiveness.<sup>168</sup> Of course, the authority to disapprove rules, bylaws or budgets, only extends so far—even the most carefully-considered and appropriately-devised rules, bylaws or budgets could, in theory, be circumvented, after adoption, either intentionally or inadvertently, and that is a prime consideration in assessing a nonprofit’s governance structure. Ensuring a nonprofit’s adherence to its mission and accountability, therefore, must start with each board member.<sup>169</sup> As a result, it is critical that the board of a nonprofit corporation implement processes and structures to assist directors and other senior management in fulfilling these responsibilities.

## 2.2. The PCAOB as a D.C. Nonprofit Corporation

As noted above, the PCAOB was established by Title I of S-Ox, as a District of Columbia nonprofit corporation.<sup>170</sup> Its stated mission is to oversee the audits of public companies and registered securities broker-dealers to protect investors and the public, by encouraging robust and correct independent audit reports.<sup>171</sup>

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<sup>166</sup> See, e.g., *Horizontal Fiduciary Duty*, *supra* n. 156, 104 CORNELL L. REV. at 804.

<sup>167</sup> See, e.g., *Nonprofit Governance*, *supra* n. 155, Tab 1, at p. 2. For most nonprofits, this role is performed by attorneys general and the IRS. *Id.*

<sup>168</sup> See nn. 58-62, *supra*, and accompanying text.

<sup>169</sup> See, e.g., *Nonprofit Governance*, *supra* n. 155, Tab 1, at p. 2.

<sup>170</sup> See n. 53, *supra*, and accompanying text.

<sup>171</sup> See PCAOB Website, “About the PCAOB,” <https://pcaobus.org/About/Pages/default.aspx>.

Specifically, the PCAOB is tasked with registering public accounting firms, establishing auditing, quality control and independence standards, conducting inspections of registered public accounting firms, and conducting investigations and disciplinary proceedings when appropriate.<sup>172</sup> Although the PCAOB was established by Congress, it is neither an agency nor an establishment of the U.S. Government.<sup>173</sup> However, despite its status as a nonprofit corporation, the SEC has broad oversight authority over the PCAOB, including approval of the PCAOB's rules, standards, and budget.<sup>174</sup>

The interplay between S-Ox and the DCNPCA is a subject that appears to have received scant attention on the part of Board Members and the PCAOB's staff.<sup>175</sup> S-Ox declares that the PCAOB

*[S]hall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act.*<sup>176</sup>

S-Ox authorizes the PCAOB to conduct its operations “without regard to any qualification, licensing, or other provision of law in effect” in any State or other political subdivision where it operates.<sup>177</sup> The PCAOB submitted Title I of S-Ox as its “Articles of Organization,” required for tax-exempt status with the IRS, and as its “Articles of Incorporation” pursuant to the DCNPCA.<sup>178</sup> The PCAOB took the

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<sup>172</sup> S-Ox §101 (c)(1)-(4), codified at 15 U.S.C. §7211(c)(1)-(4).

<sup>173</sup> S-Ox §101(a), codified at 15 U.S.C. §7211(a) (The PCAOB is “not an agency or establishment of the United States government”). It is, therefore, generally exempt from statutory governance requirements applicable to such entities. *See* O.L.C., “*Status of Public Company Accounting Oversight Board Under 18 U.S.C. §207(c)*,” (Mar. 30, 2007), available at <https://www.justice.gov/sites/default/files/olc/opinions/attachments/2015/05/29/op-olc-v031-p0047.pdf>.

Earlier this year, in connection with the President's proposed budget, the White House proposed that, by 2022, the SEC should absorb the PCAOB, essentially making the PCAOB a department of the SEC. *See, e.g.,* M. Maurer & P. Kiernan, “*White House Proposal for SEC to Absorb Audit Watchdog Raises Concerns*,” *Wall St. J.* (Feb. 13, 2020), available at <https://www.wsj.com/articles/white-house-proposal-for-sec-to-absorb-audit-watchdog-raises-concerns-11581624345>. This proposal is unlikely to gain any traction. *Id.*

<sup>174</sup> *See* nn. 58-62, *supra*, and accompanying text.

<sup>175</sup> *See, e.g.,* Witness X (1<sup>st</sup> Interview), at p. 15; Witness X (1<sup>st</sup> Interview), at p. 17; Witness X Interview, at p. 8; Witness X (1<sup>st</sup> Interview), at pp. 7-8; Witness X Interview, at p. 8.

<sup>176</sup> *See* S-Ox §101(b), 15 U.S.C. §7211(b) (emphasis supplied).

<sup>177</sup> *See* S-Ox §101(f)(2), 15 U.S.C. §7211(f)(2). This necessarily includes D.C. law.

<sup>178</sup> *See* G. Seymour, Email to KLS (Nov. 20, 2020). In other words, the PCAOB did not claim an exemption from the process of filing Articles of Incorporation with the D.C. Government, but

sensible precaution, at the outset of its existence, of working with an attorney familiar with both nonprofit law, and the obligations of statutorily-created nonprofit corporations.<sup>179</sup>

Throughout the course of our review, it appeared that a number of current and former Board Members do not, or did not, have a clear understanding of the interplay between S-Ox and the DCNPCA.<sup>180</sup> This is problematic, since the PCAOB's status as a D.C. nonprofit corporation imposes its own set of fiduciary responsibilities on each Board Member, in addition to those obligations already imposed upon each Board Member, and the Board collectively, by S-Ox.<sup>181</sup>

Indeed, some former Board Members, while acknowledging that they were subject to important fiduciary obligations, nonetheless indicated that they had neither discussed nor weighed their fiduciary obligations (from any source) when dealing with discrete issues presented to the Board for votes.<sup>182</sup> As a result, we believe that integrating guidance on the nature of these fiduciary responsibilities, and how Board Members should seek to comport themselves in light of their existence, should be included as a facet of the onboarding process for each new Board Member, and the subject of periodic refresher courses for veteran Board Members.<sup>183</sup>

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rather decided that, as a corporation established by an Act of Congress—the legislation, rather than some separately created document restating its requirements as to Members, etc., would serve as the PCAOB's Articles of Incorporation. *Id.* See also PCAOB, Letter in Response to IRS concerning Form 1023 Application (Feb. 23, 2004); IRS, Approval of PCAOB 501(c)(3) Notice (Mar. 22, 2004); PCAOB, Application for Exemption with D.C. Office of Tax and Revenue (Mar. 22, 2004); and D.C. Office of Tax and Revenue, Approval of PCAOB Exemption (May 18, 2004), all annexed as Exhibit 11.

At the time of the PCAOB's creation, the law governing nonprofit corporations in the District of Columbia was a 1962 statute. See Pub. L. 87-569 (Aug. 6, 1962), available at <https://www.govinfo.gov/content/pkg/STATUTE-76/pdf/STATUTE-76-Pg265.pdf>. Effective in 2012, that statute was replaced by the DCNPCA. See D.C. Bar Pro Bono Center, *Summary of some of the Critical Provisions of the D.C. Nonprofit Corporation Code*, (Jan. 2012; updated Apr. 2017 and Aug. 2018), available at <https://www.lawhelp.org/files/7C92C43F-9283-A7E0-5931-E57134E903FB/attachments/02B6E2E1-A240-4C24-A5DB-C38080FD7F57/summary-of-some-of-the-critical-provisions-of-dc-nonprofit-code.pdf>.

<sup>179</sup> *Id.* That attorney was Arthur Herold, of Webster, Chamberlain & Bean. *Id.*

<sup>180</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 15; Witness X (1<sup>st</sup> Interview), at p. 17; Witness X Interview, at p. 8; Witness X Interview, at p. 10; Witness X Interview, at p. 7-8; Witness X Interview, at p. 4; Witness X Interview, at p. 16.

<sup>181</sup> See DCNPCA, §29–406.30.

<sup>182</sup> See, e.g., Witness X Interview, at p. 6; Witness X Interview, at p. 11.

<sup>183</sup> Our recommendations include such proposals. See Section 3.2.1., *infra*.

### 2.3. PCAOB Bylaws<sup>184</sup>

Under S-Ox §101(d), before the PCAOB could become operational, it was required to take appropriate actions—including the hiring of staff and the proposal of rules (which the Commission’s Order approving the PCAOB’s operational status found included *proposing* bylaws<sup>185</sup>)—to enable the Commission to determine, not later than nine months after the adoption of the

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<sup>184</sup> Bylaws, as defined by the DCNPCA, *see* §29-401.02, are the code of rules, *other than the articles of incorporation*, adopted for the regulation and governance of the internal affairs of the nonprofit corporation, regardless of the name or names used to refer to those rules. The PCAOB has never adopted articles of incorporation.

At the time the PCAOB was created, the 1962 D.C. Nonprofit Act specifically provided that “articles of incorporation” in the case of a corporation created by a special act of Congress, means that special act and any amendments to it. *See* former §29-301.02(4). Thus, the PCAOB was able to treat Title I of S-Ox as its articles of incorporation. When the 1962 Act was repealed and replaced by the DCNPCA, that language was omitted from the statute. However, as we have seen, *see* n. 173, *supra*, under S-Ox the PCAOB is expressly permitted to operate without regard for state or local political subdivision qualification or licensing acts.

Pursuant to S-Ox §2(a)(13), 15 U.S.C. §7201(a)(13), the term “rules of the Board,” is defined to include “the bylaws and rules of the Board (as submitted to, and approved, modified, or amended by the Commission, in accordance with [S-Ox §] 107.”

<sup>185</sup> The first set of PCAOB Bylaws was proposed in March of 2003, *see* SEC, “*PCAOB Proposed Bylaws*,” (Mar. 3, 2003), available at <https://www.sec.gov/rules/pcaob/pcaob200301.htm>; after amendments, the PCAOB’s Bylaws were adopted four months later. *See* Secs. Exch. Act Rel. No. 48212, “*Order Approving Proposed Rules Relating to Bylaws*,” (Jul. 23, 2003), available at <https://www.sec.gov/rules/pcaob/34-48212.htm>.

Act,<sup>186</sup> that the PCAOB was appropriately organized and had the capacity to comply with its responsibilities under S-Ox.<sup>187</sup>

The Commission did so by issuing an Order to that effect, although it expressly noted that, in issuing it, the Order did not constitute “approval of any specific PCAOB action.”<sup>188</sup> As part of its responsibilities pursuant to S-Ox §101(d), the PCAOB proposed Bylaws, defined its registration process for public accounting firms and, in reliance upon S-Ox §103(a)(3)(B), adopted Interim Standards relating to Auditing, Attestation, Quality Control, Ethics, and Independence Standards.<sup>189</sup>

The PCAOB is required to follow Securities Exchange Act Rule 19b-4<sup>190</sup> when it submits proposed rules to the SEC for approval, including its Bylaws and amendments thereto.<sup>191</sup> That submission generally includes two parts: a standardized submission of materials by the PCAOB and a proposed *Federal Register* notice for the SEC to use in its public notice-and-comment rulemaking process.<sup>192</sup>

At the outset, the founding Board Members debated whether the Bylaws should give Board Members administrative responsibility or place administrative

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<sup>186</sup> The Act became effective on July 30, 2002, making the deadline for this determination April 30, 2003.

<sup>187</sup> See 15 U.S.C. §7211(d).

<sup>188</sup> See Securities Exch. Act Rel. No. 47746 (Apr. 25, 2003), available at <https://www.sec.gov/rules/other/33-8223.htm>. This included, of course, the Bylaws that the PCAOB had proposed. *Id.*

<sup>189</sup> See 15 U.S.C. §7213(a)(3)(B) (authorizing the PCAOB to adopt as its rules, any portion of any statement of auditing or professional standards the PCAOB deems appropriate, and to do so without the necessity of Commission approval on an interim basis). In fact, the Commission did issue an Order approving the PCAOB’s interim standards. See Secs. Exch. Act Rel. No 47745, “*Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002*” (Apr. 25, 2003), available at <https://www.sec.gov/rules/other/33-8222.htm>.

<sup>190</sup> See 17 C.F.R. §240.19b-4(2020).

<sup>191</sup> See S-Ox §107(b)(4), 15 U.S.C. §7217(b)(4), which provides that the “provisions of paragraphs (1) through (3) of [Securities Exchange Act §] 19b . . . shall govern the proposed rules of the Board, as fully as if the Board were a “registered securities association” for purposes of that section 19(b).” Consistent with the language of this provision, the SEC’s website does not list the PCAOB as a Self-Regulatory Organization (“SRO”), see SEC Website, “*Self-Regulatory Organization Rulemaking*,” <https://www.sec.gov/rules/sro.shtml> (June 26, 2020), but it helpfully references PCAOB rulemaking in a sidebar on the same page.

<sup>192</sup> See SEC Form 19b-4, 17 C.F.R. §249.819 (2020); and see <https://www.sec.gov/files/form19b-4.pdf>.

control in the Board’s Chairman/CEO.<sup>193</sup> The initial draft of the PCAOB’s proposed Bylaws—that the PCAOB’s staff informally provided to the SEC Staff in advance of its filing—vested the authority to hire employees and administer the PCAOB’s day-to-day activities in the full Board, acting as such, rather than in the Chairman/CEO.<sup>194</sup>

We were told by several former PCAOB staff members that, at the time, the SEC Staff advised PCAOB personnel that the SEC Staff believed the PCAOB should centralize the organization’s executive and administrative powers in the Board’s Chairman, preferring that the PCAOB’s organization and structure mirror those vested in the SEC’s Chairman as a result of the adoption of Reorg Plan 10.<sup>195</sup>

Reorg Plan 10, in essence, transferred all executive and administrative functions originally vested in the full Commission to the SEC’s Chairman, making the Chairman the Chief Executive and Administrative Officer of the Agency. The powers vested in the Chairman by Reorg Plan 10 include the

- Appointment and supervision of all Commission personnel; although the
  - Appointment of the heads of major SEC Administrative Units requires the approval of the Commission;<sup>196</sup>
  - Personnel employed regularly and full time in the immediate offices of Commissioners other than the Chairman are not “affected by” the provisions of Reorg Plan 10;<sup>197</sup>
- Assignment of responsibilities to all employees, and among the various administrative units of the Commission; and

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<sup>193</sup> See, e.g., Witness X Interview, at p. 3; Witness X Interview, at pp. 3-4 & 9-11.

<sup>194</sup> See, e.g., Witness X Interview, at p. 2; Witness X Interview, at pp. 16-17; Witness X Interview, at pp. 2-3.

<sup>195</sup> See, e.g., Witness X Interview, at p. 2; Witness X Interview, at p. 9; Witness X Interview, at p. 3. See Reorg Plan 10, *supra* n. 78.

<sup>196</sup> Reorg Plan 10, *supra* n. 78, at §1(b)(2). This has been construed to mean that a majority—or at least two other members of the Commission (in addition to the Chairman)—must approve the hiring of senior SEC staff officials.

There is no requirement in Reorg Plan 10 that the SEC Chair consult with, or obtain the approval of, the other Commissioners when it comes to discharging senior SEC Staff members.

<sup>197</sup> Reorg Plan 10, *supra* n. 78, at §1(b)(3). Of course, the Chairman’s authority over the Agency’s budget might allow the Chairman, indirectly, to influence certain aspects of the personnel employed in individual Commissioners’ offices.

- Use and expenditure of Agency funds.<sup>198</sup>

Certain initial Members of the PCAOB, and its staff, were under the impression that the SEC Staff’s objective at that time was to have the PCAOB’s structure mirror that of the SEC,<sup>199</sup> and that the SEC Staff believed that structure to be superior.<sup>200</sup>

In early 2003, the PCAOB formally filed its first draft of Proposed Bylaws with the SEC.<sup>201</sup> That draft included a provision designating the Chairman as President of the Board, and the four other Board Members as Vice Presidents, but clarified that all Board Members would serve as corporate officers without additional compensation.<sup>202</sup> The title of Vice President was neither intended to limit nor expand the power of the Board Members;<sup>203</sup> the decision to label Board Members as Vice Presidents was intended to signify that they are employees of the PCAOB, and thus fall within the provision of S-Ox that confers immunity from liability for PCAOB “employees” in connection with enforcement matters.<sup>204</sup>

In addition to the Chairman/CEO and the four other Board Members/Vice Presidents, the PCAOB’s Bylaws also provided for seven additional officers—a Secretary, Treasurer, General Counsel, Chief Auditor, Chief Administrative Officer, Director of Registration and Inspections, and Director of Enforcement and Investigations.<sup>205</sup> A catchall supplementary power was also included in the Bylaws—in the form of a reference to “such other officers as the Governing Board may establish in accordance with such rules of the Governing Board as may be

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<sup>198</sup> *Id.*, at §1(a)(3). The Commission as a whole, however, retained its authority to revise budget estimates and determine whether the distribution of appropriated funds is consistent with the Agency’s major programs and purposes. *Id.*, at §1(b)(4).

<sup>199</sup> *See, e.g.*, Witness X Interview, at p. 3; Witness X Interview, at p. 3; Witness X Interview, at p. 6.

<sup>200</sup> *See, e.g.*, Witness X Interview, at p. 5; Witness X Interview, at pp. 3-5. Some individuals at the PCAOB thought the rationale behind utilizing the structure of Reorg Plan 10 was to accommodate incoming Board Chairman McDonough. *Id.*

<sup>201</sup> *See* PCAOB 2003-01 (Mar. 13, 2003), available at <https://www.sec.gov/rules/pcaob/pcaob200301.htm> (“*PCAOB Originally Filed Bylaws*”).

<sup>202</sup> *Id.*, at p. 9; *see also, e.g.*, Witness X Interview, at pp. 7-8; Witness X Interview, at p. 6.

<sup>203</sup> *See, e.g.*, Witness X Interview, at p. 7; Witness X Interview, at p. 6.

<sup>204</sup> *See* S-Ox §105 (b)(6), 15 U.S.C. §7215 (b)(6); *see also, e.g.*, Witness X Interview, at p. 7. at p. 7; Witness X Interview, at p. 6.

<sup>205</sup> *PCAOB Originally Filed Bylaws, supra* n. 201, Art. VI, §6.2.

adopted for establishing officers.”<sup>206</sup> Since the beginning of 2018, the PCAOB has appointed a large number of new senior staff members, but the existing provisions of the Bylaws listing senior officers have not been amended to reflect those developments.<sup>207</sup>

The PCAOB stated in its initial submission of Bylaws that “the bylaws do not address the division of powers and duties between the Chair and the Board. The PCAOB will consider this issue once a permanent Chair is named.”<sup>208</sup> The PCAOB also requested that the Bylaws be approved retroactively as of January 2003.<sup>209</sup>

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<sup>206</sup> *Id.*

<sup>207</sup> As a practical matter, the duties of most nonprofit officers are described in the nonprofit’s bylaws. *See, e.g.*, G. Takagi, “*Nonprofit Directors and Officers—Not the Same Thing*,” NONPROFIT LAW BLOG (May 14, 2019), available at <https://nonprofitlawblog.com/nonprofit-directors-and-officers-not-the-same-thing/>. The PCAOB’s Bylaws indicate, by title, each of the senior officers of the organization. Once so designated, that designation imposes obligations upon the Board’s Chairman vis-à-vis consultation and approval of the other Board Members before filling vacancies in those positions, and consulting before terminating the employment of persons filling those positions.

We recommend amending the Bylaws to take account of current senior staff designations. *See* Section 3.5.1., *infra*.

<sup>208</sup> *See PCAOB Originally Filed Bylaws, supra* n. 201.

Initially, a full complement of initial Board Members had been appointed by the SEC. *See* SEC, “*Commission Announces Founding Members of Public Company Accounting Oversight Board*,” SEC Press Rel. No. 2002-153 (Oct. 25, 2002), available at <https://www.sec.gov/news/press/2002-153.htm>. After a factually incorrect story appeared in the press regarding the SEC’s initial choice for Board Chairman, Judge William H. Webster (who had previously served as the head of the CIA and the FBI), *see* S. Labaton, “*Audit Overseer Cited Problems in Previous Post*,” NY Times (Oct. 31, 2002), available at <https://www.nytimes.com/2002/10/31/business/audit-overseer-cited-problems-in-previous-post.html>, Judge Webster resigned from the Board. *See* SEC, “*SEC Accepts Resignation of Judge Webster*,” SEC Press Rel. No. 2002-159 (Nov. 12, 2002), available at <https://www.sec.gov/news/press/2002-159.htm>. That left only four Board Members, and no Chairman, although Board Member Niemeier was designated Acting PCAOB Chair in January 2003. *See* SEC, “*Commission Reappoints Charles D. Niemeier to Public Company Accounting Oversight Board*,” SEC Press Rel. No. 2003-141 (Oct. 23, 2003), available at <https://www.sec.gov/news/press/2003-141.htm> (Noting that Board Member Niemeier had been named Acting Chairman in January 2003, a position he held until June 2003).

<sup>209</sup> *Id.* Presumably, this was due to the fact that the PCAOB had been acting in reliance upon the powers set forth in the Bylaws, by hiring individuals and creating various protocols for the work that was about to begin.

After submitting revised Bylaws to the SEC, the PCAOB staff was advised that the incoming PCAOB Chairman, William J. McDonough,<sup>210</sup> disagreed with the then-current version of the PCAOB's bylaws.<sup>211</sup> The perception of the Board's Members and staff at that time was that the PCAOB's Bylaws would be approved by the Commission if, *but only if*, the Bylaws expressly provided that the operational and administrative authority of the organization resided solely with the Chairman.<sup>212</sup> Whether as a result of this perception or otherwise, the Bylaws were amended to vest complete operational and administrative authority in the Chairman, via Article VI.<sup>213</sup>

This was accomplished by adding a provision to the Bylaws that delineated the specific authority of the Chairman, and described the Chairman as the President and CEO of the PCAOB.<sup>214</sup> Thus, Article VI of the amended Bylaws enumerated the CEO's powers, including: management and administration of the Corporation, appointment, dismissal, and supervision of employees of the PCAOB, and management of corporate funds.<sup>215</sup>

The Chairman's power to hire and terminate PCAOB employees was limited by Article VI, however, in a number of significant ways, including that it

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<sup>210</sup> See SEC, "Statement of the Commission Regarding the Selection of the Chairperson of the Public Company Accounting Oversight Board," SEC Press Rel. No. 2003-48 (Apr. 15, 2003), available at <https://www.sec.gov/news/press/2003-48.htm>.

<sup>211</sup> See, e.g., Witness X Interview, at p. 7; Witness X Interview, at p. 4; *but see* Witness X Interview, at pp. 4-5.

<sup>212</sup> See, e.g., Witness X Interview, at p. 6; Witness X Interview, at p. 4.

<sup>213</sup> See Secs. Exch. Act Rel. No. 48027, "Notice of Filing of Proposed Bylaws and Amendment No. 1 Thereto," (June 12, 2003), available at <https://www.sec.gov/rules/pcaob/34-48027.htm>; *see also, e.g.*, Witness X Interview, at p. 4; Witness X (1<sup>st</sup> Interview), at p. 27.

<sup>214</sup> See PCAOB Bylaws, Art. VI, §6.3 (a), available at <https://pcaobus.org/Rules/Pages/Bylaws.aspx>:

Management and administration of the Corporation, including responsibility and authority for the appointment, dismissal, and supervision of personnel (other than Governing Board members and personnel employed regularly and full-time within the immediate offices of the Governing Board members), the distribution of business among such personnel and among organizational units of the Corporation, the use and expenditure of funds (including the procurement of goods and services), and the development (for Governing Board review) of strategic policy initiatives.

<sup>215</sup> *Id.*

- Excluded from the Chairman/CEO’s authority the appointment, dismissal, and supervision of personnel employed regularly and full-time within the immediate offices of other Board Members;<sup>216</sup>
- Subjected all aspects of the Chairman’s authority, including the appointment or discharge of employees, to the “general policies of the Governing Board, and by any rules and decisions the Governing Board may legally make;”<sup>217</sup>
- Required the Chairman, in appointing PCAOB officers designated in the Bylaws as senior officers,<sup>218</sup> to consult with and obtain the approval of the Board;<sup>219</sup>
- Preconditioned the ordinary discharge of senior officers listed in the Bylaws upon “consultation” with the other Board Members;<sup>220</sup>

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<sup>216</sup> See *id.*, at §6.3 (b)(3). This wording picks up the comparable provision of Reorg Plan 10. See *supra*, n. 78, and accompanying text. This provision also included a general caveat that, in appointing full-time staff to their individual offices, each Board Member was required to comply with the PCAOB’s “overall personnel policies.” *Id.*

<sup>217</sup> See *id.*, at §6.3 (b)(1). This language was borrowed directly from Reorg Plan 10 §1(b)(1), *supra* n. 78.

<sup>218</sup> See nn. 198-200, *supra*, and accompanying text.

By adding new senior officers to the PCAOB, but doing so without amending the PCAOB’s Bylaws to account for these changes, the Chairman could circumvent the approval and employment termination restrictions set forth in the Bylaws. As we discuss below, however, virtually all the new positions added since 2018 were subject to Board approval. See n. 359, *infra*. Nonetheless, we recommend formal changes to the Bylaws to prevent the possibility of inadvertent or advertent circumvention of this restraint on the Chairman’s hiring authority. See Section 3.5., *infra*.

<sup>219</sup> See PCAOB Bylaws, Art. VI, §6.3 (b)(2). This provision is identical to Reorg Plan 10 §1(b)(2), with the exception that Reorg Plan 10 does not require consultation, only approval. See n. 78, *supra*, and accompanying text.

Approval requires the support of two Board Members in addition to the Chairman. There is no limit on consultation—presumably, the Chairman must consult with *all* Board Members. This contributes to good governance by ensuring that, in making appointments, the Chairman will include all Board Members. See, e.g., I. Millstein, “*The Professional Board*,” 50 Bus. Law. 1427 (Aug. 1995), available at <https://www.weil.com/~media/Files/PDFs/professionalboard.pdf>.

<sup>220</sup> See PCAOB Bylaws, Art. VI, §6.3 (b)(2). There is no analogue to this in Reorg Plan 10. The term “consultation” has been defined to mean

[T]he act of exchanging information and opinions about something in order to reach a better understanding of it or to make a decision, or a meeting for this purpose.

See Cambridge Univ. Press, Cambridge Academic Content Dictionary, available at <https://dictionary.cambridge.org/us/dictionary/english/consultation>.

- Necessitated that the Chairman obtain the approval of the Board for dismissals of senior officers that the Board finds arise out of a conflict regarding the general policies of the Governing Board;<sup>221</sup> and
- Vested in the full Board, not the Chairman, the *exclusive* authority to hire, fire, establish the compensation and other terms of employment of the Director of IOPA.<sup>222</sup>

In 2004, the PCAOB proposed to amend its Bylaws again.<sup>223</sup> While the changes were largely technical, among other things these amendments

- Defined the “Object” of the PCAOB, with specific reference to S-Ox, but omitted any mention of the applicability of the DCNPCA,<sup>224</sup> an omission that continues to the present day;<sup>225</sup>
- Affirmed the PCAOB’s nonprofit, tax-exempt status;<sup>226</sup>
- Authorized seriatim voting;<sup>227</sup>
- Committed the Board to hold at least one public meeting each calendar quarter (as opposed to requiring an open meeting at least once each month), with at least five days’ advance notice to the public;<sup>228</sup>

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<sup>221</sup> See PCAOB Bylaws, Art. VI, §6.3 (b)(2). In essence, this provision can only be effective if the Chairman consults with the other Board Members *before* the dismissal of any member of the senior PCAOB staff, and the other Board Members have the ability to determine whether—in their opinion—the dismissal arises out of a conflict regarding the general policies of the PCAOB.

<sup>222</sup> See PCAOB Bylaws, Art. VI, §6.3 (b)(4). This provision was added when the Bylaws were amended in 2005. See n. 230, *infra*, and accompanying text.

The Director of IOPA’s functions most closely resemble those of Inspector Generals, and the protections built into the Bylaws are comparable to those imposed on the SEC by the Inspector General Act of 1978, 5a U.S.C. §§1-13, as amended in 1988 to require all federal entities to establish an Office of Inspector General.

<sup>223</sup> See SEC, “Notice of Filing of Proposed Rule and Amendment No. 1 Amending [PCAOB] Bylaws,” Secs. Exch. Act Rel. No. 50936 (Dec. 27, 2004), available at <https://www.sec.gov/rules/pcaob/34-50936.htm>.

<sup>224</sup> *Id.*, at proposed Art. II. In that Article, under the heading “Organization,” the PCAOB proposed to state that it was “organized pursuant to, and shall be operated for such purposes as are set forth in, Title I of [S-Ox]”. *Id.*, at proposed §2.1.

<sup>225</sup> We recommend that the PCAOB revise its Bylaws in a number of ways, see Section 3.5.3., *infra*, including making explicit reference to its status under the DCNPCA.

<sup>226</sup> See *supra*, n. 223, at proposed §§2.2. and 2.3.

<sup>227</sup> *Id.*, at proposed §4.4.

<sup>228</sup> *Id.*, at proposed §5.1.

- Authorized telephonic attendance at meetings;<sup>229</sup>
- Vested in the full Board, acting *qua* Board, exclusive authority over the hiring, discharge and other aspects of the employment of the Director of IOPA;<sup>230</sup>
- Revised the liability and indemnification provisions of Art. VIII of the Bylaws;<sup>231</sup> and
- Modified the provisions on amendments to the Bylaws to reflect that the effectiveness of such amendments must be approved by the SEC.<sup>232</sup>

These Bylaw amendments were approved by the Commission, as proposed, in early 2005, after the closing of the publication and comment period.<sup>233</sup> Since the approval of these changes, there have been no further amendments to the PCAOB’s Bylaws.<sup>234</sup>

The founding Board Members attempted to define, with a measure of precision, the dichotomy between the roles of the Board’s Chairman and the other four Board Members. Notwithstanding those efforts, however, former Board Members expressed the view—fairly consistently—that their roles were shaped by whoever was the Board’s Chairman at the time they served and that, in actual practice, their roles were quite dependent upon the Chairman’s personal interpretation of the Bylaws.<sup>235</sup>

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<sup>229</sup> *Id.*, at proposed §5.2. The proposal required that at least one Board Member be physically present at an open Board meeting. *Id.*

<sup>230</sup> *Id.*, at proposed §6.3. (c).

<sup>231</sup> *Id.*, at proposed §7.2.

<sup>232</sup> *Id.*, at proposed §8.1.

<sup>233</sup> See SEC, “Order Approving Proposed Rule and Amendment No. 1 Amending Bylaws,” Secs. Exch. Act Rel. No. 51155 (Feb. 8, 2005), available at <https://www.sec.gov/rules/pcaob/34-51155.htm>. No comments were received on the proposed Bylaw amendments. *Id.*

<sup>234</sup> See SEC Website, *Self-Regulatory Organization Rulemaking*, <https://www.sec.gov/rules/sro.shtml>, where the SEC maintains an archive of all filings made by SROs and the PCAOB.

Former and current Board Members and senior staff have expressed the opinion that the PCAOB’s Bylaws are ambiguous and should be updated for clarification. See, e.g., Witness X Interview, at p. 6; Witness X Interview, at p. 26; Witness X Interview, at pp. 28-29; Witness X (1<sup>st</sup> Interview), at p. 8. As of the date of this Report, to our knowledge there are no plans to undertake any such revisions. We offer recommendations on amendments to the Bylaws, below. See Section 3.5., *infra*.

<sup>235</sup> See, e.g., Witness X Interview, at p. 3; see also Witness X Interview, at p. 6 (Noting that most Chairmen did not exercise the full extent of their authority under the Bylaws); Witness X

Consequently, we learned through conversations with current and former Board and staff members that there is an element of confusion throughout the various levels of the organization as to the Board’s authority vis-à-vis that of the Chairman.<sup>236</sup> Some of the difficulties and ambiguities raised include the:

- Designation of Board Members (other than the Chairman) as Vice Presidents;<sup>237</sup>
- Hiring and firing of senior PCAOB staff members, and the lack of any clarity when those decisions should be submitted to all Board Members before implementation;<sup>238</sup>
- Combination of the Chairman and CEO designations in a single Board Member;<sup>239</sup> and
- Commonly accepted rubric that all power resides with the Chairman, but without any clarity with respect to “what powers we are talking about, [and] what rises to [a level] where the Board should be engaged.”<sup>240</sup>

As we discuss below, this has created some difficulties that we believe should be remedied.<sup>241</sup>

To some extent, however, this inherent flexibility of the PCAOB’s corporate governance structure can be helpful on occasion.<sup>242</sup> The development of rigid

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Interview, at pp. 19-20 (Discussing how the culture of the organization was generally shaped by its Chairman and adding that there is a need for guidelines that define each Board Member’s organizational identity and independence).

This makes the nature of the PCAOB’s governance practices subject to broad variances and fluctuation, depending on the management style and approach of the current Chairman. While governance will always depend on the predilections of those who are assigned the responsibility of governing, the PCAOB should be subject to more concrete standards of governance than seem to have prevailed throughout its history. We recommend changes to reduce the potential for such broad variances in governance, going forward. *See* Section 3.2.2., *infra*.

<sup>236</sup> *See, e.g.*, Witness X Interview, at p. 4; Witness X Interview, at p. 6-7; Witness X Interview, at p. 22; Witness X (1<sup>st</sup> Interview), at p. 7.

<sup>237</sup> *See, e.g.*, Witness X Interview, at p. 6.

<sup>238</sup> *See, e.g.*, Witness X Interview, at p. 26.

<sup>239</sup> *See, e.g.*, Witness X Interview, at pp. 28-29.

<sup>240</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 8.

<sup>241</sup> *See* Section 2.5.2., *infra*.

<sup>242</sup> Formal governance documents, embodying an organization’s structure, policies and procedures, must be adaptable to situations as they arise, especially those unforeseen at the time the formal governance policies were adopted. *See, e.g.*, OECD, *Flexibility and Proportionality in*

rules, applied in a rote manner irrespective of the specific circumstances being confronted, surely do not reflect good governance:

Truly good corporate governance is not readily subject to simplistic, one-size-fits-all rules. Corporations are large, often immense, aggregations of people, assets technology and know-how tied together by very complex systems and cultures. . . . Truly good corporate governance is about the complex of relationships of the people who lead the enterprise and the systems and policies that influence their behavior. What works for one successful corporation . . . may not work for another . . . . In short, truly good corporate governance is about human dynamics in a complex organizational setting . . . . There are no simple principles that will always work . . . . Good corporate governance more closely resembles art than science.<sup>243</sup>

Nonetheless, this lack of clarity about the respective roles of the Chairman vis-à-vis the other four Board Members continues to afflict the PCAOB in the execution of its functions.<sup>244</sup> As long as this ambiguity or lack of clarity continues, the PCAOB will have difficulty achieving effective corporate governance; and, effective governance of nonprofit corporations is particularly critical, because it is a key contributor to the ability (and capacity) of the nonprofit corporation to achieve its stated mission, the standard by which the accountability of nonprofit corporations is understood by the external world.<sup>245</sup>

At the PCAOB, this unclear internal hierarchical system has caused what, in other organizations, would also be a serious problem, but unfortunately, while

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*Corporate Governance*, OECD iLibrary, pp. 11–12 (Nov. 06, 2018), available at [https://read.oecd-ilibrary.org/governance/flexibility-and-proportionality-in-corporate-governance\\_9789264307490-en#page2](https://read.oecd-ilibrary.org/governance/flexibility-and-proportionality-in-corporate-governance_9789264307490-en#page2) (Flexibility and adaptability in formal governance policies represents a functional and outcome oriented approach to regulation that facilitates implementation and makes enforcement more effective.); Bus. Roundtable, *Principles of Corporate Governance*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Sept. 8 2016), available at <https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance/> (Noting that the U.S. has the best corporate governance, financial reporting, and securities markets systems in the world because companies operate with “the flexibility to implement customized practices that suit the companies’ need and to modify those practices in light of changing conditions and standards”).

<sup>243</sup> See, e.g., C. Nathan, “A 12-Step Program to Truly Good Corporate Governance,” Harv. L. S. Forum on Corp. Gov. (May 18, 2011), available at <https://corpgov.law.harvard.edu/2011/05/18/a-12-step-program-to-truly-good-corporate-governance/>.

<sup>244</sup> See, e.g., Witness X Interview, at p. 4; Witness X Interview, at p. 6-7; Witness X Interview, at p. 22; Witness X (1<sup>st</sup> Interview), at p. 7.

<sup>245</sup> See, e.g., *Nonprofit Governance*, *supra* n. 155, at Tab 1, p. 3.

other organizations might be able to resolve the problem internally and outside the harsh glare of publicity, that is not the case with the PCAOB, especially given its quasi-regulatory and highly visible status and mission. Rather, this problem has bled throughout the organization, and has percolated to the surface, influencing the public’s perception of the PCAOB,<sup>246</sup> and continues to do so.<sup>247</sup> This is an area that can, and should, be addressed by improvements in the PCAOB’s current policies and procedures.<sup>248</sup>

#### **2.4. Issues Specific to the Interrelationship between S-Ox, the DCNPCA, and the PCAOB’s Bylaws**

As we have seen, the PCAOB is subject to both S-Ox and the DCNPCA.<sup>249</sup> But, throughout the PCAOB’s history, it has treated the DCNPCA as an afterthought, at best.<sup>250</sup> Little attention, if any, is given to the DCNPCA during the onboarding process for new Board Members, and there is no training or guidance provided on the implications for them—individually and collectively—of the PCAOB’s status as a D.C. nonprofit organization.<sup>251</sup> The PCAOB’s Bylaws are

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<sup>246</sup> See, e.g., nn. 26, 29-33, *supra*, and accompanying text.

<sup>247</sup> See, e.g., J. Brown, “PCAOB 3.0: The Evolving Role of Investor Protection at the PCAOB,” Speech to the 50<sup>th</sup> World Continuous Auditing & Reporting Symposium (Nov. 6, 2020), available at <https://pcaobus.org/News/Speech/Pages/Brown-PCAOB-3-0-Evolving-Role-Investor-Protection-PCAOB.aspx> (Arguing that the PCAOB has failed to achieve its mandate, or codify its mandate in its Bylaws).

<sup>248</sup> See Sections 2.5.2. and 3.5., *infra*.

<sup>249</sup> See nn. 170-176, *supra*, and accompanying text. It is also an IRS-approved §501(c)(3) tax-exempt nonprofit corporation, subject to the prohibitions against private inurement. See n. 178, *supra*, and Ex. 11, *supra* n. 178.

<sup>250</sup> Thus, there is no reference to the DCNPA in the PCAOB’s Bylaws; the PCAOB merely filed Title I of S-Ox when it sought a tax exemption as a D.C. nonprofit (*see* n. 178, *supra*). See Witness X Interview, at p. 7; *see also* Witness X Interview, at p. 5 (Describing the DCNPA as a “red herring,” since the PCAOB Board does not have the same powers as a normal Board or Directors); See, e.g., Witness X Interview, at p. 14 (Noting that PCAOB staff members with any DCNPA expertise are “few and far between”). And, as we discuss below, *see* nn. 569-571, *infra*, the current onboarding memorandum given to newly appointed Board Members does not mention the DCNPCA.

<sup>251</sup> As a result, Board Members are left to interpret the scope of their responsibilities and the breadth of their fiduciary duties individually. See, e.g., Witness X Interview, at pp. 8-9; Witness X Interview, at pp. 11-12; Witness X (1<sup>st</sup> Interview), at pp. 8-10, 25; Witness X Interview, at p. 9; Witness X Interview, at pp. 13-14. This potential tension between a Board Member’s fiduciary duties, the Bylaws’ description of the Board Members as “Vice Presidents,” and the lack of formal guidance as to how to navigate the two designations, creates conflicting opinions among the

largely seen by both past and present Board Members, and past and present PCAOB legal staff, as an instrument for elaborating on the PCAOB’s mandate under S-Ox, but not as a vehicle for articulating the responsibilities of Board Members under the DCNPCA.

Nor have the PCAOB’s Bylaws been embraced as the place where the duties imposed on Board Members under both statutory provisions can be accommodated and harmonized. S-Ox, of course, must form the starting point in any analysis of each Board Member’s responsibilities, but it is merely the beginning of analysis, not its end. For its part, S-Ox was essentially agnostic with respect to the division of authority among Board Members—it merely required that the Board, with the approval of the Commission, must

[P]rovide for the operation and administration of the Board, the exercise of its authority, and the performance of its responsibilities under [S-Ox].<sup>252</sup>

As we have seen, the initial Board Members sought to vest the operating and administrative power in the five Board Members, acting collectively, but acceded to their understanding that the Commission’s Staff, and incoming Chairman McDonough, wanted a strong, centralized Chairman to govern the operations and administration of the PCAOB.<sup>253</sup>

But, by remaining silent on the implications arising from the PCAOB being subject to the DCNPCA, the PCAOB’s Bylaws, in essence, leave the manner in which the responsibilities emanating from S-Ox and the DCNPCA are to be woven into a set of harmonized principles up to Board Members to interpret individually. That is an ineffective method of establishing a set of foundational governance policies and practices.<sup>254</sup> And, it fails to take into account the fact that the DCNPCA assigns Board Members responsibilities applicable to any director of a D.C. nonprofit corporation, including fiduciary duties—that is, the duties of care, loyalty, and obedience.<sup>255</sup>

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various Board Members, and senior PCAOB staff, on the Board Member’s role within the organization. *See, e.g.*, Witness X Interview, at pp. 24-25; Witness X (1<sup>st</sup> Interview), at pp. 7-8; Witness X Interview, at pp. 8-9; Witness X Interview, at pp. 5-6.

<sup>252</sup> *See* S-Ox §101(g), 15 U.S.C. §7211(g).

<sup>253</sup> *See* nn. 210-212, *supra*, and accompanying text.

<sup>254</sup> *See, e.g.*, *Nonprofit Governance*, *supra* n. 155, at Tab 1, p. 4 (Advocating that nonprofit boards define the respective roles of board members in a formal “delegation of authority” that addresses the specific matters reserved to the CEO and those reserved to the board).

<sup>255</sup> *See* nn. 156-158, *supra*, and accompanying text.

Our interviews highlighted the adverse implications of two principal weaknesses in the PCAOB’s governance structure. The first weakness is the lack of clarity in the PCAOB’s Bylaws regarding the respective roles of the Chairman and the four other Board Members. The second weakness is the omission—in the PCAOB’s onboarding training for new Members—of a discussion of the impact of the DCNPCA on Board Members. The result of these weaknesses is that, frequently, past and present Board Members (other than the Chairman) fall into either of two categories:

- Those Board Members who believe the Chairman essentially possesses all the significant power and responsibility vested in the PCAOB by S-Ox, and who therefore limit themselves to expressing their views on issues of substance, but defer to the Chairman when decisions must be made, or votes taken;<sup>256</sup> and
- Board Members who believe they have assumed fiduciary responsibilities as directors of a D.C. nonprofit corporation, and must do more than merely express their views and defer, including opposing those positions taken by the Chairman with which these Board Members disagree, and reference their fiduciary responsibilities as the reason for opposing the Chairman’s policy initiatives.<sup>257</sup>

Both these extreme views are, ultimately, inconsistent with good governance. Indeed, if all that were required of Board Members is that they express their views, but ultimately defer to the Chairman, there would be no rational reason to have five Board Members.<sup>258</sup> On the other hand, utilizing the concept of fiduciary duties to justify recalcitrance and opposition to the Chairman and/or other Board Members, deprives the organization of the benefits of having Board Members with a diverse set of perspectives who can harmonize their differing perspectives into an acceptable set of standards and agenda items.

Worse, that approach ultimately, can create dysfunctional tendencies—such as publicly reflecting deep-seated enmity toward, and a lack of respect for, various Board Members and/or the Chairman. That is a problem that has surfaced

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<sup>256</sup> See, e.g., Witness X Interview, at pp. 12-13; Witness X Interview, at pp. 7-8.

<sup>257</sup> See, e.g., Witness X Interview, at pp. 12-13; Witness X Interview, at pp. 7-8.

<sup>258</sup> See, e.g., BoardSource®, “Nonprofit Board Member Job Description Template,” (May 25, 2016), available at <https://boardsource.org/resources/board-member-job-description/>; Nat’l Council of Nonprofits, “Board Roles and Responsibilities,” (2020), available at <https://www.councilofnonprofits.org/tools-resources/board-roles-and-responsibilities>.

at the PCAOB.<sup>259</sup> Instead, Board Members are obligated—both statutorily and by their fiduciary duties—to find their way to a constructive partnership with one another, and with the Chairman.<sup>260</sup>

One reason for some of the collaboration difficulties experienced over the course of the PCAOB’s existence could be its hybrid status—the PCAOB is not a governmental body, but it possesses quasi-governmental authority and responsibility (as well as quasi-governmental immunity from liability). And yet, the PCAOB is also a nonprofit corporation with a specific statutory mandate to fulfill.

In governmental regulatory agencies, since a 1994 informal working agreement between Congressional leaders and the President, although individual members are all formally appointed by the President, the requirement that most governmental agencies reflect a division between members of the two major political parties<sup>261</sup> led to an agreement whereby minority-party individual agency members are actually selected by the Congressional leaders of the party that does not control the White House.<sup>262</sup> As a result, each individual agency member has a status independent of his/her colleagues, and presumably owes his/her selection to “political mentors.”<sup>263</sup> This has led to a number of 3-2 votes at the SEC, for example, and the issuance of formal dissents by minority Commissioners.<sup>264</sup>

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<sup>259</sup> See nn. 468-475, *infra*, and accompanying text.

<sup>260</sup> See, e.g., M. Herman & E. Gloeckner, “*Let’s Work Together’—the Sweet Sounds of a Board-CEO Partnership*,” NONPROFIT RISK MANAGEMENT CENTER (2020), available at <https://nonprofitrisk.org/resources/articles/lets-work-together-the-sweet-sounds-of-a-board-ceo-partnership/> (“*Let’s Work Together*”); M. Hiland, “*Effective Board Chair Relationships*,” NONPROFIT QUARTERLY (Aug. 29, 2018), available at <https://nonprofitquarterly.org/effective-board-chair-executive-director-relationships-not-about-roles/>.

<sup>261</sup> See, e.g., Secs. Exch. Act §4(a), 15 U.S.C. §78d(a) (“Not more than three of such commissioners shall be members of the same political party”).

<sup>262</sup> See, e.g., F. Norris, “*Independent Agencies, Sometimes in Name Only*,” NY Times (Aug. 8, 2013), available at <https://www.nytimes.com/2013/08/09/business/independent-agencies-sometimes-in-name-only.html> (“*Independent Agencies in Name Only*”); see also, B. Romanek, “*What is the Process for Selecting SEC Commissioners?*,” The Corporate Counsel. net (Aug. 13, 2013), <https://www.thecorporatecounsel.net/blog/2013/08/what-is-the-process-of-selecting-sec-commissioners.html>.

<sup>263</sup> See, e.g., *Independent Agencies in Name Only*, *supra* n. 262.

<sup>264</sup> *Id.*

To some extent, some Board Members have behaved more like members of these governmental agencies than as members of a corporate nonprofit board—that is, they have assumed their responsibilities with the mindset that they are beholden to the particular philosophical leanings of those to whom they believe they owe their appointment. This may have been the inevitable consequence of the PCAOB’s general attitude of treating its obligations under the DCNPCA solely as an afterthought, or it may be due to the lack of emphasis on the DCNPCA during onboarding efforts for new Board Members, or both.

The exact causes of the problem may not be ascertainable with any degree of certainty, but the problem nonetheless exists, and has manifested itself—from time-to-time—in difficult or unhealthy Board relationships. Experts in nonprofit corporate governance have suggested that there are three recurrent reasons for difficult, or unhealthy, nonprofit board relationships—

- A lack of trust;<sup>265</sup>
- An ineffective division of labors;<sup>266</sup> and
- Poor communication.<sup>267</sup>

The action steps necessary to resolve difficult board relationships include, among other things, the creation of a constructive *partnership* among the Board Members.<sup>268</sup>

Such a partnership exists when there is a “mindset of interdependence and a culture of shared responsibility.”<sup>269</sup> In addition, there is a need for clear expectations, strategic thinking, and a culture of candor.<sup>270</sup> In our review, we

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<sup>265</sup> See, e.g., *Let’s Work Together*, supra n. 260 (Referencing three levels of trust, and indicating nonprofit boards must seek to obtain the third level, one where the CEO and the board “work together as a seamless entity,” and where the relationships “will feel like a family with an unbreakable bond”).

<sup>266</sup> See, e.g., *id.* (Noting that “when the CEO and board repeatedly step on each other’s toes, the awkward result is jarring to the senses of any stakeholder audience”).

<sup>267</sup> *Id.* (Attributing unhealthy Board relationships to situations where “communication is sporadic, stingy or overly formal”).

<sup>268</sup> *Id.* (attributing this element to Association consultant Jeff De Cagna).

<sup>269</sup> *Id.*

<sup>270</sup> *Id.*

found that the PCAOB lacks that culture of shared responsibility—and the absence of that culture has been described as the difference between responsible nonprofit corporate boards and exceptional nonprofit corporate boards.<sup>271</sup>

This lack of clarity on the part of Board Members as to their proper roles—vis-à-vis the Chairman and vis-à-vis the organization as a whole—has created confusion on the part of some of the PCAOB’s Division Directors and other senior staff members, both as to the question of from whom they should take direction, and the question of their own authority.<sup>272</sup> This confusion also creates impediments to efficiency in operations, and can be the source of a less than collegial and effective work environment.<sup>273</sup>

The existence of this problem is a reflection of the fact that members of nonprofit governing boards typically respond only to the level of expectations persistently articulated by the organization and its leaders.<sup>274</sup> Where those expectations are not articulated, the result is less competent governance. Typically, there are several elements that are critical in developing and sustaining effective board performance, including:

- Clarifying expectations for all board members;<sup>275</sup>

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<sup>271</sup> See BoardSource®, “*The Source: Twelve Principles of Governance that Power Exceptional Boards*” (2005). As there noted (*id.*, at pp. 3-5),

Responsible boards are competent stewards. Focusing on fiduciary oversight, they ensure that their organizations comply with the law, act with financial integrity, and operate effectively and ethically. . . . Exceptional boards govern in constructive partnership with the chief executive, recognizing that the effectiveness of the board and chief executive are interdependent.

We have set forth recommendations designed to assist the Board in developing the necessary framework and culture it requires. See Section 3.4., *infra*.

<sup>272</sup> See, e.g., Witness X Interview, at pp. 6-7; Witness X Interview, at p. 22.

<sup>273</sup> See, e.g., sources cited in nn. 250-251, *supra*.

<sup>274</sup> See, e.g., R. Ingram, TEN BASIC RESPONSIBILITIES OF NONPROFIT BOARDS (2015, 3<sup>rd</sup> ed.), at p. 65 (“*Ten Basic Responsibilities*”).

<sup>275</sup> *Id.*, at p. 67.

- Periodically assessing board member performance (as well as assessing the performance of the board itself),<sup>276</sup>
- Orienting new board members effectively, and offering continuing board members a periodically refreshed orientation program;<sup>277</sup> and
- Ensuring opportunities for in-service education.<sup>278</sup>

With the possible exception of the PCAOB’s Culture Survey,<sup>279</sup> which was not meaningfully directed toward the PCAOB’s effectiveness, other than in a general manner, the PCAOB has not engaged—in any formal sense—in any of these basic methods of developing and sustaining its effective performance.

Thus, as we have seen, there is a lack of clarity about the expectations for individual Board Members, as well as the Board collectively.<sup>280</sup> Although the PCAOB has created job descriptions for most of its critical staff positions, there is no “job description” for Board Members, or for the Board itself, something most well-managed nonprofit corporations prepare.<sup>281</sup> Beyond job descriptions, well-managed nonprofit corporate boards create yearly “work plans” to guide them through the year’s contemplated efforts.<sup>282</sup>

Similarly, the Board has not engaged in a regular program designed to assess individual Board Member performance or the PCAOB’s collective performance, two highly recommended staples of both nonprofit and for-profit governance experts.<sup>283</sup> And, although the PCAOB has developed an onboarding

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<sup>276</sup> *Id.*

<sup>277</sup> *Id.*, at p. 68.

<sup>278</sup> *Id.*

<sup>279</sup> *See* Ex. 2, *supra* n. 29.

<sup>280</sup> *See* nn. 235-236, *supra*, and accompanying text.

<sup>281</sup> *See, e.g.*, BoardSource®. “Sample Board Member Job Description, available at <https://boardsource.org/resources/board-member-job-description/>.

<sup>282</sup> *See, e.g.*, Arizona Alliance of Arizona Nonprofits, “The Board Member’s Yearbook” (2017), available at <https://arizonanonprofits.org/page/Yearbook>; *see also*, Nat’l Council of Nonprofits, “Board Roles and Responsibilities,” available at <https://www.councilofnonprofits.org/tools-resources/board-roles-and-responsibilities>.

<sup>283</sup> *See, e.g.*, Deloitte, “Performance Evaluation of Boards and Directors” (2014), available at <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/risk/Corporate%20Governance/in>

regimen for new Board Members, as we discuss below,<sup>284</sup> that program has functioned largely as a “data dump,” and does not focus on the responsibilities imposed on directors of nonprofit corporations under the DCNPCA. Nor is there provided any refresher programs provided for seated Board Members who wish to avail themselves of such opportunities.

Ideally, nonprofit board member orientation programs are frequently divided into two discrete segments—one devoted to exploring the

- Responsibilities of board service;
- Board’s corporate responsibilities;
- Board’s culture and style of operating;
- Organization of the board to do its work;
- Bylaw provisions—at least in an overview;
- Board’s members;
- Relationships of board members with the staff;
- Key constituencies of the board; and
- Similar matters.<sup>285</sup>

The second segment of nonprofit board member orientation programs is often focused on the

- Organization as an enterprise;
- Board’s mission;
- History, and major achievements, of the entity;
- Current priorities and needs of the organization;

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[-cg-performance-evaluation-of-boards-and-directors-noexp.pdf](#); *Nonprofit Governance*, *supra* n. 155, at Tab 1, p. 11, and Tab 16.

<sup>284</sup> See nn. 562-564, *infra*.

<sup>285</sup> See, e.g., *Ten Basic Responsibilities*, *supra* n. 274, at p. 69.

- Manner in which the entity’s staff is organized;
- Facilities available to, and employed by, the organization;
- Enterprise finances;
- Various programs and services offered or performed by the organization; and
- Similar matters.<sup>286</sup>

Finally, we are unaware of any collective PCAOB efforts to ensure opportunities for in-service education. This involves periodic opportunities to focus conversations on particular board responsibilities, including plenary sessions with occasional guest speakers, to engage the board in discussions of key trends and new developments.<sup>287</sup>

Another tension that exists as a result of the PCAOB’s obligation to harmonize its responsibilities under S-Ox and the DCNPCA relates to the question of how its Board Members are utilized. S-Ox mandates that Board Members must be fulltime employees,<sup>288</sup> while traditional nonprofit board membership is viewed as a part-time position.<sup>289</sup> During our interviews, we discussed how Board Members occupy their time, with some former and current Board Members, as well as some PCAOB staff members, indicating that they perceive the position as lacking in meaningful substantive responsibility.<sup>290</sup>

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<sup>286</sup> *Id.*, at p. 68.

<sup>287</sup> *Id.*

<sup>288</sup> See S-Ox §101(e)(3), 15 U.S.C. §7211(e)(3):

Each member of the Board shall serve on a full-time basis, and may not, concurrent with service on the Board, be employed by any other person or engage in any other professional or business activity.”

<sup>289</sup> See, e.g., The Bridgespan Group, Insights, “*Nonprofit Boards: How to Find a Rewarding Board Position*,” (2020), available at <https://www.bridgespan.org/insights/library/boards/how-find-rewarding-board-position> (Estimating that, for a mid-sized, average, nonprofit board, members should expect to commit between 75 to 100 hours per year).

<sup>290</sup> See, e.g., Witness X Interview, at p. 9-10; Witness X Interview, at p. 19-20; Witness X Interview, at p. 29.

In part, this is a reflection of the fact that expectations for Board Members have not been fully thought out, or made clear, by the Board, either to the Board Members themselves, or to the PCAOB's staff. Thus, as we have noted, through the course of our review, it became apparent that most current and former Board Members did not, or do not, clearly understand the interplay between S-Ox and the DCNPCA.<sup>291</sup> As discussed, many are unclear about the distribution of powers delegated to the Chairman under Article VI of the PCAOB's Bylaws. There is also, unfortunately, a lack of clarity as to how the Chairman/CEO should interact with the other Board Members, and how, if at all, this dynamic affects each Board Member's ability to fulfill his/her fiduciary duties.<sup>292</sup> Some former Board Members, while acknowledging their awareness of the fiduciary duties to which they are subject, do not recall ever discussing their adherence to these duties during meetings or having weighed them when dealing with specific issues.<sup>293</sup>

## 2.5. Specific Governance-Related Issues

The PCAOB's historical lack of attention to the implications of its status—and that of its individual Board Members—under the DCNPCA has created additional issues vis-à-vis PCAOB governance. These problems are, to some extent, exacerbated by the Bylaws' designation of Board Members (other than the Chairman) as Vice Presidents of the Corporation,<sup>294</sup> without also providing Board Members and, concomitantly, the PCAOB's staff, with appropriate context as to the meaning of that title, or how much involvement Board Members ideally should have in shaping the strategy and overall direction of the PCAOB, as well as specific issues the PCAOB considers during the course of each year.<sup>295</sup> As has wisely been noted by nonprofit board experts,

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<sup>291</sup> See, e.g., Witness X Interview, at p. 6; Witness X Interview, at p. 4; Witness X (1<sup>st</sup> Interview), at p. 7; Witness X Interview, at pp. 7-8.

<sup>292</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 7; Witness X Interview, at pp. 15-16.

<sup>293</sup> See, e.g., Witness X Interview, at p. 3; Witness X Interview, at p. 7-8.

<sup>294</sup> See nn. 201-203, *supra*, and accompanying text.

<sup>295</sup> The intended—but unspecified—reason the Board Members other than the Chairman were designated as Vice Presidents—avoidance of liability, as per S-Ox—has had seemingly little relevance over time. Given the lack of any supporting context, as well as the absence of clear focus on the DCNPCA during onboarding of new Members, Board Members have largely been left to interpret that designation according to their own perspectives, experiences, and ideas about how the PCAOB should be run. Significantly, institutional knowledge about the derivation of this nomenclature apparently has not been codified anywhere in the PCAOB's readily ascertainable

If your Board members and staff aren't clear about the Board's responsibilities, the nonprofit is set up for a big mess. People are going to be frustrated and unhappy . . . .<sup>296</sup>

### 2.5.1. The Board Champions Initiative

Thus, for example, current Chairman Duhnke instituted a so-called “Board Champions” initiative in early 2018, at the outset of his tenure as PCAOB Chairman.<sup>297</sup> Under this initiative, individual Board Members were designated as “Champions” of a particular facet of the Board’s efforts in which those Board Members had specific expertise and/or interest, to help in the achievement of the PCAOB’s program of transformational change.<sup>298</sup>

The intent behind this initiative—which we now understand was largely abandoned toward the end of 2019<sup>299</sup>—was consistent with good governance best practices<sup>300</sup>—and allowed Board Members to serve as “Champions” for areas of interest/expertise, and for Board Members to identify policy matters of interest to

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records, or easily shared. *See, e.g.*, Witness X Interview, at p. 10; Witness X Interview, at p. 11; Witness X Interview, at p. 8; Witness X Interview, at p. 20; and Witness X Interview, at p. 6.

<sup>296</sup> *See, e.g.*, S. Rees, “*The 10 Roles and Responsibilities of a Nonprofit Board of Directors*,” GET FULLY FUNDED (Oct. 7, 2019), available at <https://getfullyfunded.com/the-10-roles-and-responsibilities-of-a-nonprofit-board-of-directors/>.

<sup>297</sup> *See, e.g.*, *Kaiser Perspectives*, *supra* n. 10 (“To fully realize the potential of such a broad spectrum of viewpoints and experience [among the five Board Members appointed at the end of 2017], Chairman Duhnke has created ‘Board champions’ to facilitate transformation in specific areas”); *see also*, Witness X (2<sup>nd</sup> Interview), at pp. 17-18; Witness X (1<sup>st</sup> Interview), at p. 27; Witness X (2<sup>nd</sup> Interview), at p. 9; Witness X (1<sup>st</sup> Interview), at p. 28; Witness X (2<sup>nd</sup> Interview), at p. 18; Witness X interview, at p. 29; Witness X (2<sup>nd</sup> Interview), at p. 12.

<sup>298</sup> Thus, for example, Board Member Kaiser was designated as the Board Champion, or Co-Champion, “for inspections, standard-setting, and technology.” *Kaiser Perspectives*, *supra* n. 10.

<sup>299</sup> *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at p. 12; Witness X (2<sup>nd</sup> Interview), at pp. 17-18; Witness X (2<sup>nd</sup> Interview), at p. 9. The program was effectively “neglected to death,” after certain Board Members transcended their intended *mentorship* role into one of directing policy decision making. *See, e.g.*, Witness X Interview, at pp. 24-25; Witness X Interview, at p. 17.

<sup>300</sup> *See, e.g.*, *Ten Basic Responsibilities*, *supra* n. 274, at p. 91:

Clearly articulating the board’s corporate responsibilities and authority (preferably in the bylaws) and the responsibilities and expectations of board members (preferably codified in separate policies) are best practices.

the Chairman and/or the entire Board, and bring those back to the Board for discussion and, if appropriate, formal Board decision making.<sup>301</sup> Unfortunately, the Board Champions initiative commenced without the preparation of a written description of its purpose, the written assignment of differing functions to different Board Members, and a written articulation of the manner in which individual Board Members were intended to carry out their designated responsibilities under the program.<sup>302</sup>

As a result, the Board Champions program, rather than serving what should have been a valuable and efficacious policy, and providing substantive responsibilities to fill out Board Members' daily efforts,<sup>303</sup> essentially resulted in further confusion about some Board Members' understandings of the scope and reach of their authority,<sup>304</sup> and concomitantly created confusion for senior and mid-level PCAOB staff.<sup>305</sup> In essence, some Board Members appeared to misunderstand (or perhaps misuse) the program, and the extent of their authority under it—as individual Board Members<sup>306</sup>—leading to both PCAOB staff confusion, and conflicts with the Chairman and his Office.<sup>307</sup>

The Board Champions program, or something similar to it,<sup>308</sup> should be a part of the PCAOB's normal practices. First, it would ensure the active

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<sup>301</sup> See, e.g., *Kaiser Perspectives*, *supra* n. 10; see also, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X (1<sup>st</sup> Interview), at p. 28; Witness X Interview, at p. 25.

<sup>302</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 10-11.

<sup>303</sup> As noted above, see nn. 288-290, *supra*, and accompanying text, there is some doubt about whether serving as a Board Member—at least as currently constructed—has enough substance to it to make it a full-time job.

<sup>304</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X (2<sup>nd</sup> Interview), at pp. 18-19; Witness X (2<sup>nd</sup> Interview), at p. 9; Witness X Interview, at pp. 24-25

<sup>305</sup> See, e.g., Witness X Interview, at pp. 10-11; Witness X (1<sup>st</sup> Interview), at p. 6; Witness X (3<sup>rd</sup> Interview), at p. 5.

<sup>306</sup> As a practical matter,

Boards operate as a group. Board members have no power to make decisions or take action individually, unless the board delegates such power to them.

See, e.g., J. Thompson, “Do All Nonprofit Organizations Have Boards?” <https://smallbusiness.chron.com/role-board-members-nonprofit-organizations-21291.html>.

<sup>307</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at pp. 24-25.

<sup>308</sup> Another method of achieving what the Board Champions program was intended to achieve is the utilization of formal Committees to handle certain projects or practice areas. See, e.g., N.

involvement of individual Board Members in the work of the Board. Second, if properly documented and structured, it would assist in the creation of a *collaborative* environment among Board Members, and among Board Members and PCAOB staff. Third, it would give the PCAOB staff a mechanism for having direct communications with individual Board Members, as well as with the Chairman, something the PCAOB’s employee surveys suggested was something employees thought could prove beneficial.<sup>309</sup>

### **2.5.2. The PCAOB Has Insufficiently Documented the Role of Board Members, Individually and Collectively**

The PCAOB has, since its inception, and currently, suffered from insufficient documentation detailing the specific role of Board Members—both collectively and individually. This is a problem not just with respect to the Board Champions program, but with respect to the PCAOB’s governance in general. This lack of appropriate documentation on the role of Board Members has trickled down through the organization, and led to confusion among Division Directors, senior staff members, and middle managers, about the Board’s collective and individual understanding of the authority individual Board Members can and should exercise.<sup>310</sup>

In this respect, another significant governance concern is the differing understandings—by various Board Chairs, on the one hand, and individual Board Members (past and current), on the other—of the precise extent of the Chairman’s authority. The Board’s Chairmen uniformly have believed that, based on the PCAOB’s Bylaws (as well as the precedents under those Bylaws set by prior Board Chairs), the Chairs are authorized to exercise the PCAOB’s final decision-

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Price, “*What Does a Committee Member Do on a Nonprofit Board?*,” BoardEffect (Mar. 7, 2018), available at <https://www.boardeffect.com/blog/committee-member-nonprofit-board/>:

Forming committees is a good solution to packed board agendas. Committee work divides the board’s work into manageable tasks. Committees are smaller groups with a tight focus on a particular issue. . . . To get the best value from committees, boards should form as few committees as they need to address critical issues. Committees should be clear in their directives and scope of work.

<sup>309</sup> See nn. 29-33, *supra*, and accompanying text, discussing the 2019 PCAOB Employee Surveys, Exs. 3 & 4, *supra* n. 30.

<sup>310</sup> See *e.g.*, Witness X Interview, at p. 18; Witness X (1<sup>st</sup> Interview), at pp. 6-7

making vis-à-vis any matter that does not require a formal Board vote, but that view has not been shared by other, non-Chairmen Board Members.<sup>311</sup> This has created significant ambiguity surrounding where the Chairman’s authority ends, and where the Board’s collective authority begins.<sup>312</sup>

The impact on the PCAOB of this difference in understanding of the scope of the Chairman’s authority has been decidedly detrimental. For example, all five Board Members in place in 2018 agreed to review and ultimately discharge seven senior PCAOB staff members who voluntarily resigned or whose employment was terminated by the PCAOB. But confusion over the roles of the Board Members made it impossible for the Board to fill certain critical senior vacancies relatively promptly, when several Members made it impossible to reach a consensus on candidates that had been identified for certain of these positions.<sup>313</sup> As noted earlier, this led to criticism of the PCAOB, and particularly of the Chairman, for not filling certain vacancies more promptly.<sup>314</sup>

### **2.5.3. The PCAOB Has Not Always Complied with its Own Bylaws, or its Obligations as a D.C.- and IRS-Approved Nonprofit Corporation**

Since the beginning of 2018, the PCAOB has created eight additional senior level positions or, in one case, modified the terms of compensation and the scope of the authority of a position previously used at the PCAOB. These new positions include:

- Chief of Staff;<sup>315</sup>

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<sup>311</sup> See, e.g., Witness X Interview, at pp. 7-8; Witness X Interview, at p. 15.

<sup>312</sup> See, e.g., Witness X Interview, at pp. 7-8; Witness X Interview, at pp. 15-16.

<sup>313</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 14-15; Witness X (1<sup>st</sup> Interview), at pp. 17-19. As we understand it, these Board Members effectively prevented the Board from moving forward on certain candidates, even by a divided vote.

<sup>314</sup> See nn. 27-28, *supra*, and accompanying text.

<sup>315</sup> See PCAOB, “Francis ‘Abe’ Dymond Named Chief of Staff for the PCAOB,” Press Rel. (Jan. 2, 2018), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/francis-abe-dymond-named-chief-of-staff-for-the-pcaob> 653.

While the position of a Chief of Staff had previously existed, the PCAOB’s press release indicated that Mr. Dymond was named Chief of Staff “for the PCAOB,” and that he would “advise the Board on all matters that come before the PCAOB, work closely with Board members and staff, and assist the chairman in his management and administration of the PCAOB.” *Id.*

- Chief Risk Officer;<sup>316</sup>
- Chief Compliance Officer;<sup>317</sup>
- Chief Information Security Officer;<sup>318</sup>
- Project and Portfolio Management Experts;<sup>319</sup>
- Director of the Office of External Affairs;<sup>320</sup>
- Chief Data Officer;<sup>321</sup> and
- PCAOB Liaison for Investors, Audit Committees, and Preparers.<sup>322</sup>

There is little doubt that the PCAOB had a legitimate need for the creation of these positions.<sup>323</sup> What is less clear, however, is the Board’s consideration of

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<sup>316</sup> See, e.g., W. Duhnke, “Keynote Speech at Baruch College’s 14<sup>th</sup> Annual Audit Conference,” (Dec. 3, 2019), available at <https://pcaobus.org/news-events/speeches/speech-detail/keynote-speech-at-baruch-college's-14th-annual-audit-conference> 716 (“Duhnke 2019 Keynote”); see also, PCAOB, “PCAOB Announces New Office of Enterprise Risk Management, Names Chief Risk Officer,” Press Rel. (Feb. 25, 2019), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-announces-new-office-of-enterprise-risk-management-names-chief-risk-officer> 694.

<sup>317</sup> See Duhnke 2019 Keynote, *supra* n. 316.

<sup>318</sup> *Id.*

<sup>319</sup> *Id.*

<sup>320</sup> See PCAOB, “Torrie Miller Matous Named PCAOB Director of Newly Formed Office of External Affairs,” Press Rel. (Nov. 12, 2018), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/torrie-miller-matous-named-pcaob-director-of-newly-formed-office-of-external-affairs> 686.

<sup>321</sup> See PCAOB, “PCAOB Names Eric Hagopian Chief Data Officer,” PCAOB Press Rel. (Feb. 25, 2019), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-names-eric-hagopian-chief-data-officer> 695.

<sup>322</sup> See PCAOB, “PCAOB Announces New Liaison for Investors, Audit Committees, and Preparers,” PCAOB Press Rel. (May 29, 2019), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-announces-new-liaison-for-investors-audit-committees-and-preparers> 700. This position was designated as a Deputy Director of the Office of External Affairs. *Id.*

<sup>323</sup> See, e.g., Duhnke 2019 Keynote, *supra* n. 316; see also, e.g., M. Lipton, *et al.*, “Risk Management and the Board of Directors,” HARV. L. SCH. FORUM ON CORP. GOV. (Mar. 20, 2018) available at <https://corpgov.law.harvard.edu/2018/03/20/risk-management-and-the-board-of-directors-5/> (Highlighting the importance of Risk Management and a CRO, noting “Comprehensive risk management should not be viewed as a specialized corporate function, but instead should be treated as an integral, enterprise-wide component that affects how the company measures and rewards its success”); C. Williams, “3 Key Infrastructure Elements for a Successful ERM

corporate governance issues (or more accurately, the PCAOB’s failure to consider corporate governance issues)—especially for nonprofit corporations—and the manner in, and methodology by, which

- These positions were created;
- The scope or breadth of the authority for them was determined;
- Compensation associated with these positions was determined; or
- PCAOB foundational governance documents—such as the PCAOB’s Bylaws—were considered and applied as the PCAOB created these new positions.

Under S-Ox, the Board had ample authority to create the new senior staff positions, and to fix their compensation.<sup>324</sup> But, the Board’s authority in that regard is not unlimited, especially since the PCAOB is a nonprofit, tax-exempt, corporation subject to both the DCNPCA<sup>325</sup> and the IRS Code.<sup>326</sup>

As the IRS Code provides, to qualify as a tax-exempt corporation under §501(c)(3), an organization must be organized and operated “*exclusively*” for exempt purposes, and “none of its earnings may inure to any private” individual.<sup>327</sup> As further explained on the IRS’ website, this prohibition against self-inurement essentially precludes a nonprofit from operating for the benefit of *any* private

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*Program*,” ERM INSIGHTS (Mar. 26, 2018), available at <https://www.erm insightsbycarol.com/3-key-erm-infrastructure-elements/>; J. De Groot, “Chief Compliance Officer: “What CCOs Do (and Why Your Company Should Have One),” DATAINSIDER (Sept. 10, 2018), available at <https://digitalguardian.com/blog/chief-compliance-officer-what-ccos-do-and-why-your-company-should-have-one>; EC-Council Blog, “Why Does Your Business Need a CISO,” (Jul. 20, 2020), [https://blog.eccouncil.org/why-does-your-business-need-a-ciso/#:~:text=The%20role%20of%20a%20CISO,technical%20savviness%20and%20managerial%20proficiencies](https://blog.eccouncil.org/why-does-your-business-need-a-ciso/#:~:text=The%20role%20of%20a%20CISO,technical%20savviness%20and%20managerial%20proficiencies;);

<sup>324</sup> See S-Ox §§101(c)(7), 15 U.S.C. §7211(c)(7) (Authorizing *the PCAOB* to set its budget and manage the operations of the PCAOB and the staff of the PCAOB), and 101(f)(4), 15 U.S.C. §7211(f)(4) (Authorizing *the PCAOB* to appoint such employees as may be necessary or appropriate and to determine their qualifications, define their duties, and fix their salaries or other compensation (at a level comparable to private sector self-regulatory, accounting, technical, supervisory, or other staff or management positions)).

<sup>325</sup> See DCNPCA §29-403.02(11) (Authorizing *the nonprofit corporation* to appoint officers, employees, and agents of the corporation, define their duties, and fix their compensation).

<sup>326</sup> See 26 U.S.C. §501(c)(3).

<sup>327</sup> *Id.* (emphasis supplied). And see, IRS, “Exemption Requirements—501(c)(3) Organizations,” <https://www.irs.gov/charities-non-profits/charitable-organizations/exemption-requirements-501c3-organizations>.

interest, including the personal interests of the nonprofit’s directors and/or officers.<sup>328</sup> The DCNPCA has a similar prohibition.<sup>329</sup>

The private inurement prohibition requires that companies granted tax-exempt status under Internal Revenue Code §501(c)(3) operate so that none of its income or assets unreasonably benefits any of its board members, officers, or key employees.<sup>330</sup> In assessing the appropriateness of compensation or any transaction, the decisive factor is whether the compensation (or the transaction) is reasonable under all the circumstances.<sup>331</sup>

For compensation paid to nonprofit officers and directors to be deemed reasonable, there must be an approximately equal exchange of benefits between the nonprofit and the director/officer, so that the nonprofit’s employee does not receive an unreasonable or unwarranted benefit from the nonprofit.<sup>332</sup> In this context, several factors are commonly considered in evaluating the reasonableness of the compensation<sup>333</sup> paid to a nonprofit’s directors and/or officers, including the:

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<sup>328</sup> See, IRS, “*Inurement/Private Benefit—Charitable Organizations*,” <https://www.irs.gov/charities-non-profits/charitable-organizations/inurement-private-benefit-charitable-organizations>; and see K. Emerson, “*The Private Inurement Prohibition, Excess Compensation, Intermediate Sanctions, and the IRS’s Rebuttable Presumption*,” GuideStar USA (2009), available at <https://learn.guidestar.org/hubfs/Docs/private-inurement-prohibition.pdf> (“*Private Inurement Prohibition*”).

<sup>329</sup> See DCNPCA §§29-402.02(b)(7)(A) (Precluding D.C. nonprofit corporations from indemnifying a director for liability for receipt of a financial benefit to which the director is not entitled); 29-402.02(c)(1) (Same); 29-404.40(a) (Prohibiting a nonprofit corporation from paying dividends, or making distributions of any part of its assets, income or profits to its directors or officers).

<sup>330</sup> See, e.g., *Private Inurement Prohibition*, *supra* n. 328, at p. 2. As there noted, “The courts and the IRS have consistently ruled that any unreasonable benefit or inurement, however small, is impermissible and can result in the revocation of the [corporation’s] tax-exempt status.” *Id.*, at p. 3.

<sup>331</sup> *Id.*

<sup>332</sup> *Id.*

<sup>333</sup> Total compensation paid by a nonprofit to an insider includes more than just the salary or wages paid to that individual. It also includes all other forms of compensation received, such as fringe benefits, deferred compensation, severance payments, retirement and pension benefits, expense allowance, and insurance benefits. See, e.g., *Private Inurement Prohibition*, *supra* n. 328, at p. 4.

- Compensation paid by similar organizations, both tax-exempt and taxable, for equivalent positions in the same community or geographic area;<sup>334</sup>
- Demonstrated need for the particular services of the person in question;<sup>335</sup>
- Unique nature of the person’s background, education, training, experience, and responsibilities;<sup>336</sup>
- Approval of the compensation by an independent board of directors, and the data they had before them in reaching their conclusions;<sup>337</sup>
- Prior compensation history of the individual in question;<sup>338</sup>
- Job performance of the individual in question,<sup>339</sup> and
- Relationship of the individual’s compensation to the compensation paid to the nonprofit’s other directors, officers and employees.<sup>340</sup>

A nonprofit can avoid violating the private inurement prohibition for compensation it pays to its directors, officers and employees, as long as it is able, among other things, to:

- Explain exactly how the nonprofit determined the total compensation package;<sup>341</sup>
- Provide adequate documentation, such as comparable salaries paid by similar organizations, that show the reasonableness of the compensation;<sup>342</sup>
- Show, through appropriate documentation, that the nonprofit’s governing body approved the amount of the compensation, and that the

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<sup>334</sup> See, e.g., B. Hopkins, THE LAW OF TAX-EXEMPT ORGANIZATIONS (12<sup>th</sup> ed., Mar. 2019) (“*Law of Tax-Exempt Organizations*”), at p. 571, cited by *Private Inurement Prohibition*, *supra* n. 328, at p.2.

<sup>335</sup> See, e.g., *Law of Tax-Exempt Organizations*, *supra* n. 334, at p. 571.

<sup>336</sup> *Id.*

<sup>337</sup> *Id.*

<sup>338</sup> *Id.*

<sup>339</sup> *Id.*

<sup>340</sup> *Id.*

<sup>341</sup> See, e.g., *Private Inurement Prohibition*, *supra* n. 328, at p. 4.

<sup>342</sup> *Id.*

recipient (or someone related to the recipient) did not participate in the process,<sup>343</sup> and

- Demonstrate that the use of the nonprofit’s credit cards, laptops, cell phones or other property for other than fulfilling the nonprofit’s exempt purposes were included in his/her compensation and properly documented as such.<sup>344</sup>

To assist nonprofits to comply with this complex area of the law, the IRS has established a “rebuttable presumption” that payments to nonprofit directors, officers and/or employees are presumed to be reasonable and not excessive, upon a showing that the

- Nonprofit’s board obtained and relied upon appropriate comparability data prior to making its determination;<sup>345</sup>
- Total compensation package was approved *in advance*;<sup>346</sup> and
- Nonprofit’s board contemporaneously documented the basis for its determination.<sup>347</sup>

The difficulty for the PCAOB in this context is the PCAOB’s historical lack of focus on its status as a nonprofit, tax-exempt, organization, as described above.<sup>348</sup> Apparently this lack of focus on its status has caused the PCAOB to neglect following the IRS’ preferred safe-harbor methodology to justify either the compensation for its senior hires, or the severance agreements it has entered into with departing PCAOB employees since the beginning of 2018.<sup>349</sup>

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<sup>343</sup> *Id.*

<sup>344</sup> *Id.*

<sup>345</sup> *Id.*, at p. 6.

<sup>346</sup> *Id.*

<sup>347</sup> *Id.*

<sup>348</sup> *See nn. 249-255, supra, and accompanying text.*

<sup>349</sup> We discuss the difficulties with the PCAOB’s approach to severance agreements below. *See nn. 681-689, infra, and accompanying text.*

We were not provided with any documentation about how the PCAOB arrived at the amounts of compensation it authorized for individual positions, that all benefits—including non-cash benefits—were included in calculating each senior employee’s compensation, or that, for those whose employment was terminated, severance agreements were factored into the calculations of total compensation and determined to be reasonable, using the methodology approved by the IRS.

Beyond these issues, information provided to us reflected an unusual process that was employed to come up with the compensation for the newly revised position of *Board* Chief of Staff, first held by Abe Dymond. Instead of following the tri-partite IRS safe-harbor methodology to avoid possible charges of private inurement, we were told that the process worked in reverse order. First, the amount of compensation the Board wished to see Mr. Dymond receive was apparently arrived at, and then the job description for his position—as newly defined—was edited multiple times until it was felt that the final job description warranted the amount of annual compensation—\$(b)(6) in salary alone<sup>350</sup>—that had originally been designated.<sup>351</sup>

The PCAOB's unusual procedure does not mean that the compensation paid to Mr. Dymond—or anyone else—was excessive or could not be justified to the IRS or the D.C. Attorney General, after-the-fact. But it does demonstrate that the PCAOB's failure to focus on its status as a nonprofit, tax-exempt, organization, and concomitantly, its failure to follow approved procedures and guidelines, leaves the PCAOB open to potential challenges, and reflects problems with its existing corporate governance policies and procedures.<sup>352</sup>

With respect to the position of the Chairman's Chief of Staff, as noted above, the position became Chief of Staff *to the Board*, and not solely *to the Board's Chairman*.<sup>353</sup> From our interviews, we understood that the purpose of this reformulation of the designated functions of the Chief of Staff was to have this position function in a manner closely analogous to the position of Chief Operating Officer at most corporations.<sup>354</sup> While that may have been the intent behind the reformulated position, the scope of the Chief of Staff's responsibilities and authority was particularly unclear to certain current Board Members and staff.<sup>355</sup>

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<sup>350</sup> See S. Trotman, Email to E. Horton, J. Cook re A. Dymond (Dec. 15, 2020).

<sup>351</sup> See Witness X (3<sup>rd</sup> Interview), at p. 3; Witness X Interview, at p. 2; Witness X Interview, at pp. 2-3.

<sup>352</sup> As noted, the SEC approves the PCAOB's budget each year, but it does not approve individual salaries. Our recommendations for improvements in the PCAOB's processes are set forth below, see Section 3.3.1., *infra*.

<sup>353</sup> See n. 315, *supra*, and accompanying text.

<sup>354</sup> See, e.g., Witness X Interview, at p. 4; Witness X (2<sup>nd</sup> Interview), at p. 19; Witness X (1<sup>st</sup> Interview), at p. 8.

<sup>355</sup> See, e.g., Witness X (3<sup>rd</sup> Interview), at pp. 1-3; Witness X (2<sup>nd</sup> Interview), at pp. 12-13; Witness X Interview, at pp. 13-14.

Indeed, the nature of the reformulated Chief of Staff position is not clearly defined in the Chief of Staff position description.<sup>356</sup>

In addition, as noted above,<sup>357</sup> when new senior positions are created, the PCAOB's Bylaws contemplate that, for at least some of those positions, the Bylaws will be amended, and that some of the new positions will be included with those positions already listed. The listing of senior positions carries with it significant governance consequences—among other things, a majority of the Board must approve the persons selected to fill those positions, and the full Board must be consulted before the persons occupying those positions are discharged.<sup>358</sup> Although the PCAOB's creation of eight new senior staff positions was subject to the appropriate involvement of all five Board Members at the time, the lack of any amendments to the Bylaws to designate some of these new positions as senior staff positions could permit a future Board Chair to hire or fire the occupants of one or more of these positions without obtaining necessary Board approval or undertaking required consultation with the Board.<sup>359</sup>

#### 2.5.4. The Status of the PCAOB's CECO

An additional structural governance issue involves the PCAOB's Ethics Office. Historically, the PCAOB has had a separate position designated as its Chief Ethics Officer,<sup>360</sup> and that position reported to, and operated from, the PCAOB's General Counsel's office.<sup>361</sup> This is an approach favored by some governance experts and reflected a sensible allocation of responsibility for

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<sup>356</sup> See PCAOB Chief of Staff Position Description (Jan. 2018), annexed as Exhibit 12.

<sup>357</sup> See nn. 205-207, *supra*, and accompanying text.

<sup>358</sup> See PCAOB Bylaws, Art. VI, §§6.2 & 6.3(b)(2).

<sup>359</sup> We note, however, that in the only case to our knowledge in which the occupant of one of these new senior positions was discharged, she was discharged after consultation *and approval* of the entire Board. See KLS, Notes of Telephone Conversation with K. Lench (Dec. 8, 2020).

<sup>360</sup> That position was restructured when its current occupant was hired by the PCAOB to combine the Ethics and Compliance functions and is now the CECO. See Witness X Interview, at pp. 2-3. The combination of these functions is currently the approach taken by most large organizations. See, e.g., T. Reichert, "The Roles of General Counsel and Chief Compliance Officers," CORP. COMPL. INSIGHTS (Jan. 18, 2011), available at <https://www.corporatecomplianceinsights.com/the-roles-of-general-counsel-and-chief-compliance-officers/>.

<sup>361</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 26; Witness X (1<sup>st</sup> Interview), at p. 12.

ensuring that the PCAOB's own internal ethical standards were of the highest level.<sup>362</sup>

There has been a movement away from that model,<sup>363</sup> however, and many governance professionals now recommend that the Chief Ethics and Compliance Officer stand as an independent position with direct access to the organization's board of directors.<sup>364</sup> In this regard, recent so-called "corporate integrity agreements" reflect the U.S. government's insistence on stand-alone Ethics and Compliance officials, ensconced as senior officers of the organization, who are not subject or subordinate to the organization's General Counsel, to ensure greater independence.<sup>365</sup>

In reformulating the position into a CECO, in May 2019, the PCAOB restructured the position so that it now reports to the Chief Risk Officer, who is part of the Chairman's Office.<sup>366</sup> But this structure creates an unnecessary potential for conflicts, should allegations be made against the Chairman or those working out of the Chairman's office, as occurred with the May and September Whistleblower Complaints.

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<sup>362</sup> See, e.g., B. Heineman, Jr., "The Inside Counsel Revolution," *Bus. Law Today* (July 20, 2006), available at [https://www.americanbar.org/groups/business\\_law/publications/blt/2016/07/06\\_heineman/](https://www.americanbar.org/groups/business_law/publications/blt/2016/07/06_heineman/) ("I believe the CCO should report to the GC because the legal department is responsible for the foundational task of determining what the law is. But I offer this as a preference, not an iron-clad prescription").

<sup>363</sup> See, e.g., M. Kelly, S. Bernstein & B. Kipp, "Broader Perspectives; Higher Performance, State of Compliance 2012 Study," *COMPLIANCE WEEK SUPP.* (June 2012), at p. 8, available at <https://www.pwc.com/us/en/risk-management/assets/2012-compliance-study.pdf> (Noting a 6% decline in the number of Chief Ethics and Compliance Officers reporting to corporate GCs).

<sup>364</sup> See, e.g., D. Boehme, "Structuring the Chief Ethics and Compliance Officer and Compliance Function for Success," *The Complete Compliance and Ethics Manual* (2020), available at <https://compliancecosmos.org/structuring-chief-ethics-and-compliance-officer-and-compliance-function-success-six-essential#fnote-58>

<sup>365</sup> See, e.g., HHS OIG, "Corp. Integrity Agreement with Tenet Healthcare Corp.," (Sept. 27, 2006), at p. 5, available at <https://oig.hhs.gov/fraud/cia/agreements/TenetCIAFinal.pdf>:

The Chief Compliance Officer shall be a member of senior management of Tenet, shall make periodic (at least quarterly) reports regarding compliance matters directly to the Board of Directors of Tenet, and shall be authorized to report on such matters to the Board of Directors at any time. . . . The Chief Compliance Officer shall not be, or be subordinate to, Tenet's General Counsel . . . .

<sup>366</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 26; Witness X (1<sup>st</sup> Interview), at p. 12.

Under the current structure, any complaints filed using the PCAOB’s EthicsPoint® Hotline<sup>367</sup> will necessarily be required to silo through the Chairman’s office, which could have a chilling effect on the posting of future complaints involving the Chairman or anyone on the Chairman’s immediate staff. Either of the structures discussed above—having the CECO in a stand-alone position or reporting to the PCAOB’s General Counsel—would obviate this potential conflict.<sup>368</sup>

### 2.5.5. The PCAOB’s Governance Records and Recordkeeping Practices

It is, by now, well established that recordkeeping is a key component of any organization’s corporate governance, and is critical to the organization’s accountability and performance.<sup>369</sup> Among other things, sound information and records management promotes six key requirements for good corporate governance:

- Transparency;<sup>370</sup>
- Accountability;<sup>371</sup>
- Due Process;<sup>372</sup>

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<sup>367</sup> See *supra*, n. 34, for a description of the EthicsPoint® hotline.

<sup>368</sup> See Section 3.1.2., *infra*, and accompanying text, for our recommendations in this regard.

<sup>369</sup> See, e.g., A. Willis, “Corporate Governance and Management of Information and Records,” 15 RECORDS MGMT. J.L. 86 (2005), available (by subscription) at, <https://www.deepdyve.com/lp/emerald-publishing/corporate-governance-and-management-of-information-and-records-WO0ab5hSik?> (“Corporate Governance and Information Management”); M. Garland, “The Importance of Records Management Policy,” NETWRIX BLOG (Sept. 26, 2019), available at <https://blog.netwrix.com/2019/09/26/the-importance-of-records-management-policy/> (“Ensuring the authenticity and availability of records over time can help [an] organization achieve its mission,” and also helps “ensure compliance with government laws”); P. Svärd, “Records Management and Information Culture,” ENTERPRISE CONTENT MANAGEMENT (2017), available at <https://www.sciencedirect.com/topics/social-sciences/records-management> (“Good records management underpins good governance”).

<sup>370</sup> *Corporate Governance and Information Management*, *supra* n. 369, at p. 86.

<sup>371</sup> *Id.*

<sup>372</sup> *Id.*, at p. 87.

- Compliance;<sup>373</sup>
- Demonstrable satisfaction of statutory, legal, regulatory and ethical requirements;<sup>374</sup> and
- Security of personal and corporate information.<sup>375</sup>

The PCAOB’s principal recordkeeping mechanism has been its Secretary’s Office, which is responsible for recording the minutes at Office Board meetings and maintaining its various intranet documents.<sup>376</sup> As a result of our review, however, we learned that, frequently, Board policy discussions and considerations of significant issues are not documented, including conversations that ultimately result in organizational and structural changes.<sup>377</sup>

We have already discussed this problem vis-à-vis the PCAOB’s creation of new senior staff positions, its compensation-related determinations and similar decisions.<sup>378</sup> The same principles apply, for example, to discussions about a reasonable severance package for a departing employee.<sup>379</sup>

Based on our interviews, it appears that, in early 2018, when the Board collectively decided to assess existing senior managers and their commitment to transformational change,<sup>380</sup> the PCAOB informally reached a *general* conclusion

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<sup>373</sup> *Id.*

<sup>374</sup> *Id.*

<sup>375</sup> *Id.*

<sup>376</sup> *See, e.g.,* Witness X Interview, at p. 6; Witness X (1<sup>st</sup> Interview), at p. 30.

An intranet is a computer network for sharing information, collaboration tools, operational systems and other computing services within an organization, usually excluding access by persons outside the organization. *See, e.g.,* TechTerms®, “*Intranet*,” <https://techterms.com/definition/intranet>.

<sup>377</sup> We do not suggest that informal conversations are required to, or even should, be documented. Such a requirement would stultify the Board Members’ exchange of ideas, by compelling them to speak “on the record” at all times. However, certain conversations—even if begun informally—will ultimately result in a concrete determination, and therefore require some type of record to be created, so that the Board’s actions—and even more importantly, its rationale for those actions—can be preserved, both in response to questions about actions taken, and to provide guidance for future Board Members and PCAOB staff.

<sup>378</sup> *See* nn. 348-352, *supra*, and accompanying text.

<sup>379</sup> Every grant of a severance package, by definition, potentially raises the issue of private inurement violations. *See* nn. 330-340, *supra*, and accompanying text.

<sup>380</sup> *See* n. 23, *supra*, and accompanying text.

that it would pay *all* departing senior employees—except, perhaps, if there were any whose employment was terminated for cause—a “rote” payment of six months’ annual compensation.<sup>381</sup> These discussions took place in informal meetings and were not memorialized in any written record, although as a result of the PCAOB’s tax-exempt status under federal and D.C. law, the PCAOB was obligated to do a case-by-case, individual analysis and document its efforts and the bases for its conclusions for each individual departing staff member.<sup>382</sup>

This difficulty has arisen, not because the PCAOB sought to engage in activities that could be described as private inurement, but rather, because the PCAOB has not—either prior to 2018 or subsequently<sup>383</sup>—focused on the types of records it is required to maintain as a result of its status as an IRS and D.C. registered, tax-exempt nonprofit organization. Nor has the PCAOB focused on the myriad other activities in which it engages in which appropriate records should be—but currently are not—maintained and preserved.<sup>384</sup>

#### **2.5.6. Records and Information Management<sup>385</sup>**

With respect to the documents the PCAOB does create and maintain, as has increasingly been recognized by governance experts,

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<sup>381</sup> See, e.g., Witness X Interview, at p. 11; Witness X Interview, at p. 16; Witness X (1<sup>st</sup> Interview), at p. 16; Witness X (1<sup>st</sup> Interview), at p. 19.

<sup>382</sup> See nn. 345-347, *supra*, and accompanying text.

<sup>383</sup> This lack of attention to the need for adequate recordkeeping had, unfortunately, been standard practice at the PCAOB since its inception. See, e.g., Witness X Interview, at p. 10; Witness X (1<sup>st</sup> Interview), at p. 9; Witness X Interview, at pp. 23-24.

<sup>384</sup> Thus, for example, the PCAOB did not, and does not, maintain any written records documenting the consultation or consensus process related to its 2018 employment terminations or the subsequent appointments of senior PCAOB staff. See, e.g., Witness X Interview, at p. 10; Witness X (1<sup>st</sup> Interview), at p. 9; Witness X Interview, at pp. 23-24.

The PCAOB should formally obligate itself to establish a recordkeeping mechanism that ensures that documentation of significant PCAOB decisions is created whenever the possibility exists that those decisions require appropriate documentation. Our recommendations addressing this situation are set forth below. See Section 3.3.3., *infra*, and accompanying text.

<sup>385</sup> Records and information management is an organizational function devoted to the management of information in an organization throughout its life cycle. This includes identifying, classifying, storing, securing, retrieving, tracking and disposing of or permanently preserving records. See, e.g., Arma Int’l, GLOSSARY OF RECORDS AND INFORMATION MANAGEMENT TERMS (4<sup>th</sup> ed. 2018).

[S]ound information and records management underpins, in a direct or indirect way, many of the vital aspects of corporate governance.<sup>386</sup>

There are global standards that have been established, articulating the principles and concepts of sound records management, by the International Organization for Standardization (“ISO”).<sup>387</sup> These include creating and capturing records to meet requirements of business activity, and taking appropriate action to protect their authenticity, reliability, integrity and useability as their business context and requirements for their management change over time.<sup>388</sup>

One criticism raised vis-à-vis the Board’s Chairman in the September Whistleblower Complaint was that the termination of the employment of several senior members of the PCAOB’s staff was intended to deprive the PCAOB of its institutional memory.<sup>389</sup> But, as we have discussed, the termination of those senior members of the PCAOB’s staff was not done by the Board’s Chairman, acting unilaterally, nor was it done to deprive the PCAOB of its institutional knowledge.<sup>390</sup>

While the loss of long-serving senior staff will almost always make it more cumbersome to cull forth an organization’s institutional memory, here the PCAOB appointed deputies—in an acting capacity—to take the places of those whose employment was terminated, or who left voluntarily,<sup>391</sup> while permanent senior staff were recruited. We found no support for the assertion that the departure of a number of senior staff members in early 2018 *was intended to* deprive the PCAOB of its institutional knowledge. Further, the Board Members took appropriate action, by appointing interim replacements for those who left the organization, to preserve as much institutional memory as possible. And, as also noted, these terminations were undertaken after a collective decision of the five new incoming Board Members, designed to ensure that those in a position of staff

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<sup>386</sup> See, e.g., *Corporate Governance and Information Management*, *supra* n. 369; see also, A. Dikopoulou & A. Mihiotis, “*The Contribution of Records Management to Good Governance*,” 24 TQM JI. 123, 124 (Feb. 24, 2012), available (by subscription) at <https://www.deepdyve.com/lp/emerald-publishing/the-contribution-of-records-management-to-good-governance-mp6j531UhM?key=emerald>.

<sup>387</sup> See ISO, “*Records Management—Principles and Concepts*,” (2016), available at <https://committee.iso.org/home/tc46sc11> (“*ISO Records Management Principles*”).

<sup>388</sup> *Id.*

<sup>389</sup> See nn. 48-50, *supra*, and accompanying text, discussing Ex. 6, *supra* n. 48.

<sup>390</sup> See nn. 20-26, *supra*, and accompanying text.

<sup>391</sup> See n. 28, *supra*, and accompanying text.

leadership were committed to the Board’s unanimous determination to effect transformational change for the organization.<sup>392</sup>

In any event, from a corporate governance perspective, the preservation of an organization’s institutional memory cannot be achieved solely, or even primarily, by refraining from making changes in the composition of senior staff personnel—the “protection of corporate, personal and collective memory” is one of the critical functions of sound organizational records management practices.<sup>393</sup>

Institutional memory that is preserved solely by the continued employment of certain individuals eventually provides no institutional memory at all, since individuals are always free to leave their employment voluntarily, or may be (or may feel) compelled to terminate their employment for a variety of reasons, and many factors along those lines make it impossible for any organization to rely on the continued employment of certain individuals as their principal means of ensuring the preservation of the organization’s institutional memory.<sup>394</sup>

Given this criticism, however, and the important role institutional memory plays vis-à-vis good corporate governance, KLS examined the PCAOB’s enterprise records management system, and the accessibility of the PCAOB’s true institutional memory to various levels of the Board and its staff. In this context, enterprise records management takes on added significance, given the PCAOB’s central role in implementing the important changes effected by S-Ox, since it has been observed that,

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<sup>392</sup> See nn. 23-26, *supra*, and accompanying text.

This does not mean, however, that the decision to replace a significant number Division and Office heads was effected utilizing appropriate governance processes. We discuss this below. See nn. 700-710, *infra*.

<sup>393</sup> See *ISO Records Management Principles*, *supra* n. 387, at Preview, p. vi, “Benefits,” available at [https://webstore.ansi.org/preview-pages/ISO/preview\\_ISO+15489-1-2016.pdf](https://webstore.ansi.org/preview-pages/ISO/preview_ISO+15489-1-2016.pdf).

<sup>394</sup> See, e.g., I. Mowder, “Five Things You Should Know About Capturing Institutional Knowledge,” RIGHT WAY MEDICAL (Jan. 29, 2019), available at <https://rightwaymed.com/5-things-you-should-know-about-capturing-institutional-knowledge/> (“Create a central knowledge library, using tools such as enterprise content management systems”); see also, R. Ashkenas, “How to Preserve Institutional Knowledge,” HARV. BUS. REV. (Mar. 5, 2013), available at <https://hbr.org/2013/03/how-to-preserve-institutional> (Recommending that organizations “use technology to create a process by which [their] team continually captures and curates institutional knowledge”); W. Day, “Avoiding Institutional Memory Loss,” Axyon Consulting Blog (Apr. 5, 2019), <https://www.axyonconsulting.com/services/avoiding-institutional-memory-loss/> (Recommending a robust enterprise content management solution consisting of digitizing the organization’s most critical institutional knowledge).

From a records management perspective, *Sarbanes-Oxley* is, arguably, the single most significant piece of [U.S.] federal legislation in decades. In fact, *The Sarbanes-Oxley Act* introduces compelling reasons for CEOs to implement corporate records management.<sup>395</sup>

At the PCAOB, its Secretary is responsible for maintaining PCAOB records.<sup>396</sup> From the outset, the PCAOB and its staff collected various official and internal documents they created, on numerous shared drives, but until recent years there was no digitized central database into which all documents were fed, no organized libraries of various documents collected, and no indices that permitted Board Members and PCAOB staff to access relevant documents.<sup>397</sup> In 2014, the PCAOB's Secretary, along with the IT Department, began to digitize available PCAOB documents, and began implementing a central document management platform intended to connect all databases to which a PCAOB employee may have access.<sup>398</sup>

An integrated, overarching enterprise records management system ("ERM") was not a subject that received a great deal of attention from the Board, certainly not prior to 2014. The improvements made since 2014 are impressive, especially given what existed prior to that time, but there does not appear to be

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<sup>395</sup> See, e.g., D. Stephens, "The Sarbanes-Oxley Act Records Management Implications," 15 Records Mgmt. JI. 98, 99 (Aug. 1, 2005) (emphasis in original), available (by subscription) at [https://www.deepdyve.com/lp/emerald-publishing/the-sarbanes-oxley-act-records-management-implications-SQeab7aXwn?utm\\_medium=email&utm\\_campaign=batchRecsEmail&utm\\_source=batchRecsEmail&loginPrompt=true](https://www.deepdyve.com/lp/emerald-publishing/the-sarbanes-oxley-act-records-management-implications-SQeab7aXwn?utm_medium=email&utm_campaign=batchRecsEmail&utm_source=batchRecsEmail&loginPrompt=true).

<sup>396</sup> See, e.g., PCAOB Website, "About: Senior Staff: Phoebe W. Brown, Secretary, Office of the Secretary," <https://pcaobus.org/about/senior-staff/senior-staff-bios/phoebe-w.-brown>:

Phoebe W. Brown, PCAOB secretary, oversees . . . preparing and maintaining records of board actions. She also is responsible for receiving and tracking documents filed with the board, including comment letters on proposed rules and auditing standards.

See also, PCAOB, Bylaws, Arts. III, §3.3. & VII, §7.2. (h).

<sup>397</sup> See, e.g., Witness X Interview, at p. 10; see also, P. Brown & E. Hagopian, "Memorandum on PCAOB Document Repositories," (Dec. 7, 2020), annexed as Exhibit 13 ("Repositories Memo"); and see, KLS, Notes of PCAOB Call with K. Lench, P. Brown & E. Hagopian (Dec. 8, 2020) ("Repositories Telephone Call Notes").

<sup>398</sup> See n. 406, *infra*, and accompanying text; see also, e.g., Witness X Interview, at pp. 11-12. This effort was, remarkably, accomplished by the PCAOB's Secretary, working with a single part-time paralegal with digitizing expertise. See, e.g., Witness X Interview, at pp. 10-11.

an overall design, structure or plan for what now constitutes the PCAOB's ERM.<sup>399</sup> But, having an overall design, structure and plan is a key element of any ERM, and the starting point in assuring the development and maintenance of sound ERM policies,<sup>400</sup> something the PCAOB lacks, even today, since there is no single document that sets forth the entire system of enterprise records management that is currently maintained by the PCAOB.<sup>401</sup>

KLS reviewed the information that is housed within the PCAOB's several databases; however, we noted that many on the PCAOB's current staff appear largely unaware of the documents that are available, and where.<sup>402</sup> We believe this stems from the existence of multiple databases (some of which, *intentionally*, hold the same documents<sup>403</sup>), the number of documents that are kept on the varying databases, and the lack of precision regarding restrictions on access to documents.<sup>404</sup> There has been no well-publicized communication that lays out, in useful detail, what PCAOB staff need to know in order to make use of the document digitization efforts that have already taken place, and that will continue to take place in the near term.<sup>405</sup>

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<sup>399</sup> This is the objective of an enterprise records management system. *See, e.g.*, Ash Conversions Int'l, "Benefits of a Document Management System and Nine Things to Look for," (Feb. 13, 2020), available at <https://www.ashconversions.com/blog/document-management/benefits-document-management-system-9-things-look/> ("*Benefits of a Document Management System*").

<sup>400</sup> *See, e.g.*, Hewlett-Packard Develop. Co., Best Practices Record Management (2010), available at [http://www.records.com.au/pdf/Best%20Practices\\_Selecting%20ERM.PDF](http://www.records.com.au/pdf/Best%20Practices_Selecting%20ERM.PDF).

<sup>401</sup> *See Repositories Telephone Call Notes, supra* n. 397, at p. 7 (Noting that the Secretary's Office tailors training on available information and database access for each onboarding session depending on anticipated need, and adding, that it would not be practical for all staff members to have a detailed list of what information is or is not available to them).

<sup>402</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 54; Witness X Interview, at p. 17; Witness X Interview, at p. 11; Witness X Interview, at p. 7; Witness X (1<sup>st</sup> Interview), at p. 30.

<sup>403</sup> *See, e.g., Repositories Memo, Ex. 13, supra* n. 397, at pp. 2-3 (Noting a document entitled "Advice Memorandum on Overview of PCAOB Procedure" is contained within all three SharePoint® databases).

<sup>404</sup> Because different databases have different rules regarding access, staff members seemed confused about whether they had access to particular databases, or parts of different databases. *See supra*, n. 400.

<sup>405</sup> *See Repositories Telephone Call Notes, supra* n. 397, at p. 7.

### 2.5.6.1. Document Databases

Currently, the PCAOB utilizes Microsoft's SharePoint® as the foundation for its document management system.<sup>406</sup> SharePoint® was used to develop three of the PCAOB's main internal document databases:<sup>407</sup>

- *The “Board Portal” platform,*<sup>408</sup> administered by the Secretary Office,<sup>409</sup> which houses
  - Timelines outlining upcoming Board meetings, deadlines, and events;<sup>410</sup>
  - Tracking Tools;<sup>411</sup>
    - Board Tracking Tool, allowing Board Members, Board Counsel, and Board Advisors to track Board Action materials, including documents that have been provided by Divisions or Offices for review before Board votes, along with deadlines and delivery dates;<sup>412</sup>
    - Board “Working Hours”<sup>413</sup> Meeting Materials—that is, documents or presentations related to issues that do not require a formal Board vote, but are used to update the Board, and/or advise the Board of the staff's planned

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<sup>406</sup> Organizations use Microsoft SharePoint® to create internal websites, or Intranets. It can be used to store, organize, share and access information from any device. *See* Microsoft, “*What is SharePoint*,” available at <https://support.microsoft.com/en-us/office/what-is-sharepoint-97b915e6-651b-43b2-827d-fb25777f446f>.

<sup>407</sup> *See, e.g.,* Witness X Interview, at p. 11; Witness X Interview, at p. 19; Witness X (1<sup>st</sup> Interview), at p. 41; *see also* *Repositories Memo*, Ex. 13, *supra* n. 397, at p.1 (Divisions and Offices have their own record centers and team sites in SharePoint®).

<sup>408</sup> Board portals are secure environments for administrators and board directors to access meeting materials, communicate with each other, and execute their governance responsibilities. *See* OnBoard®, by Passageways, “*What is a Board Portal?*,” <https://www.passageways.com/board-portal/everything-you-need-to-know>.

<sup>409</sup> *See e.g.,* Witness X Interview, at p. 30; Witness X Interview, at p. 5; Witness X (1<sup>st</sup> Interview), at p. 41; *see also*, *Repositories Memo*, *supra* n. 397, at pp. 4-6.

<sup>410</sup> *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 4.

<sup>411</sup> *Id.*

<sup>412</sup> *Id.*; *see also, e.g.,* Witness X Interview, at p. 17; Witness X (1<sup>st</sup> Interview), at pp. 40-42.

<sup>413</sup> Board “Working Hours” are informal meetings employed by the PCAOB to discuss projects at various stages of their development. We delineate each of the different meeting types in which the PCAOB engages below, *see* Sections 2.12.1 & 2.12.2., *infra*.

activities, including agendas and materials to be discussed at Board “Working Hours” sessions;<sup>414</sup>

- Anticipated PCAOB Communications, listing materials that Divisions or Offices intend to provide to Board Members, Board counsels, and Board advisors, in the future.<sup>415</sup>
  - Review documents for Board approval, staff recommendations for consideration at upcoming open or closed Board meetings or for seriatim consideration;<sup>416</sup>
  - Links to Division or Office Specific Libraries, each including different information, such as budget, strategic planning, draft minutes, talking points, etc., as determined and maintained by the Division or Office whose materials are posted.<sup>417</sup>
  - Calendars and PCAOB Organization Charts, including dates of upcoming Board “Working Hours” sessions, open and closed Board meetings, conferences and training sessions, Board speaking engagements, etc.<sup>418</sup>
- The Office of the Secretary Records Center, administered by the Secretary’s Office,<sup>419</sup> which houses
  - Board Minutes;<sup>420</sup>
  - Staff recommendations during meetings;<sup>421</sup>
  - Final PCAOB Budgets;<sup>422</sup>

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<sup>414</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 5; see also, e.g., Witness X Interview, at p. 17; Witness X (1<sup>st</sup> Interview), at pp. 40-42.

<sup>415</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 5; see also, e.g., Witness X Interview, at p. 17; Witness X (1<sup>st</sup> Interview), at pp. 40-42; Witness X (2<sup>nd</sup> Interview), at p. 5.

<sup>416</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 5; see also, e.g., Witness X Interview, at p. 17; Witness X (1<sup>st</sup> Interview), at pp. 40-42.

<sup>417</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 5.

<sup>418</sup> *Id.*

<sup>419</sup> *Id.*, at p. 6; see also, e.g., Witness X Interview, at p. 8; Witness X Interview, at p. 9.

<sup>420</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 6; see also, e.g., Witness X Interview, at p. 10.

<sup>421</sup> *Id.*

<sup>422</sup> *Id.*; see also, e.g., Witness X (1<sup>st</sup> Interview), at p. 41; Witness X Interview, at p. 10.

- Codes of Ethics and Conduct;<sup>423</sup> and
- Other advice memoranda.<sup>424</sup>
- “myPCAOB,” a database accessible by all PCAOB employees,<sup>425</sup> which houses employee resources, such as
  - The PCAOB’s Employee Manual,<sup>426</sup>
  - Individual pages describing the work of each Division and Office;<sup>427</sup>
  - Guidelines on PCAOB processes,<sup>428</sup> and
  - Templates for PCAOB documents.<sup>429</sup>

In addition to SharePoint®, the PCAOB uses the Diligent Board & Executive Communications Software® platform as a supplementary tool to organize the Board’s review of staff recommendations.<sup>430</sup>

- Using this tool, the Secretary’s Office creates individual “Board Books” organizing materials for upcoming open and closed Board meetings, such as, the meeting agenda and staff recommendations and corresponding supporting documents;<sup>431</sup>
- Similarly, the Office of the Chairman uses “Board Books” to organize materials for upcoming Board Working Hour sessions;<sup>432</sup>

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<sup>423</sup> See, e.g., Witness X Interview, at p. 18; see also, *Repositories Telephone Call Notes*, supra n. 397.

<sup>424</sup> See, e.g., Witness X Interview, at p. 10; see also, *Repositories Memo*, Ex. 13, supra n. 384, at p. 5.

<sup>425</sup> See *Repositories Memo*, Ex. 13, supra n. 397, at p. 3.

<sup>426</sup> See *Repositories Telephone Call Notes*, supra n. 397.

<sup>427</sup> See *Repositories Memo*, Ex. 13, supra n. 397, at p. 3

<sup>428</sup> *Id.*

<sup>429</sup> *Id.*

<sup>430</sup> Diligent Boards® is a content management solution for creating, distributing and collaborating on board meeting materials. Diligent Boards® aids in creating digital materials to support Board activities. See, e.g., Software Advice, Inc., “*Diligent Boards Software*,” available at <https://www.softwareadvice.com/board-management/diligent-boards-profile/>.

<sup>431</sup> See *Repositories Memo*, Ex. 13, supra n. 397, at p. 7.

<sup>432</sup> *Id.*

- The Diligent platform largely houses the same documents as are available on the Board Portal; however, this platform is more cell-phone friendly than the Board Portal platform;<sup>433</sup> and
- The Diligent platform, unlike the Board Portal platform, facilitates seriatim or remote voting by Board Members.<sup>434</sup>

The existence of multiple document repositories—although intentional<sup>435</sup>—is confusing and inefficient, especially given the fact that three of the main repositories largely duplicate the same information.<sup>436</sup>

Indeed, when we first spoke with the five Board Members appointed in 2018, some were unfamiliar with these platforms, and advised us that they did not make use of all them; that was, however, still at an early stage in their tenure. Since then, it has been reported to us that there is much more utilization of these systems.<sup>437</sup> Similarly, PCAOB staff demonstrated an equal amount of confusion, and many said that they had not used the main repositories.<sup>438</sup>

#### 2.5.6.2. Access to the PCAOB’s Various Document Repositories

Access to the Board Portal, Office of the Secretary Records Center, and Diligent is restricted, but there are no written descriptions of the rules governing who has such access, or the procedures that must be followed by those who do

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<sup>433</sup> See *Repositories Telephone Call Notes*, *supra* n. 397; see also, *e.g.*, Witness X (2<sup>nd</sup> Interview), at p. 3; Witness X Interview, at p. 13.

<sup>434</sup> See, *e.g.*, Witness X (2<sup>nd</sup> Interview), at p. 2; Witness X (2<sup>nd</sup> Interview), at p. 5.

<sup>435</sup> See *Repositories Telephone Call Notes*, *supra* n. 397.

<sup>436</sup> See, *e.g.*, *Benefits of a Document Management System*, *supra* n. 399.

<sup>437</sup> See *Repositories Telephone Call Notes*, *supra* n. 397.

<sup>438</sup> See, *e.g.*, Witness X Interview, at p. 26; Witness X Interview, at p. 17; Witness X Interview, at p. 11; Witness X Interview, at p. 7; Witness X (1<sup>st</sup> Interview), at p. 30; Witness X Interview, at p. 10.

We discuss below our recommendations for a more efficient and less confusing approach. See Section 3.3.2., *infra*.

not have automatic access, in order to obtain access (or to obtain limited access).<sup>439</sup>

In the case of the Board Portal platform, the Secretary's Office, some staff in OGC, and each of the Board Members, as well as each Board Member's counsel and advisor, have access to the entire portal.<sup>440</sup> Certain other staff have access to Division or Office specific libraries and/or sub-sites within the portal.<sup>441</sup> Individual PCAOB staff cannot seek or be granted access to the Board Portal; however, if an unauthorized individual attempts to open a restricted document, the system will automatically send the Secretary's Office a "request to open" email containing the individual's identity and the document he/she is trying to open.<sup>442</sup>

The same restrictions on access apply to the Office of the Secretary Records Center and Diligent, which are primarily utilized by the Board Members and each Board Member's counsel and advisor, but can also be accessed by some OGC staff.<sup>443</sup> It appears that access is never granted on an *ad-hoc* basis.<sup>444</sup> The breadth of a staff member's access changes only when the staff member switches from one role to another within the organization, requiring certain access restrictions or allowances based on the staff member's new role and responsibilities.<sup>445</sup> These reflect sound and appropriate controls.

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<sup>439</sup> See, e.g., Witness X Interview, at pp. 4-5; Witness X Interview, at p. 13.

<sup>440</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 4; see also, e.g., Witness X Interview, at p. 34; Witness X Interview, at pp. 19-20; Witness X Interview, at pp. 12-13; Witness X Interview, at p. 11; Witness X (1<sup>st</sup> Interview), at pp. 25-26; Witness X (1<sup>st</sup> Interview), at p. 25.

<sup>441</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 5.

<sup>442</sup> See, e.g., Email from C. Brennan to (b)(6) (May 30, 2018); Email from (b)(6) (b)(6) (June 8, 2018); Email from (b)(6) (Nov. 26, 2018). There apparently are no written or published criteria employed to determine why staff requests for access will be denied. See, e.g., Witness X Interview, at p. 4.

<sup>443</sup> See *Repositories Memo*, Ex. 13, *supra* n. 397, at p. 4.

<sup>444</sup> See *Repositories Telephone Call Notes*, *supra* n. 397. at pp. 2-3.

<sup>445</sup> See, e.g., *id.*, at p. 2 (An individual who switches from a position as Board Counsel to a position in OGC will lose access to sections of the Board Portal that he/she previously had as a member of a Board Member's staff, but will retain access to the Office of the Secretary Records Center).

### 2.5.6.3. Tracking Access to the PCAOB's Various Document Repositories and Specific Documents

In any enterprise information system, there are at least three major categories of documents that are stored—historical documents, informational documents, and collaborative documents.<sup>446</sup> Historical documents are those that were created for a specific purpose, and now reflect a part of the organization's institutional memory. Informational documents are those that provide critical knowledge—for example, schedules of anticipated inspections and examinations of registered audit firms.<sup>447</sup> And, collaborative documents are those that are in the process of being created and/or finalized, where multiple sources of input are necessary to complete work on the particular document/project.

It is critical in organizational document maintenance systems to have formal policies and software that enable the entity to track:

- Who has accessed the system;
- The relevant details regarding each exercise of access privileges;
- The specific libraries and documents at which individuals looked;
- Who has modified or attempted to delete documents; and
- Information regarding the exercise of access privileges.<sup>448</sup>

Maintaining records of this nature have a number of important benefits—first, the knowledge that there is tracking of access to the system can disincentivize any potentially inappropriate efforts to change records in the database.<sup>449</sup> In addition, tracking access can be helpful in determining who, if anyone, may be responsible

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<sup>446</sup> See, e.g., National Council of Nonprofits, *Document Retention Policies for Nonprofits*, available at <https://www.councilofnonprofits.org/tools-resources/document-retention-policies-nonprofits>.

<sup>447</sup> See, e.g., Secs. Exch. Act Rel. No. 86118 (June 17, 2019), available at <https://www.sec.gov/litigation/admin/2019/34-86118.pdf> (SEC settlement with KPMG LLP in which confidential information belonging to the PCAOB—including lists of the specific audit engagements the PCAOB planned to inspect, the criteria the PCAOB used to select those engagements for inspection, and the focus areas of the inspections—was improperly obtained by the accounting firm, working through former PCAOB staff members).

<sup>448</sup> See, e.g., E. Swan, “*What’s Included in an Audit Trail and Why It’s Important*,” eFileCabinet (Oct. 2, 2017), available at <https://www.efilecabinet.com/whats-included-in-an-audit-trail-and-why-its-important/> (“*Audit Trails*”).

<sup>449</sup> *Id.*

for any actual compromise of the confidentiality of documents within the database.<sup>450</sup> Moreover, keeping these kinds of records gives everyone using the system greater assurance that documents will reflect their appropriate state, and cannot have been altered without everyone using the database knowing that alterations may have occurred.<sup>451</sup>

#### 2.5.6.4. Ability to Effect Changes in System Documentation

The PCAOB needs to develop specific rules regarding the ability to effect changes in system documentation. These rules would vary, depending on the type of document involved—for example, there should be no permission on the part of anyone at the PCAOB either to alter or delete historical documents. As it stands now, it appears that the documents available on the SharePoint® databases and Diligent are in PDF format and cannot readily be modified by anyone other than the Secretary’s Office.<sup>452</sup>

Everyone else has read-only access. However, these documents can be deleted by staff who have administrative permission to manage the repositories.<sup>453</sup> In addition, the PCAOB does not—but should—have a system in place to prevent anyone with access to these documents from sending them outside the PCAOB by email.<sup>454</sup> While the PCAOB has a policy that prohibits the dissemination of nonpublic information to anyone outside the organization,<sup>455</sup>

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<sup>450</sup> *Id.* See also, e.g., B. Hendricks, W. Landsman & F. Dimas Peña-Romera, “*The Revolving Door Between the PCAOB and Large Audit Firms*,” Keenan Inst. of Private Enterprise Research Paper Series No. 18-13 (Apr., 2018), available at <https://business.gwu.edu/sites/g/files/zaxdzs1611/f/downloads/Hendricks%20et%20al%20%284-4-2018%29%20-%20The%20revolving%20door%20between%20the%20PCAOB%20and%20large%20audit%20firms.pdf> (Noting that hiring trends by large audit firms may reflect the fact that former PCAOB employees obtain confidential information about future inspections via former colleagues at the PCAOB).

<sup>451</sup> See *Audit Trails*, *supra* n. 448.

<sup>452</sup> See, e.g., Witness X Interview, at p. 12.

<sup>453</sup> See generally, *Repositories Memo*, Ex. 13, *supra* n. 397; see also, e.g., Witness X Interview, at p. 12.

<sup>454</sup> See *Repositories Telephone Call Notes*, *supra* n. 397, at p. 4.

<sup>455</sup> See PCAOB Ethics Rule EC9, *supra* n. 103.

there is no express policy prohibiting Board Members or PCAOB staff from forwarding nonpublic information to their personal emails.<sup>456</sup>

For documents maintained on the Board Portal, there apparently is version control with respect to collaborative documents,<sup>457</sup> so that PCAOB staff and Board Members can make comments alongside uploaded documents, and those comments are tracked.<sup>458</sup> With respect to the Diligent Platform, if a document is opened, Board Members can then vote on the issue to which the document pertains.<sup>459</sup> This effectively means there will be a record of what has and has not been read, and by whom.<sup>460</sup>

Access to both databases is tracked through an audit trail that exists as a technical control on all platforms.<sup>461</sup> However, the PCAOB does not actively monitor that information on a real time basis.<sup>462</sup>

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The PCAOB has made substantial progress in developing a meaningful enterprise records management program. But, a great deal of the foundational work necessary to permit such a program to be developed has never been performed.<sup>463</sup> There is a need for the PCAOB to identify the information needed

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<sup>456</sup> In connection with the events surrounding the dismissal of the PCAOB's Chief Administrative Officer (*see* n. 2, *supra*), we understand that information was transmitted between personal and PCAOB email addresses.

We believe the PCAOB should adopt express policies prohibiting the transfer of work-related information to personal email addresses. Our recommendations in that respect, are set forth below. *See* Section 3.3.7., *infra*.

<sup>457</sup> Version control is a system that enables multiple individuals to work on a single project, simultaneously. Each person edits his/her own copy of the files and decides when to share those changes with the other individuals with whom he/she is working. Version control also enable each individual working on a project to use multiple computers to work on the project. It also integrates work done simultaneously by different team members. And, version control provides access to historical versions of the project, which serves as insurance against computer crashes or data loss. *See, e.g.*, M. Ernst, "Version Control Concepts and Best Practices, Univ. of Wash. Website (Mar. 3, 2018), <https://homes.cs.washington.edu/~mernst/advice/version-control.html>.

<sup>458</sup> *See Repositories Telephone Call Notes, supra* n. 395, at p. 4.

<sup>459</sup> *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at p. 5.

<sup>460</sup> *See Repositories Telephone Call Notes, supra* n. 395, at p. 4.

<sup>461</sup> *Id.*, at pp. 1-2.

<sup>462</sup> *Id.*

<sup>463</sup> The implementation of electronic recordkeeping systems is a complex process. *See, e.g.*, W. Pan, "The Implementation of Electronic Recordkeeping Systems," 27 RECORDS MGMT. J.L. 84, 90

at each level of the organization to fulfill its mandate and objectives, and develop a comprehensive set of policies to govern complete control over the system.<sup>464</sup>

## 2.6. Historical Trends in PCAOB Functioning

To understand the context in which the PCAOB's current governance policies and procedures operate, we undertook to obtain some historical perspective on how the Board functioned, the difficulties—if any—in its ability to work collaboratively, and the approaches pursued. In that regard, former PCAOB employees recalled that, at the outset—and early stages—of its existence, the PCAOB operated collaboratively, and shared responsibilities seamlessly, among its staff members, largely due to its initial size and the pressing need to get PCAOB operations underway as quickly as possible, in order to fulfill the organization's important public responsibilities.<sup>465</sup>

This dynamic began to shift starting in 2006, however, as the organization grew in size, and a new Chairman was appointed.<sup>466</sup> It is inevitable that, as organizations grow in size and scale, collaboration becomes more difficult.<sup>467</sup> Thus, it appeared to multiple interviewees that, by 2012, conflicts and tensions among PCAOB Board Members, resulting in less effective collaboration, was more a way of life at the PCAOB, than it was an isolated or occasional occurrence.<sup>468</sup> In that vein, current and former PCAOB staff shared the same

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(2017), available (by subscription) at [www.emeraldinsight.com/0956-5698.htm](http://www.emeraldinsight.com/0956-5698.htm). It thus requires a number of preliminary steps, since when individuals do not want to use the technology, or they have to go through a painstaking process to properly use the technology, they frequently abandon it, or work around it. *Id.*, at 91. This means the first step in implementing any program of electronic recordkeeping is understanding the needs and attitudes of the users of the system. *Id.*, at 92. It also means engaging users in the development and implementation of the system. *Id.*, at 93. *See also*, R. Maguire, "Lessons Learned from Implementing an Electronic Records Management System," 15 RECORDS MGMT. J.L. 150 (2005), available (by subscription) at [www.emeraldinsight.com/0956-5698.htm](http://www.emeraldinsight.com/0956-5698.htm).

<sup>464</sup> Our recommendations in this regard are set forth below. *See* Section 3.4.6., *infra*.

<sup>465</sup> *See, e.g.*, Witness X Interview, at p. 3; Witness X Interview, at p. 2; Witness X Interview, at pp. 5-7; Witness X Interview, at pp. 31-32.

<sup>466</sup> *See, e.g.*, Witness X Interview, at pp. 12 & 20; Witness X Interview, at pp. 31-32.

<sup>467</sup> *See, e.g.*, J. Phillips, "Good Collaboration, Bad Collaboration," SLACK.COM BLOG, (Mar. 13, 2019), at Part 4, <https://slack.com/blog/collaboration/good-collaboration-bad-collaboration-a-new-report-by-slack>.

<sup>468</sup> *See, e.g.*, Witness X Interview, at p. 19; Witness X Interview, at p. 13; Witness X Interview, at p. 14, Witness X Interview, at p. 22-23; Witness X Interview, at p. 6.

perception with us—that different Board compositions prior to the current one had experienced difficulties in working collaboratively, and effectively.<sup>469</sup>

While each iteration of a complete five-Member Board must be viewed as a distinct unit, and may exhibit degrees of unsuccessful collaboration due to different causes of tensions or dissension and the lack of effective collaboration that may have existed between one or more Members during their tenures, there are at least three recurrent issues that governance experts identify as responsible, most frequently, for boards that have underachieved in their development of collaborative synergies, and that appear to have marked difficulties of various iterations of PCAOB Member composition:

- Dysfunctional group dynamics, marked by rivalries, resulting from both bad communications and bad chemistry between an organization’s board members;<sup>470</sup>
- Disengagement by an organization’s board members who do not know what is going on within the organization and, as a result, frequently retreat from meaningful participation,<sup>471</sup> and
- An organization’s board members’ uncertainty about their roles and responsibilities.<sup>472</sup>

These difficulties are exhibited by an unfortunately large number of nonprofit boards.<sup>473</sup> All these difficulties have been present at varying times, and in various manners, in the history of the PCAOB.

Thus, as we have seen, there have been instances of bad communications and bad chemistry between certain PCAOB Board Members over time.<sup>474</sup> Many of

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<sup>469</sup> See, e.g., Witness X Interview, at p. 13; Witness X Interview, at pp. 22-23; Witness X Interview, at p. 19; Witness X Interview, at p. 19; Witness X Interview, at p. 6.

<sup>470</sup> See, e.g., W. Ryan, R. Chait & B. Taylor, “*Problem Boards or Board Problem?*,” NONPROFIT QUARTERLY MAGAZINE (Apr. 20, 2018), available at <https://nonprofitquarterly.org/problem-boards-or-board-problem/> (“*Problem Boards*”).

<sup>471</sup> *Id.*

<sup>472</sup> *Id.*

<sup>473</sup> See, e.g., A. Counts, “*Spotting and Fixing Dysfunctional Nonprofit Boards*,” STANFORD SOCIAL INNOVATION REV. (Oct. 5, 2020), available at [https://ssir.org/articles/entry/spotting\\_and\\_fixing\\_dysfunctional\\_nonprofit\\_boards](https://ssir.org/articles/entry/spotting_and_fixing_dysfunctional_nonprofit_boards).

<sup>474</sup> See nn. 466-469, *supra*, and accompanying text.

Some of this was reflected in the difficulties that were observed with the “Board Champions” program that current Board Chairman Duhnke attempted to institute. See nn. 297-307, *supra*, and accompanying text. One or more Board Members seemed to believe that they had

the collaboration difficulties experienced by prior Boards that were reported to us stem from the fact that Board Members are uncertain about their roles and responsibilities, due in large measure to the PCAOB’s consistent failure to articulate a position description for individual Board Members, and provide onboarding training in what the proper role is of PCAOB Board Members.<sup>475</sup> Collaborative difficulties also seemed to arise from the lack of clarity regarding the precise allocation of authority among the Board Members.<sup>476</sup> As mentioned previously,<sup>477</sup> this theme was repeated to us during a number of our interviews.<sup>478</sup>

We were provided with several examples of this apparent lack of collaboration that predate the current Board. One of those examples, in particular, is instructive vis-à-vis the difficulties the PCAOB has confronted with respect to collaboration. This example involved a former Board Chairman who raised an issue for Board consideration and potential Board action.<sup>479</sup> There is

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been delegated full Board authority vis-à-vis the particular areas over which they were designated as “Champions,” and began meeting weekly with mid-level and higher-level staff, and instructing the staff on how to carry out their work assignments. *Id.* No formal description of the Board Champions program was created, and the ineluctable result of the failure to create formal written descriptions of intended Board responsibilities is frequently a failure on the part of one or more Board Members to fulfill his/her intended role. *See* nn. 302-303, *supra*, and accompanying text.

*See also*, SEC, “Statement on Commencement of Appointment Process for the 2019-2024 PCAOB Board Seat,” Public Statement (June 24, 2019), available at <https://www.sec.gov/news/public-statement/statement-teotia-062419>; and F. McKenna, “Regulator Seeks to Keep Job at PCAOB, but SEC Looks for New Candidates,” MARKETWATCH, (Sept. 11, 2019), available at <https://www.marketwatch.com/story/regulator-seeks-to-keep-job-at-pcaob-but-sec-looks-for-new-candidates-2019-09-10> (Reporting that then Board Member Kathleen Hamm stated she was “seeking reappointment to continue the important work [*she*] began 20 months ago,” and describing her personal activities as a Board Member in terms of “applying *my* expertise and experience in technology, risk management, and compliance to upgrading and modernizing the PCAOB’s approach to cybersecurity and emerging technologies, both at the board and among the audit firms we oversee”) (emphasis supplied)). The statement seems to reflect Board Member Hamm’s view that she had a *personal* leadership role she wished—and intended—to continue, as distinct from being part of a *collaborative effort by the entire Board* to achieve the goals she identified as part of her individual portfolio.

<sup>475</sup> *See* nn. 280-281, *supra*, and accompanying text.

<sup>476</sup> *See* nn. 235-236, *supra*, and accompanying text; *see also, e.g.*, Witness X Interview, at p. 6; Witness X Interview, at p. 25.

<sup>477</sup> *See, e.g.*, nn. 256-257, *supra*, and accompanying text.

<sup>478</sup> *See, e.g.*, Witness X Interview, at p. 11; Witness X Interview, at pp. 7-8; Witness X Interview, at pp. 3-4.

<sup>479</sup> We have consciously decided not to identify the issue that forms this example. We decided that because the actual issue was not, in our view, important vis-à-vis the points in the text we are making; rather, it was the *manner* in which competing views about the issue were handled by that iteration of the Board’s composition that we believe is significant. Beyond that, we have also

little doubt that the Board's Chairman is the PCAOB Member generally responsible for setting the Board's Agenda, and the individual who decides how the PCAOB's staff should be engaged (subject to the requirement that the deployment of PCAOB resources by the Chairman must be consistent with the overall policies established by the PCAOB, acting *qua* Board.<sup>480</sup>

The former Chairman's decision to raise this issue engendered a spirited policy debate—and some notable disagreement—among the Board Members.<sup>481</sup> Given the need for each Board Member to exercise his/her fiduciary duties and independent judgment about what is best for the constituencies the PCAOB is mandated to serve, spirited discussions—and heated debate—are entirely appropriate, and indeed required under S-Ox and the DCNPCA.<sup>482</sup> But, it is what happened subsequently that created the specter of PCAOB dysfunctionality. Thus, it is commonly accepted that

Each board member must keep an open mind while adapting to team *culture*. Individuality is an asset in a board member, but it's the collective body that determines the course of action.<sup>483</sup>

After the spirited debate, strong feelings remained on the part of some Board Members. For those Members, these strong feelings, and the tensions accompanying them, were allowed to leak from the boardroom and permeate through the entire organization.<sup>484</sup> It did not take long for the policy disagreements among various Board Members to become common knowledge throughout the organization.<sup>485</sup> This had the effect of highlighting the apparent lack of authority felt by some Board Members in the face of a strong position by the Board's Chairman; the internecine warfare that ensued created a culture of mistrust that, in some respects, continues to the current time.<sup>486</sup>

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declined to identify the issue used as an example to avoid the chance that the identities of the persons who provided these comments could be compromised.

<sup>480</sup> See nn. 214-215, *supra*, and accompanying text.

<sup>481</sup> See, e.g., Witness X Interview, at p. 19; Witness X Interview, at pp. 15-16.

<sup>482</sup> See, e.g., BoardSource®, THE HANDBOOK OF NONPROFIT GOVERNANCE 316 (1<sup>st</sup> ed. 2010), available at <http://gife.issuelab.org/resources/19261/19261.pdf> (“*Nonprofit Governance Handbook*”).

<sup>483</sup> *Id.*, at p. 315 (emphasis supplied).

<sup>484</sup> See, e.g., Witness X Interview, at pp. 18-19; Witness X Interview, at p. 32.

<sup>485</sup> See, e.g., Witness X Interview, at pp. 18-19; Witness X Interview, at p. 32.

<sup>486</sup> See, e.g., Witness X Interview, at pp. 18-19; Witness X Interview, at p. 32.

It is critical for the Board—as presently constituted, and in the future—to understand the essential difference between the Board, acting as a whole, and the Members of the Board, acting in their individual capacities:

[G]overning boards have [important responsibilities] because they have the *legal authority* to exercise them, their individual members do not. Indeed, [individual] board members . . . do not possess the board’s legal standing . . . Clearly articulating the board’s corporate responsibilities and authority (preferably in the bylaws) and the responsibilities and expectations of board members (preferably codified in separate policies) are best [governance] practices [for nonprofit boards].<sup>487</sup>

Put another way, the current and future Boards must set the appropriate tone and develop the appropriate culture. To do this, the Board should confine disagreements to their meetings, and publicly highlight their (hopefully) numerous examples of positive interactions to reinforce a culture of collaboration that is inculcated by its staff.

## **2.7. Historical Trends in Staff Functioning**

Similar to our desire to set some historical context vis-à-vis the PCAOB’s governance since its inception, we deemed it equally important to understand historical trends in how the PCAOB’s staff has functioned, in order to assess whether, and what, to recommend with respect to changes in the way the PCAOB and its staff function and interact.<sup>488</sup> Some of the observations set forth above—about the manner in which the PCAOB’s staff has historically functioned—form an important foundation for our analysis of the PCAOB’s current governance policies and practices with respect to its staff.<sup>489</sup> We set forth below, two aspects of the staff’s historical trends that have an important bearing on current governance issues.

### **2.7.1. Senior Staff Turnover**

From the outset of its existence, the PCAOB’s staff developed considerable longevity and with it, a concomitantly low staff turnover rate.<sup>490</sup> From a governance perspective, as a general proposition there are many associated positives when a corporation—be it for-profit or nonprofit—fosters staff longevity,

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<sup>487</sup> See, e.g., *Ten Basic Responsibilities*, *supra* n. 274, at p. 91 (emphasis in original).

<sup>488</sup> See Section 2.6., *supra*.

<sup>489</sup> See nn. 5-8, *supra*, and accompanying text.

<sup>490</sup> See nn. 71-78, *supra*, and accompanying text.

especially for high-performing employees who know the history, struggles, and successes of the organization.<sup>491</sup>

Among other things, the costs associated with a high degree of staff turnover can be large, and a lower rate of employee turnover can frequently generate significant operational cost savings, with those savings able to be used for other, critical purposes.<sup>492</sup> Moreover, if an organization has a great culture, staff longevity can assist in preserving and protecting that culture, and even prevent it from shifting.<sup>493</sup> Thus, in the typical corporate enterprise—either nonprofit or for-profit—companies frequently seek to promote stability in their executive leadership,<sup>494</sup> even though such stability has become increasingly more difficult to achieve in recent years.<sup>495</sup>

According to a number of long-serving current and former employees, the PCAOB’s historically low rate of senior staff turnover led to the formation of many constructive relationships, and fostered a sense, among those employees, of commonality and mission to advance the goals of the organization.<sup>496</sup> In its formative years, the PCAOB apparently enjoyed a strong mission-driven culture,

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<sup>491</sup> See, e.g., L. Haun, “*Is Employee Loyalty and Longevity Really All It’s Cracked Up to Be?*,” TALENT MANAGEMENT & HR, (Feb. 8, 2011), available at <https://www.tnt.com/is-employee-longevity-really-that-much-of-an-advantage/> (“*Employee Longevity*”).

<sup>492</sup> *Id.*

<sup>493</sup> *Id.*

<sup>494</sup> See, e.g., X. Luo, V. Kanuri & M. Andrews, “*Long CEO Tenure Can Hurt Performance*,” HARV. BUS. REV. (Mar. 2013), available at <https://hbr.org/2013/03/long-ceo-tenure-can-hurt-performance> (Noting that the longer a CEO serves, the more the firm-employee dynamic improves).

<sup>495</sup> See, e.g., The Graduate Program in Museum Studies, Syracuse University, “*The Good, the Bad, and the Ugly: How Passion, Relationships, and Expectations Affect Director Tenure*,” GUIDESTAR BLOG, (2007), <https://trust.guidestar.org/the-good-the-bad-and-the-ugly-how-passion-relationships-and-expectations-affect-director-tenure> (Noting that, in a 2006 nationwide survey of nonprofit leadership, 75 percent of executives stated they planned to leave their jobs within the next five years); M. Davies, “*CEO Turnover at Record High*,” PWC CEO SUCCESS SURVEY (2019), <https://www.pwc.com/gx/en/news-room/press-releases/2019/ceo-turnover-record-high.html> (Noting that for-profit company CEO turnover hit a record high of 17% in 2018).

<sup>496</sup> See, e.g., Witness X Interview, at p. 22; Witness X Interview, at pp. 25-26; Witness X Interview, at p. 20.

and employees exhibited a commitment to working to better the audit profession.<sup>497</sup>

But at least three significant aspects of the PCAOB's DNA ultimately made it highly unlikely that the PCAOB would—or even should—have been capable of perpetuating an enduring record of minimal staff turnover; these aspects included the PCAOB's

- Maturation as an organization;
- Hybrid nature—that is, as an institution that is both
  - Part of the private sector, but also
  - Quasi-governmental; and
- Status as a creature of statute.

As the PCAOB began maturing as an organization, it began experiencing a phenomenon typically common at both for-profit and nonprofit corporations—the inevitable softening (and diminution) of its employees' initial fervor, mission-driven culture, and clear commitment to promoting—in the case of the PCAOB—the standards and performance of the auditing profession.<sup>498</sup> Whether this phenomenon is referred to as “burnout,” “fatigue,” or “weariness,” it is often the case that initial feelings of ardent fervor on the part of employees for their company's mission tend to lessen over time.<sup>499</sup>

Beyond the PCAOB's maturation as an institution, its quasi-governmental responsibilities,<sup>500</sup> coupled with a statutorily imposed set of government-like term

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<sup>497</sup> See, e.g., Witness X Interview, at pp. 25-26; Witness X Interview, at p. 22; Witness X Interview, at p. 19; Witness X Interview, at p. 9.

<sup>498</sup> See, e.g., T. Ng & D. Feldman, “Does Longer Job Tenure Help or Hinder Job Performance,” 83 *JL. OF VOCATIONAL BEHAVIOR* 305 (Dec. 2013), available (by subscription) at <https://www.sciencedirect.com/science/article/abs/pii/S0001879113001395>; see also, e.g., Witness X Interview, at pp. 18-20; Witness X Interview, at p. 32.

<sup>499</sup> See, e.g., R. Montañez, “Burnout is Sabotaging Employee Retention,” *FORBES* (June 5, 2019), available at <https://www.forbes.com/sites/rachelmontanez/2019/06/05/burnout-is-sabotaging-employee-retention-three-things-you-must-know-to-help/?sh=56c478045f0e> (Noting that almost half of HR leaders say that employee burnout is responsible for up to half of annual workforce turnover).

<sup>500</sup> See, e.g., D. Goelzer, “Remarks During a Panel Discussion Concerning Globalization of Accounting & Auditing Standards,” DC Bar Assoc. (Feb. 28, 2012), available at <https://pcaobus.org/news-events/speeches/speech-detail/remarks-during-a-panel-discussion-concerning-globalization-of-accounting-auditing-standards-will-u-s-investors-benefit-399> (“The Board is a quasi-governmental body”); D. Nagy, “Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status,” 80 *N.D. Law Rev.* 975, 1022 n. 274 (2005), available at <https://scholarship.law.nd.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1394&context=ndlr>; P. Atkins, “Statement before the Open Meeting Regarding PCAOB

limits,<sup>501</sup> mean that, eventually, the well-recognized phenomenon of high governmental employee turnover that is coextensive with a change in administrations,<sup>502</sup> would likely catch up with, and carry over to, a quasi-governmental entity like the PCAOB.

This has translated into the fact that, on average of at least once every five years (and actually more frequently),<sup>503</sup> Board leadership—at least in the form of the PCAOB’s Chairman—has changed.<sup>504</sup> And, with those changes typically come varied perspectives, new ways of doing things, and refocused objectives.<sup>505</sup> As a generic proposition, new corporate leaders frequently demand to be surrounded

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and *FASB Budget Review*,” (Mar. 3, 2005), available at <https://www.sec.gov/news/speech/spch030305psa3.htm> (Noting that the SEC’s review and approval responsibilities vis-à-vis the PCAOB “are a required public check on a quasi-governmental organization”); K. Kosar, “*The Quasi Government: Hybrid Organizations with Both Government and Private Sector Legal Characteristics*,” CONG. RESEARCH SERV. (June 22, 2011), at p. 16, available at <https://fas.org/sgp/crs/misc/RL30533.pdf>.

<sup>501</sup> See S-Ox §§101(e)(5)(A) & (B), 15 U.S.C. §§7211(e)(5)(A) & (B).

<sup>502</sup> See, e.g., A. Bolton, J. deFigueiredo & D. Lewis, “*Elections, Ideology, and Turnover in the U.S. Federal Government*,” NBER Working Paper Series (Dec. 2016), available at [https://www.nber.org/system/files/working\\_papers/w22932/w22932.pdf](https://www.nber.org/system/files/working_papers/w22932/w22932.pdf) (Noting that between 1988 and 2011, Presidential elections increased departure rates of career senior employees).

<sup>503</sup> As we noted earlier, in the first fifteen years of the PCAOB’s existence, it had six different Chairmen or Acting Chairman. See n. 69, *supra*, and accompanying text.

<sup>504</sup> S-Ox limits the service of PCAOB Board Members to—at most—two five-year terms, although the statute permits Board Members whose terms have expired to hold over until a replacement has been appointed. See s-Ox, §101(e)(5)(A), 15 U.S.C. §§7211(e)(5)(A). If a new Board Chairman were appointed at the beginning of the term of a new Administration, and the President were re-elected for a second term, a Board Chairman might be able to serve up to ten years, plus any holdover period occasioned by a delay in the appointment of a successor by the next set of Administration officials. Given the existence of possible early retirements from Board Service, and other factors, it is unlikely that any Board Chairman would serve that long.

To date, the longest-serving Board Chairman was James R. Doty, who served as Board Chair for a total of seven years. See, e.g., PCAOB Website, “*Former Chairmen and Board Members*,” <https://pcaobus.org/about/the-board/former-chairmen-and-board-members/board-bios/james-r-doty> (Noting that former Chair Doty served as Chairman from January 2011 to January 2018). Former Board Member Daniel Goelzer served as a Board Member from October 2002 until March 2012, for a total of ten years, the last three of which he served as Acting Chairman of the PCAOB. See, e.g., *id.*, <https://pcaobus.org/about/the-board/former-chairmen-and-board-members/board-bios/daniel-l-goelzer>.

<sup>505</sup> See, e.g., *Duhnke 2019 Keynote*, *supra* n. 316; J. Doty, “*Statement on the PCAOB 2018 Budget and Related Strategic Plan*,” (Nov. 16, 2017), available at <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-the-pcaob-2018-budget-and-related-strategic-plan-668>; J. Doty, “*Keynote Address*,” (Dec. 3, 2012), available at <https://pcaobus.org/news-events/speeches/speech-detail/keynote-address-436>.

by new senior staff—the theory of many new leaders is that, since they are going to be judged on the basis of the performance of the organization under their leadership, they should insist upon being surrounded by people who are committed to their vision for the enterprise.<sup>506</sup>

The juxtaposition of the PCAOB’s historic staff longevity with the changes in senior staff members wrought in 2018 by the collaborative action of the five then newly-designated Board Members—when a total of seven senior PCAOB staff members either retired or had their employment terminated<sup>507</sup>—could not have been starker.

Former PCAOB staff members advised us that, prior to 2018, they could count on one hand the number of times senior staff personnel had their employment terminated over the course of the PCAOB’s first fifteen years.<sup>508</sup> In hindsight, it is easy to observe that the PCAOB’s implementation of significant organizational change beginning in 2018, certainly in terms of historic PCAOB staff turnover trends, were likely to, and in fact did, give rise to strong—and largely adverse—PCAOB staff reactions and, in some fashion, employee resistance.<sup>509</sup>

Recent studies demonstrate that more than half of all employees who experience significant organizational change at work report feeling chronic stress, with a large number experiencing actual physical symptoms.<sup>510</sup> More significantly vis-à-vis the significant organizational change undertaken by the

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<sup>506</sup> See, e.g., T. Hsieh & S. Bear, “*Managing CEO Transitions*,” *The McKinsey Quarterly* (1994, No. 2), at p. 47, available at <https://www.mckinsey.com/~media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Managing%20CEO%20transitions/Managing-CEO-transitions.pdf> (Noting that new CEOs have to ward against the rapid development of an entrenched status quo, by severing the web of familiar practice and bringing in new senior staff).

<sup>507</sup> See n. 26, *supra*, and accompanying text.

<sup>508</sup> See, e.g., Witness X Interview, at p. 30; Witness X Interview, at p. 18; Witness X Interview, at p. 24.

<sup>509</sup> See, e.g., H. Wickford, “*Negative Impact of Organizational Change on Employees*,” *Houston Chron.* (Jan. 31, 2019), available at <https://smallbusiness.chron.com/negative-impact-organizational-change-employees-25171.html> (Noting that significant organizational “change is almost always difficult for employees”).

<sup>510</sup> See American Psychological Association (“APA”), “*2017 Work and Well-Being Survey*,” at p. 6 (May 24, 2017), available at [http://www.apaexcellence.org/assets/general/2017-work-and-wellbeing-survey-results.pdf?\\_ga=2.163372796.1732660065.1607609865-1248162381.1607609865](http://www.apaexcellence.org/assets/general/2017-work-and-wellbeing-survey-results.pdf?_ga=2.163372796.1732660065.1607609865-1248162381.1607609865) (“*Work and Well-Being*”); see also, APA, “*Change at Work Linked to Employee Stress, Distrust and Intent to Quit*,” Press. Rel. (May 24, 2017), available at <https://www.apa.org/news/press/releases/2017/05/employee-stress>.

PCAOB beginning in 2018, employees who experience significant organizational change tend to be afflicted with lower levels of job satisfaction, and with three times higher levels of mistrust for their employers.<sup>511</sup>

In that latter context—mistrust vis-à-vis management proposing significant organizational change—underlying employees’ adverse reactions to these changes is their perception of the motivations behind those changes, as well as the likelihood of success for these changes. In the same studies, almost a third of employees reported they were cynical when it came to these types of changes, and that they believed management had:

- A hidden agenda;<sup>512</sup>
- Motives and intentions that were different from what management actually said;<sup>513</sup> and
- Tried to cover up the real reasons for the changes.<sup>514</sup>

Not surprisingly, almost sixty percent of employees surveyed had little confidence that the proposed changes would produce the desired effects.<sup>515</sup>

The findings of these generic studies came to fruition at the PCAOB in 2019. As we have seen, the 2019 PCAOB Employee Surveys evidenced mistrust for the current Board.<sup>516</sup> This was followed by the May and September Whistleblower Complaints,<sup>517</sup> which not only reflected a high level of mistrust, but also raised charges of a hidden agenda, motives and intentions that differed from what the Board said about the changes, and efforts to cover up the real reasons for the change.<sup>518</sup>

During organizational changes, the effects of distrust by employees become magnified, especially when employees do not believe what the organization’s leadership is telling them (assuming the leadership is telling them

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<sup>511</sup> *Work and Well-being*, *supra* n. 510, at p. 7.

<sup>512</sup> *Id.*

<sup>513</sup> *Id.*

<sup>514</sup> *Id.*

<sup>515</sup> *Id.*

<sup>516</sup> *See* 2019 PCAOB Employee Surveys, Exs. 3 & 4, *supra* n. 30.

<sup>517</sup> *See* Exs. 5 & 6, *supra* nn. 34 & 48, respectively.

<sup>518</sup> *See* nn. 36-39, & 48-51, *supra*, and accompanying text.

anything about the changes).<sup>519</sup> The key mechanism by which the PCAOB could have avoided these adverse reactions to its program of transformational change would have been better disclosure to the PCAOB's staff and actively engaging employees in the processes of deciding whether, and how, to make these changes.<sup>520</sup>

As we discuss below, the PCAOB conducted a number of meetings with representatives of various of its constituencies prior to embarking upon its program of transformational change. But other than a passing suggestion that the PCAOB consulted with its employees,<sup>521</sup> it did not appear from any PCAOB documents we received, or our interviews, that the PCAOB's *pre-existing* staff was advised in advance of the Board's decision to effect a large number of senior personnel changes or its program of transformational change.<sup>522</sup> Nor was there any explanation for these developments after they occurred.

Based upon our review, we believe that the Board's failure to advise the PCAOB staff in advance of the decision to implement senior personnel changes—and its failure to explain why the decision was made after it was implemented—created misunderstandings about what the Board had decided to do, and why. Moreover, those misunderstandings underlie many of the concerns expressed in the May and September Whistleblower Complaints.<sup>523</sup> In this context, in our

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<sup>519</sup> See, e.g., B. Williams, "Why Trust is Crucial When Making Organizational Change," PRIMEAST FORWARD FOCUS (2020), available at <https://www.forwardfocusinc.com/jumpstart-change/why-trust-is-crucial-when-making-organizational-change/>.

<sup>520</sup> See, e.g., S. Johnson, "How Can an Organization Overcome Employee Resistance to Change?," HOUSTON CHRON. (Dec. 6, 2020), available at <https://smallbusiness.chron.com/can-organization-overcome-employee-resistance-change-13216.html>; Paycor, "Overcoming Employee Resistance to Change in the Workplace," (Jul. 17, 2019), available at <https://www.paycor.com/resource-center/change-management-in-the-workplace-why-do-employees-resist-it> (Noting, as one of the top reasons for resistance to change, "poor communication and engagement").

<sup>521</sup> See *Duhnke 2019 Keynote*, *supra* n. 316 (emphasis supplied):

To help with this endeavor, we thought it was crucial to hear from those most impacted by the PCAOB's work. Brand new to our roles, we needed specific, thoughtful input from our stakeholders on where we should take the PCAOB to best accomplish our statutory mission. Through our strategic planning outreach, hundreds of our stakeholders weighed in on the direction we should take—including investors, audit committee members, academics, auditors, other regulators, *as well as our own employees*. We received a clear and consistent message in response: The PCAOB was ripe for change. Not incremental change, but transformational change.

<sup>522</sup> See nn. 618-622, *infra*, and accompanying text.

<sup>523</sup> See nn. 517-518, *supra*, and accompanying text.

interviews of current and past PCAOB employees, we noticed a glaring difference in attitudes and perspectives on the part of those employees who preceded the 2018 reconfiguration of the Board, and those who were hired after the new Board Members assumed their responsibilities.

Those who were hired to be agents of the new Board's program of transformational change were very enthusiastic about the things that were taking place at the PCAOB and were not aware of any of the matters that formed the gravamen of the May and September Whistleblower Complaints.<sup>524</sup> Conversely, those who predated the Board's reconfiguration were generally less upbeat about the program of transformational change, and were more likely to have an understanding of the chief concerns raised in the two whistleblower complaints—the lack of effective communication, *in advance*, of what was about to take place, and the reasons for those changes.<sup>525</sup>

### 2.7.2. Office of General Counsel

For nonprofit organizations like the PCAOB, and especially one with a quasi-regulatory mission, the role of in-house General Counsel is an indispensable one, and is certainly a critical necessity if the organization is to achieve effective operational success.<sup>526</sup> The need stems from one overarching requirement for nonprofit corporations: the fiduciary duties of their board members are tripartite—duties of loyalty and care, as is true of for-profit corporation directors, and also the duty of obedience.<sup>527</sup> As has been observed in describing the role of a nonprofit corporation's general counsel:

Sound counsel gives the [board] the courage . . . to blaze new trails . . . Well-trained lawyers can craft a position, summarize a meeting, advance a theory of the case and compose an action-forcing memorandum with ease. . . . Terrific attorneys possess clear vision: long distance, close-up and peripheral. They enjoy excellent listening skills. They acquire pertinent information rapidly and offer the [Board] . . . alternatives to consider. As such, a solid general

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<sup>524</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 6; Witness X Interview, at pp. 10-11; Witness X Interview, at p. 35.

<sup>525</sup> See, e.g., Witness X (1<sup>st</sup> Interview, at pp. 11-12; Witness X Interview, at pp. 12-13; Witness X Interview, at pp. 3-5 & 9.

<sup>526</sup> See, e.g., L. Rosenthal, *GOOD COUNSEL: MEETING THE LEGAL NEEDS OF NONPROFITS* (John Wiley & Sons, 2011), at Chap. 3, “*Advocacy and Independent Judgment: Counsel in Relation to the Chief Executive*” (“GOOD COUNSEL”).

<sup>527</sup> See nn. 155-158, *supra*, and accompanying text. See also, *GOOD COUNSEL*, *supra* n. 526.

counsel is, by turns advocate, safety net, superb advisor and excellent team member. A relationship of trust between [board] and counsel, who can provide confidential advice, act as a sounding board, and supply a wealth of good judgment while maintaining objectivity, makes the hard job of leadership a little easier.<sup>528</sup>

Several facets of the position of nonprofit corporation general counsel create the potential for inherent conflicts—in particular, the general counsel is traditionally overseen by the nonprofit’s CEO, but the key purpose of the position is to advise the *organization*, its management, and its board, concerning legal rights, obligations and privileges that relate to the nonprofit and its field of operation.<sup>529</sup> An even broader conflict inheres in the fact that nonprofit general counsel are expected to serve as “guardians of the company,” while at the same time the position has started evolving into becoming “a partner with the nonprofit’s board.”<sup>530</sup>

For the first fifteen years of its existence, the PCAOB had two General Counsel, Lewis Ferguson and Gordon Seymour.<sup>531</sup> Given the extensive involvement of the OGC in the formation and organization of the Board, that Office’s role started out rather broadly as a matter of necessity, and continued to grow over time<sup>532</sup>—the length of the service of the first two Generals Counsel, and the enormous effort of cranking up the PCAOB’s oversight of the audit profession, made it, perhaps, inevitable that, as new Chairmen and Board Members arrived at the PCAOB, they tended to defer to OGC, and effectively allowed it to assume a large role in the day-to-day operations of the PCAOB that may account for why some PCAOB employees believed that OGC was managing the work of other offices and divisions.<sup>533</sup>

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<sup>528</sup> See, e.g., GOOD COUNSEL, *supra* n. 526.

<sup>529</sup> See, e.g., ICANN, “*Position Description for General Counsel*,” (June 2003), available at <https://archive.icann.org/en/general/general-counsel-description-10jun03.pdf>.

<sup>530</sup> See, e.g., N. Price, “*The Role of the General Counsel in Governance*,” BoardEffect Blog (Mar. 9, 2018), available at <https://www.boardeffect.com/blog/role-general-counsel-governance/> (“*Role of GC in Governance*”).

<sup>531</sup> Lewis Ferguson served as General Counsel from 2003-2006. See PCAOB, “*Gordon Seymour to Succeed Lewis Ferguson as PCAOB General Counsel*,” Press Rel. (Jan. 2007). Gordon Seymour served from 2007 until 2018. See PCAOB, “*General Counsel Gordon Seymour to Leave PCAOB*,” Press Rel. (May 1, 2018), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/general-counsel-gordon-seymour-to-leave-pcaob> 661.

<sup>532</sup> See, e.g., Witness X Interview, at p. 8; Witness X Interview, at p. 14.

<sup>533</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 3-4; *cf.* Witness X Interview, at p. 20.

Given current commonly employed job descriptions for nonprofit GCs,<sup>534</sup> it has become increasingly difficult to draw a clear line between providing legal advice, on the one hand, and involvement in matters of substance and policy, on the other.<sup>535</sup> Nonetheless, it seems that, prior to 2018, OGC's role had expanded to the point that some PCAOB employees thought was inappropriate.<sup>536</sup>

These staff members believed OGC had grown unduly powerful, and that the General Counsel occasionally seemed to act more like a *de facto* Board Chief of Staff than as a legal advisor,<sup>537</sup> evidenced (in the view of these employees) by the General Counsel's and Deputy General Counsel's pursuit of personal policy preferences, as contrasted with offering legal advice.<sup>538</sup> In fact, an employee survey<sup>539</sup> reflected a sizeable body of opinion that OGC had not been operating within what was perceived as the appropriate parameters of its authority.<sup>540</sup>

In reality, of course, irrespective of what a job description for the position of corporate general counsel may say, the actual role played by a corporation's general counsel will vary, depending largely on the identity and preferences of the company's CEO to whom the GC will report and, to a somewhat lesser extent, also depending on the predilections of each company's board.<sup>541</sup> In our

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<sup>534</sup> See nn. 528-529, *supra*, and accompanying text.

<sup>535</sup> See, e.g., *Role of GC in Governance*, *supra* n. 530 (Noting the benefit in creating a job description for a nonprofit's GC "that makes them an integral part of the senior executive team"); A. Maughan, A. Boyd & A. Gillham, "The GC Disrupted: Eight Trends Redefining the Role," *The In-House Lawyer* (Summer 2018), available at <https://media2.mofo.com/documents/180709-gc-disrupted-trends-redefining-role.pdf> (Noting that the time when CEOs only consulted GCs when legal matters are involved is long over).

<sup>536</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 3-4; Witness X (1<sup>st</sup> Interview), at pp. 4-5; Witness X Interview, at p. 20.

<sup>537</sup> As noted earlier (*see* n. 315, *supra*, and accompanying text), the reference in the text is to a PCAOB Chief of Staff, not the CEO/Chairman's Chief of Staff.

<sup>538</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 3-4; Witness X (1<sup>st</sup> Interview), at pp. 4-5; Witness X Interview, at p. 20.

<sup>539</sup> See 2019 PCAOB Employee Surveys Exs. 3 & 4, *supra* n. 30, at pp. 23, 32, 44, 63, 72, and 76.

<sup>540</sup> *Id.*; and see, e.g., Witness X (1<sup>st</sup> Interview), at p. 3; Witness X (1<sup>st</sup> Interview), at pp. 4-5; Witness X Interview, at p. 20.

<sup>541</sup> See, e.g., A. Harlan, "What CEOs Want in a General Counsel," (Dec. 6, 2020), available at <https://www.barkergilmore.com/gcadvantage/what-ceos-want-in-a-gc>; L. Johnson Jr., "What CEOs Want in a GC: Five Stages in the Evolution of the Position to the Key Role it Is Today," *Corp. Counsel Bus. JI.* (Mar. 31, 2016), available at <https://ccbjournal.com/articles/what-ceos-want-gc-five-stages-evolution-position-key-role-it-today>; Assoc. of Corp. Counsel, "Role of the General

interviews, there was some speculation that, starting in 2018, the new Board was intent on “marginalizing” the General Counsel’s Office.<sup>542</sup>

That speculation—an intent to marginalize the OGC—is belied by extrinsic evidence—for example, the job description for the current GC, Kenneth Lench,<sup>543</sup> is actually more robust than the job description for his immediate predecessor, Gordon Seymour.<sup>544</sup> We found no basis for the speculation that such a mindset existed and, indeed, found that the Board collectively, as well as individually, wanted to assure itself of a robust OGC to assist the PCAOB with its commitment to transformational change.<sup>545</sup> But, as we have discussed above,<sup>546</sup> the speculation that existed was the result of less than meaningful disclosure about the new PCAOB’s approach to personnel retention and revision.

Originally at the PCAOB, the PCAOB’s Chief Ethics Officer, Barbara Hannigan, was part of the General Counsel’s Office.<sup>547</sup> In 2018, Chairman Duhnke moved this function under the Chief Risk Officer,<sup>548</sup> which made this function part of the Chairman’s Office.<sup>549</sup> As noted above,<sup>550</sup> there are conflicting views

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*Counsel,”* (2009), available at [https://www.acc.com/sites/default/files/resources/vl/membersonly/InfoPAK/700992\\_3.pdf](https://www.acc.com/sites/default/files/resources/vl/membersonly/InfoPAK/700992_3.pdf).

<sup>542</sup> See, e.g., Witness X Interview, at p. 27; Witness X Interview, at p. 2.

<sup>543</sup> See PCAOB, Job Description for General Counsel (Jul. 27, 2018), annexed as Exhibit 14.

<sup>544</sup> See PCAOB, Job Description for General Counsel (Aug. 3, 2017), annexed as Exhibit 15.

<sup>545</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 18-19; Witness X (1<sup>st</sup> Interview), at p. 33. Some on the PCAOB’s staff at that time speculated that prior Generals Counsel were unduly involved in policy matters, and the Board wanted to cut back on the OGC’s influence. See, e.g., Witness X (1<sup>st</sup> Interview), at p. 5; Witness X (1<sup>st</sup> Interview), at pp. 3-4; Witness X Interview, at p. 20.

<sup>546</sup> See nn. 519-522, *supra*, and accompanying text.

<sup>547</sup> See, e.g., Witness X Interview, at p. 2; Witness X (1<sup>st</sup> Interview), at p. 9. We were advised that Ms. Hannigan’s decision to retire from the PCAOB followed being told that her function would be placed under the Chief Risk Officer, and effectively would be made a part of the Chairman’s Office. See Witness X Interview, at p. 2; Witness X Interview, at p. 8.

<sup>548</sup> See PCAOB, Organization Chart (Nov. 30, 2020), annexed as Exhibit 16. See also, e.g., Witness X Interview, at p. 15; Witness X Interview, at p. 2; Witness X Interview, at pp. 2-3; Witness X (1<sup>st</sup> Interview), at p. 3; Witness X Interview, at p. 16.

<sup>549</sup> See Ex. 16, *supra* n. 548, at p. 2.

<sup>550</sup> See nn. 360-365, *supra*, and accompanying text.

regarding to whom the CECO should report.<sup>551</sup> While there has been some increase in the number of companies that have the CECO *report* directly to the CEO,<sup>552</sup> the most important aspect of the CECO position is the appearance, as well as the fact, of independence.

Making the CECO a third-tier official, reporting to the Chief Risk Officer, who in turn reports to the Chairman, and is surrounded by the cadre of Chairman's Office staff, could be viewed as negatively impacting the general perception held by the PCAOB's staff with respect to the CECO's independence.<sup>553</sup>

We were advised, at the outset of our interviews at the end of 2019, that the placement of the CECO within the Chairman's Office was temporary,<sup>554</sup> but more than two years have passed since that structure was adopted,<sup>555</sup> with no indication that a change is imminent. The placement of the CECO within the Chairman's office also creates palpable potential conflicts of interest whenever—as occurred with the May and September Whistleblower Complaints—there are allegations of potential misconduct on the part of the Chairman or members of the Chairman's Office. We believe the PCAOB should move the location of the Chief Ethics Officer's location, and in any event, make the CECO's termination of employment the subject of a full Board decision, similar to the treatment of the IOPA Director.<sup>556</sup>

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<sup>551</sup> See, e.g., Soc. of Corp. Compl. and Ethics & Health Care Compl. Assoc., “*Should Compliance Report to the General Counsel?*,” (2013), available at [https://assets.corporatecompliance.org/portals/1/PDF/resources/surveys/908\\_0\\_908\\_0\\_2013-compliance-gen-counsel-survey-report.pdf](https://assets.corporatecompliance.org/portals/1/PDF/resources/surveys/908_0_908_0_2013-compliance-gen-counsel-survey-report.pdf).

<sup>552</sup> See, e.g., J. Jaeger, “*More Compliance Departments Reporting Directly to the CEO*,” Compliance Week (Nov. 11, 2013), available at <https://www.complianceweek.com/more-compliance-departments-reporting-directly-to-the-ceo/3815.article>.

<sup>553</sup> See, e.g., Witness X Interview, at p. 8; Witness X (2<sup>nd</sup> Interview), at p. 17; Witness X (2<sup>nd</sup> Interview), at p. 12; Witness X (1<sup>st</sup> Interview), at p. 29.

The most important aspect of the CECO's position is independence. Having the CECO be subject to a Chief Risk Officer who, in turn, is directly responsive to the Chairman, dilutes the significance of this position, and potentially compromises the appearance, as well as the fact, of independence.

<sup>554</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 26; Witness X (2<sup>nd</sup> Interview), at pp. 9-10.

<sup>555</sup> See Ex. 16, *supra* n. 548.

<sup>556</sup> Our recommendations in this respect are set forth below. See Sections 3.1.2. & 3.1.3., *infra*.

The General Counsel's Office is currently structured to include one Deputy General Counsel, the Secretary, the PCAOB's Chief Hearing Officer,<sup>557</sup> three Senior Associate General Counsel, and an Associate General Counsel for Adjudication.<sup>558</sup> The total staff of the PCAOB's OGC (not including the PCAOB's Chief Hearing Examiner and his assistant) is currently twenty persons, of whom eighteen are attorneys.<sup>559</sup>

## 2.8. Preparations for Incoming Board Members

As noted above,<sup>560</sup> the process of onboarding new Board Members is a critical function for the PCAOB, as it is for any nonprofit corporation, and one that establishes the perspective of each new Board Member for the duration of his/her tenure on the Board.<sup>561</sup> Over the course of the past two years, we believe the process of onboarding new Board Members has improved considerably.

At the beginning of 2018, when five new Board Members took their seats, the practice appeared to be to provide incoming Board Members with a number of thick binders, each containing relevant materials from each Division.<sup>562</sup> This was the equivalent of a data dump,<sup>563</sup> and it is not surprising that, despite the considerable effort that went into producing the massive quantities of data provided to new Board Members, several Board Members who assumed their

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<sup>557</sup> The Hearing Officer (who has an assistant) reports to the General Counsel for certain limited purposes (*e.g.*, timekeeping), but is not considered to be an employee of OGC. *See* K. Lench, Email to KLS (Dec. 14, 2020).

<sup>558</sup> *See* Ex. 16, *supra* n. 548.

<sup>559</sup> *See* K. Lench, Email to KLS (Dec. 14, 2020).

<sup>560</sup> *See* n. 475, *supra*, and accompanying text.

<sup>561</sup> *See, e.g.*, Nat'l Council of Nonprofits, "*Board Orientation*" (2020), <https://www.councilofnonprofits.org/tools-resources/board-orientation>; N. Price, "*Board Leadership Onboarding Best Practices*," BoardEffect (May 29, 2019), available at <https://www.boardeffect.com/blog/board-leadership-onboarding-best-practices/> ("*Onboarding Best Practices*").

<sup>562</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 8; Witness X (1<sup>st</sup> Interview), at p. 7; Witness X (2<sup>nd</sup> Interview), at p. 14; Witness X (2<sup>nd</sup> Interview), at p. 20; Witness X (2<sup>nd</sup> Interview), at p. 6.

<sup>563</sup> *See* Cambridge Dictionary, "*Data Dump*," <https://dictionary.cambridge.org/us/dictionary/english/data-dump>, defining the term as "a large amount of data that is moved from one computer system, file, or device to another."

duties in early 2018 professed to have had no recollection of any organized onboarding process that was provided at the outset of their tenures.<sup>564</sup>

Some Board Members expressed concern for their receipt of what was described by some as the “entire library of records from the Board’s inception,” and several felt that the materials given to them during the onboarding process were overwhelming.<sup>565</sup> As a further facet of the onboarding process, each major Division or Office also meets with new Board Members to assist in bringing “them up to speed.”<sup>566</sup>

One of the main purposes of the onboarding process for nonprofit corporations is to familiarize new board members with their duties and responsibilities.<sup>567</sup> In the latest iteration of onboarding materials, the PCAOB’s staff does a much better job of identifying how the PCAOB operates, how Board Members vote, the different materials available in reference libraries for Board Members, and the work of each Division and Office. The centerpiece of this new effort is a memorandum prepared by the PCAOB’s current General Counsel, Kenneth Lench, which provides an extremely useful, twenty-seven page, “Overview of PCAOB Procedure.”<sup>568</sup> The Memorandum:

- Provides an overview of the PCAOB, its mission and its core responsibilities;
- Describes the meeting and seriatim processes through which the Board formally acts;
- Summarizes the important types of staff recommendations in each of the PCAOB’s program areas;

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<sup>564</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 8; Witness X (1<sup>st</sup> Interview), at pp. 9-10.

<sup>565</sup> See, e.g., Witness X Interview, at p. 3; Witness X (2<sup>nd</sup> Interview), at p. 6; Witness X Interview, at pp. 7-8.

<sup>566</sup> See, e.g., Witness X Interview, at p. 4; Witness X (1<sup>st</sup> Interview), at p. 8; Witness X (1<sup>st</sup> Interview), at p. 8.

<sup>567</sup> See, e.g., *Onboarding Best Practices*, *supra* n. 561:

About half of the nonprofit] board members surveyed stated that their boards had some type of onboarding process. Less than half of the directors who responded to the survey indicated that their organization’s onboarding process had properly prepared them for their board duties.

<sup>568</sup> See K. Lench, Advice Memorandum: “*Overview of PCAOB Procedure*” (Nov. 20, 2020).

- Discusses the work of the PCAOB’s Office of Economic and Risk Analysis; and
- Addresses
  - General authorizations the PCAOB has granted the staff;
  - PCAOB annual budget processes; and
  - The PCAOB’s annual report and audit process.

While this Memorandum usefully covers the procedural ground it states it will cover, it does not provide all the onboarding experience governance experts believe is crucial for a nonprofit corporation<sup>569</sup>—a discussion of the responsibilities of, expectations for, and roles of, individual Board Members other than the Chairman/CEO.<sup>570</sup> The fact that the PCAOB is subject to (and created by) S-Ox is covered exceedingly well; but the fact that the PCAOB is also governed by, and subject to, the DCNPCA is not mentioned anywhere in the Memorandum. Nor does the Memorandum discuss the so-called private inurement prohibition applicable to nonprofit, tax exempt corporations.<sup>571</sup>

There is also no discussion in the Memorandum of how individual Board Members should work collaboratively with one another, as well as with the Chairman. And finally, there is no discussion about how interactions between Board Members and the PCAOB’s staff should be structured. These topics are extremely vital to the effective governance of the PCAOB.<sup>572</sup> We acknowledge that creating a discussion of some of these governance-related topics might be difficult for a member of the staff—even for the PCAOB’s General Counsel—to write on his/her own; but that suggests that careful coordination with the

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<sup>569</sup> See nn. 567-568, *supra*, and accompanying text.

<sup>570</sup> See, e.g., Wagenmaker & Oberly, “Onboarding New Directors: Top Ten Legal Tips,” W&O Blog, (Nov. 26, 2019), <https://wagenmakerlaw.com/blog/onboarding-new-directors-top-ten-legal-tips> (Advocating that each director of a nonprofit corporation understand his/her role).

<sup>571</sup> See n. 568, *supra*, and accompanying text.

<sup>572</sup> See, e.g., SpencerStuart, “New Director Onboarding: Five Recommendations for Enhancing Your Program,” (Sept. 2018), available at <https://www.spencerstuart.com/research-and-insight/new-director-onboarding>:

Bringing a new director up to speed as quickly as possible is an imperative in today’s world of heightened expectations of corporate directors. In the past boards may have expected new directors to take a back seat and observe proceedings for a year or so before making an active contribution. Today’s boardrooms don’t have that luxury, and regardless, new directors want to contribute from day one. A thorough yet tailored onboarding process is essential for all new appointments.

Chairman and the Chairman's Chief of Staff should be the basis for the preparation of this type of memorandum. The absence of a number of critical topics from this Memorandum is unfortunate, and should be remedied.<sup>573</sup>

The PCAOB should reconsider providing each incoming Board Member with so much voluminous information in the form of hard-copy materials. We believe the organization would benefit from revamping its orientation for incoming Board Members by reducing the amount of paper materials and binders provided and, instead, limiting document production to critical documentation and consider individual presentations by Division Directors, limited to a reasonable amount of time.<sup>574</sup>

## 2.9. PCAOB Ethics and Compliance Codes

Over the last two decades, the importance of legal compliance by both profit and nonprofit corporations has grown exponentially.<sup>575</sup> This is especially the case for nonprofit corporations, given a variety of difficulties encountered by nonprofit organizations since 2000.<sup>576</sup> As we have seen, the PCAOB has itself been afflicted by serious breaches of the organization's existing code of conduct, as well as mail and wire fraud criminal statutes.<sup>577</sup>

Thus, between 2015 and 2017, KPMG employees seeking to improve the Firm's problematic inspection results<sup>578</sup> illegally obtained "valuable confidential

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<sup>573</sup> Our proposals for revising the PCAOB's current onboarding memorandum are set forth below. *See* Section 3.2.1., *infra*.

<sup>574</sup> Our recommendations for revising the PCAOB's onboarding processes are set forth below. *See* Section 3.2.1., *infra*.

<sup>575</sup> *See, e.g.*, D. Martin & P. Pohlen (eds.), CORPORATE DIRECTOR'S GUIDEBOOK, ABA Corporate Laws Comm. (7<sup>th</sup> Ed., 2020), at pp. 35 & 41; BoardSource®, "Code of Ethics," (2018), available at [https://boardsource.org/wp-content/uploads/2018/05/Code-of-Conduct-Ethics.pdf?\\_hssc=98438528.2.1608273700509&\\_hstc=98438528.cdc229b848427db1b1d66a543f6a5214.1606099700886.1607990481895.1608273700509.8&\\_hsfp=3704322953&hsCtaTracking=508c16c3-f23d-48cb-87e3-e72111881869%7Ce9e66529-f81f-4def-81c1-8973c53d66bc](https://boardsource.org/wp-content/uploads/2018/05/Code-of-Conduct-Ethics.pdf?_hssc=98438528.2.1608273700509&_hstc=98438528.cdc229b848427db1b1d66a543f6a5214.1606099700886.1607990481895.1608273700509.8&_hsfp=3704322953&hsCtaTracking=508c16c3-f23d-48cb-87e3-e72111881869%7Ce9e66529-f81f-4def-81c1-8973c53d66bc).

<sup>576</sup> *See, e.g.*, C. DiGangi, "Seven Scandals from the Nonprofit World," Yahoo! Finance, (Jan. 14, 2016), available at [https://finance.yahoo.com/news/7-scandals-nonprofit-world-120046834.html?guccounter=1&guce\\_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce\\_referrer\\_sig=AQAAAJopCcREYrOZwM4gExuQQYiolG5XvKGu60DXy9NvJwNYQTqma\\_b31d\\_ovvg\\_06srhqlEqCKiTaLMfNX9gDYJs5iwg4Kymjl7cISAnzAy7tTX5rsuil\\_K-pGelJXK\\_EJUWwp20YrGoAHC3CVkAJgkfxmgd8uU1KpTgojX3b1NIGhJy](https://finance.yahoo.com/news/7-scandals-nonprofit-world-120046834.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAJopCcREYrOZwM4gExuQQYiolG5XvKGu60DXy9NvJwNYQTqma_b31d_ovvg_06srhqlEqCKiTaLMfNX9gDYJs5iwg4Kymjl7cISAnzAy7tTX5rsuil_K-pGelJXK_EJUWwp20YrGoAHC3CVkAJgkfxmgd8uU1KpTgojX3b1NIGhJy).

<sup>577</sup> *See* n. 13, *supra*, and accompanying text (Discussing the KPMG/PCAOB criminal prosecutions).

<sup>578</sup> *Id.*, and sources cited therein.

PCAOB information concerning which KPMG audits would be inspected,<sup>579</sup> and the aspects of those audits that were of particular interests to the PCAOB staff.”<sup>580</sup> A disgruntled PCAOB employee who allegedly had been passed over for promotion offered KPMG employees confidential PCAOB information—namely the final 2017 inspections list—in exchange for assistance in gaining employment at KPMG.<sup>581</sup> Both the KPMG and PCAOB employees were convicted of conspiracy to commit wire fraud and related charges.<sup>582</sup> This breach of bedrock ethical requirements demonstrated a need for the PCAOB to improve its restrictions of access to, and monitor the dissemination of, critical confidential information.<sup>583</sup>

The KPMG matter demonstrated a lack of sufficient controls and internal oversight at the PCAOB, during the 2015-2017 time period.<sup>584</sup> During our review, we were advised of enhancements that have been made to strengthen the restrictions that prevent inappropriate access to the list of issuer audits, and the contemplated areas subject to particular focus by the PCAOB’s examiners.<sup>585</sup> In addition, the PCAOB now archives audit files before any access can be obtained to these sensitive data points.<sup>586</sup>

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<sup>579</sup> *Id.*

<sup>580</sup> See DOJ, *Former KPMG Executive and Former PCAOB Employee Convicted of Wire Fraud for Scheme to Steal and Use Confidential PCAOB Information* Press Rel. (Mar. 11, 2019), available at <https://www.justice.gov/usao-sdny/pr/former-kpmg-executive-and-former-pcaob-employee-convicted-wire-fraud-scheme-steal-and>.

<sup>581</sup> *Id.*

<sup>582</sup> *Id.*

<sup>583</sup> See, e.g., Witness X Interview, at p. 18; Witness X Interview, at pp. 8-9.

<sup>584</sup> See, e.g., Witness X Interview, at p. 22; Witness X Interview, at p. 10.

<sup>585</sup> See, e.g., Witness X Interview, at p. 18; Witness X Interview, at pp. 8-9. There have been both practical and technological solutions to strengthen the safeguards in place that prevent inappropriate access to the list of issuer audits. These efforts include revisions to who has access to the full list of issuers, ensuring audit files are archived before they are accessed, and the implementation of a data loss prevention system called Digital Guardian that allows documents to be classified and tagged with a digital record leaving a trail of anywhere the file goes. Further the OIT has the ability to investigate irregular activity and a security incident response plan has been developed for responding to instances implicating security vulnerabilities. See, e.g., Witness X Interview, at pp. 6-8.

<sup>586</sup> See, e.g., Witness X Interview, at p. 18; Witness X Interview, at p. 9. Archiving represents a crucial tool to prevent data loss. A repository of archived documents guards against accidental or malicious deletion or modification of those documents. Securely archived data removes documents from general circulation and allows senior staff to know when documents have been accessed or altered. See, e.g., Secure Data Management, Blog: “*What is Archiving and Why is it Important,*” (Mar. 23, 2015), <https://www.securedatamgt.com/blog/what-is-archiving/>; and see,

Perhaps one of the main changes made by the current Board was the retention of a CECO, Elizabeth Horton,<sup>587</sup> who was tasked with upgrading and updating the PCAOB’s Code of Ethics.<sup>588</sup> This was a salutary effort, and one that was essential. To date, however, progress on the effort to upgrade and update the existing Code of Ethics has been slow—both in absolute terms and in terms of the time elapsed since the KPMG misconduct—the KPMG misconduct that had occurred from 2015-2017 was the subject of a public announcement in January 2018.<sup>589</sup> Ms. Horton first began work at the PCAOB in May 2019, nearly two years after the KPMG events had already transpired,<sup>590</sup> and more than one year after KPMG’s conduct was first publicly revealed.<sup>591</sup>

In any event, after the passage of nineteen months—or almost another two years—as we begin 2021, the Board has not yet formally taken up Ms. Horton’s draft of a new Code of Conduct or her draft of an Amended Ethics Code, and the Board will not do so until February 1, 2021.<sup>592</sup> Given the seriousness of the

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Cloudian, Blog: “*Data Archives and Why You Need Them*,” (2020), available at <https://cloudian.com/guides/data-backup/data-archive/>.

<sup>587</sup> Despite the critical importance of this position, especially in light of the KPMG problems, Ms. Horton was not hired until almost eighteen months after the new Board Members had assumed their roles. In addition, the PCAOB did not issue a press release when Ms. Horton was hired, the way it does for so many other positions. See PCAOB Website, “*Press Releases*,” <https://pcaobus.org/search?keyword=press%20releases&searchWithin=2019&indexName=pcaob.20201216.221915.all-data-types>. This is unfortunate, since it implicitly denigrates the importance of this position. More explicit as an indication of limited importance for the role is the fact that the PCAOB’s website lists the organization’s senior staff, but does not include any entry for the position of CECO within that category. See PCAOB Website, “*Senior Staff*,” <https://pcaobus.org/about/senior-staff>.

<sup>588</sup> See, e.g., Witness X Interview, at p. 3; Witness X (2<sup>nd</sup> Interview), at p. 13; Witness X (2<sup>nd</sup> Interview), at p. 20.

<sup>589</sup> See, U.S. Atty’s Off. S.D.N.Y., “*Five Former KPMG Executives and PCAOB Employees Charged in Manhattan Federal Court for Fraudulent Scheme to Steal Valuable and Confidential PCAOB Information and Use that Information to Fraudulently Improve KPMG Inspection Results*,” Press Rel. (Jan. 23, 2018), available at <https://www.justice.gov/usao-sdny/pr/5-former-kpmg-executives-and-pcaob-employees-charged-manhattan-federal-court-fraudulent>.

<sup>590</sup> Ms. Horton’s predecessor, Barbara Hannigan, “voluntarily” retired from the PCAOB in early 2018. See nn. 91 & 547, *supra*, and accompanying text.

<sup>591</sup> See *supra*, n. 587. Of course, the Board presumably was well aware of the difficulties involving KPMG long before the events in question became a matter of public record.

<sup>592</sup> See E. Horton, Email to H. Pitt (Jan. 6, 2021) (Noting that the proposed changes were sent to the Board on December 1, 2020, and time has been scheduled during a Board Working Hours meeting “at the first of February”); see also, KLS, Notes of Zoom Video Conference with E. Horton (Nov. 30, 2020) (Indicating that, with the PCAOB closed for the last two weeks of December, Ms. Horton did not anticipate receiving comments back from Board Members until the first few weeks

misconduct involving KPMG and certain of the PCAOB's former employees, this slow pace of progress in addressing the organization's need for revised ethics and new compliance codes is troublesome.

Some of the lack of progress can be attributed to the fact that, for most of her tenure at the PCAOB, Ms. Horton had no assistants assigned to her on a full-time (or even a part-time) basis.<sup>593</sup> Even now, we understand that she only has a single individual assisting her in her efforts to produce a new Compliance Code and a revised Ethics Code.<sup>594</sup> Additional delays are likely attributable to the fact that no time frames were established for the completion of these important projects.<sup>595</sup>

We believe the Board should treat the process of amending the PCAOB's ethics code and creating a new code of conduct as far more important than it has done to date, and assign clear priority to completing these efforts as soon as possible. In addition, we believe that the CECO should undertake a formal review of the codes no less frequently than once a year,<sup>596</sup> and that the Board should assign additional personnel to work with Ms. Horton on a permanent basis, to ensure that delays of the sort currently being experienced do not continue and are not repeated.<sup>597</sup>

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of January); *see also*, E. Horton, Email to N. Rodriguez, "Follow up—Code of Ethics," (Nov. 23, 2020). It is noteworthy that the Draft Advice Memorandum prepared by Ms. Horton affirmatively states that expedited review is *not* required.

<sup>593</sup> *See, e.g.*, Witness X Interview, at p. 3.

<sup>594</sup> *See* KLS, Notes of Zoom Video Conference with E. Horton (Nov. 30, 2020), at p. 6.

<sup>595</sup> *See, e.g.*, L. Soard, "What Are the Benefits of Deadlines for Projects?," HOUSTON CHRON. (Dec. 17, 2020), available at <https://smallbusiness.chron.com/benefits-deadlines-projects-44815.html>.

Each of the changes mandated by the Board's program of transformational change were tracked for progress and status, and the PCAOB retained project facilitators to assist those who were assigned the responsibility of completing each of the changes. In stark contrast, nothing similar was implemented with respect to the need for a new code of conduct and new ethics rules. *See, e.g.*, Witness X Interview, at p. 13.

<sup>596</sup> With the exception of a minor amendment to the PCAOB's Ethics Code to reflect the grant of additional authority to oversee the audits of registered securities broker-dealers, the Ethics Code has not been amended in the seventeen years since it was first drafted. *See* E. Horton, *Draft Revised Ethics Rules and Standards of Conduct* (Nov. 19, 2020) ("Draft Revised Ethics Rules"), at p. 2.

<sup>597</sup> Our recommendations in this regard are set forth below. *See* Section 3.1.4., *infra*.

An additional—and more worrisome—reason for the delay in progress on revisions to the PCAOB’s Ethics Code has stemmed from Ms. Horton’s concern that S-Ox’s requirement—that PCAOB Ethics Code provisions are rules of the organization—which means that they carry with them potential civil and criminal penalties, may be unconstitutionally broad.<sup>598</sup> Thus, Ms. Horton has concerns that certain of the PCAOB’s ethics rules—specifically, “certain subjective and appearance-related concerns”—use “overly broad subjective language,” and, along with “specific rules related to gifts and misuse of position,” do not, and should not, “rise to the level of civil or criminal enforcement.”<sup>599</sup>

We understand Ms. Horton’s concerns, but disagree with aspects of this revision predicated on those assumptions, and their unintended potential consequence of *weakening* the force, impact and enforceability of PCAOB ethical standards.<sup>600</sup> Thus, there is no doubt that “appearance-related concerns,” identified by Ms. Horton as rules not worthy of criminal or civil enforcement, have for decades been, and should be, the basis for disciplinary action of both a civil and criminal nature.<sup>601</sup> Indeed, the very provisions that Ms. Horton’s proposed revision would relegate to second-tier status—in her words, “the appearance standards, overly broad subjective language, and specific rules related to gifts and misuse of position”<sup>602</sup>—are the subject of legally enforceable prohibitions of

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<sup>598</sup> See *Draft Revised Ethics Rules*, *supra* n. 596, at App. A, pp. 4-5, and see S-Ox §§101(g)(3) & §3(b)(1), 15 U.S.C. §7211(g)(3) & 15 U.S.C. §7202(b)(3).

<sup>599</sup> *Draft Revised Ethics Rules*, *supra* n. 596, at App. A, p. 5.

<sup>600</sup> By publicly declaring that there are provisions of ethical standards that are not subject to formal enforcement mechanisms, the PCAOB would—no doubt inadvertently—encourage its employees to believe that those standards are viewed as being of lesser importance than those standards that are formally “rules of the PCAOB.”

<sup>601</sup> See, e.g., N. Moore, “*Is the Appearance of Impropriety an Appropriate Standard for Disciplining Judges in the Twenty-First Century?*,” 41 LOYOLA UNIV. CHICAGO L. J. 285 (2010), available at [https://www.luc.edu/media/lucedu/law/students/publications/llj/pdfs/moore\\_appearance.pdf](https://www.luc.edu/media/lucedu/law/students/publications/llj/pdfs/moore_appearance.pdf); and see, C. Wolfram, MODERN LEGAL ETHICS 67, 86 & n. 48 (“Most attacks . . . charging that they are void for vagueness in violation of the due process clause have been unavailing”); N. Birdsong, “*Ethics and Public Corruption Laws: Penalties*,” NAT’L CONF. OF STATE LEGIS. (Sept. 8, 2020), available at <https://www.ncsl.org/research/ethics/50-state-chart-criminal-penalties-for-public-corr.aspx> (Listing the statutory provisions of all fifty states using “appearance” and other similar standards for both civil and criminal penalties, and noting the existence of a large number of additional regulatory provisions covering the same ground).

<sup>602</sup> *Draft Revised Ethics Rules*, *supra* n. 596, at App. A, p. 5.

the SEC and the Office of Government Ethics, as well as the overwhelming majority of for-profit and nonprofit corporations.<sup>603</sup>

Of course, even if there is a legitimate question whether each of the PCAOB's rules would be enforced criminally and/or civilly, that is virtually irrelevant given the purpose of ethical codes of conduct, and in any event the problem can be readily handled in two ways—by the administration of penalties for violations of the rules, and contractually.

First, the purpose of codes of ethics and conduct is to state the principles and moral values of an organization.<sup>604</sup> The main purpose of codes is to provide guidance to those employees who want to do the right thing (or to create an *in terrorem* effect for those who might otherwise not be inclined to do the right thing).<sup>605</sup> Creating (or maintaining) a two-tiered structure of ethical principles, perforce, relegates those relegated to the second tier more to observance in the breach.<sup>606</sup>

In essence, no code of ethics can prevent those employees determined to engage in misconduct from doing so<sup>607</sup>—therefore, the enforceability of a particular provision of a code of ethics is not the paramount concern in drafting a code of ethics; rather, the focus should be on getting the organization's principles set forth, directly, and making it known to employees that *any* violation of the code

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<sup>603</sup> See, e.g., 5 C.F.R. §§4401.101-103 (2020) (SEC supplemental rules); 5 C.F.R. §§2635.101-2635.902 (2020) (Federal Gov't rules).

<sup>604</sup> See, e.g., A. Laj, "How to Enforce a Code of Ethics," CAREER TREND (Dec. 19, 2018), available at <https://careertrend.com/how-6458362-enforce-code-ethics.html>.

<sup>605</sup> See, e.g., Int'l Fed. of Accountants, "Defining and Developing an Effective Code of Conduct for Organizations," (June 2007), available at [https://www.ifac.org/system/files/publications/files/Defining-and-Developing-an-Effective-Code-of-Conduct-for-Orgs\\_0.pdf](https://www.ifac.org/system/files/publications/files/Defining-and-Developing-an-Effective-Code-of-Conduct-for-Orgs_0.pdf) ("Defining and Developing").

<sup>606</sup> See, e.g., H. Smith, "Two-Tier Moral Codes," 7 SOCIAL PHILOSOPHY & POLICY 112 (1989), available at [http://fas-philosophy.rutgers.edu/hsmith/Papers/Two-Tier\\_Moral\\_Codes.pdf](http://fas-philosophy.rutgers.edu/hsmith/Papers/Two-Tier_Moral_Codes.pdf); W. Mahan, "How to Define Ethical Behavior & Why It's Important in the Workplace," WORK INSTITUTE (Oct. 17, 2019), available at <https://workinstitute.com/how-to-define-ethical-behavior-why-its-important-in-the-workplace-2/>; S. Mintz, "The Purpose of a Code of Ethics," ETHICS SAGE (Dec. 14, 2016), available at <https://www.ethicssage.com/2016/12/the-purpose-of-a-code-of-ethics.html>.

<sup>607</sup> See, e.g., G. Hamel, "Can a Corporate Code of Ethics Influence Behavior?," HOUSTON CHRON., available at <https://smallbusiness.chron.com/keep-positive-integrity-workplace-15990.html> (Noting that a "corporate code of ethics cannot prevent unethical behavior, but it can have an impact on employee decisions").

will have consequences, up to and including loss of job, and/or referral to legal authorities.<sup>608</sup>

Second, the PCAOB can solve the problem of sanctions for violations by providing that the specific response to violations will be determined based on the nature of the violation and the circumstances under which it occurred. Alternatively, the PCAOB can condition its offer of employment, and/or the right to maintain employment, on a contractual agreement by each prospective (and continuing) employee to be bound by any and all the organization’s ethics standards, accompanied by a formal waiver of any objection to the enforceability of those provisions.<sup>609</sup> “A properly framed code is, in effect, a form of legislation with [an organization] binding on its employees, with specific sanctions for violation of the code.”<sup>610</sup>

In any event, the proposed creation of two separate documents setting forth employee obligations is likely to create problems down the road for the PCAOB—it is always preferable to house employee ethical standards in a single document, to ensure that employees have only one place to look in determining what is expected of them:

It is rare to find businesses that have two separate policies . . . employees will have less difficulty recalling important points around conduct and ethics if they have a single document to refer to.<sup>611</sup>

We believe the PCAOB should rethink its current draft’s approach to the revision of its existing Code of Ethics.<sup>612</sup>

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<sup>608</sup> See, e.g., *Defining and Developing*, *supra* n. 605.

<sup>609</sup> This is not a new concept. See, e.g., Dell Technologies, “*How We Win: Dell Technologies Code of Conduct*” (2017), available at <https://www.delltechnologies.com/content/dam/delltechnologies/assets/whoweare/resources/Dell%20Technologies%20Code%20of%20Conduct%20-%20English.pdf>; WebsitePolicies, “*How to Write Code of Conduct and Code of Ethics*,” (Sept. 9, 2020), available at <https://www.websitepolicies.com/blog/code-of-conduct-ethics>; K. Biason, “*Is a “Code of Conduct” Legally Binding*,” LegalVision®, (Aug. 20, 2018), available at <https://legalvision.com.au/is-a-code-of-conduct-legally-binding/>; A. Brien, “*Regulating Virtue: Formulating, Engendering and Enforcing Corporate Ethical Codes*,” 15 BUS. & PROF. ETHICS JL. 21 (1996).

<sup>610</sup> See, e.g., Inc., “*Code of Ethics*,” (Feb. 6, 2020), available at <https://www.inc.com/encyclopedial/code-of-ethics.html>.

<sup>611</sup> See Betterteam, “*Code of Ethics and Professional Conduct*,” (Jul. 6, 2020), available at <https://www.betterteam.com/code-of-ethics-and-professional-conduct>.

<sup>612</sup> Our recommendations in this regard are set forth below. See Section 3.1.5., *infra*.

## 2.10. Assessing the PCAOB Staff's Commitment to Transformational Change

As previously noted, following their arrival at the PCAOB, in early 2018, the five new Board Members collectively agreed that they would undertake to determine which senior staff members were likely to be amenable to a thorough revamp of the organization's structure and established way of conducting business, and those who did not appear to be so amenable.<sup>613</sup> The ostensible purpose of this effort was to assess which, if any, members of the PCAOB's senior staff would fully embrace a new culture of transformational change that the Board intended to create.<sup>614</sup>

We were advised that the new Board Members had discussions with various members of the SEC staff about assessing the PCAOB's senior staff,<sup>615</sup> and it was understood that those who were perceived by the new Board as being too wed to the "old way of doing things," or who did not appear to have the skills to adapt, would be transitioned out of the organization.<sup>616</sup> Given the events that had preceded the naming of a completely new Board,<sup>617</sup> these efforts were both necessary and appropriate.

What was neither necessary nor appropriate—from a governance standpoint—however, was the manner in which these efforts were undertaken and executed. Looked at from the perspective of the PCAOB's staff, the only thing the PCAOB's staff understood was that, over a span of a few weeks in 2018, seven

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<sup>613</sup> See nn. 23-26, *supra*, and accompanying text.

<sup>614</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 32-33; Witness X (1<sup>st</sup> Interview), at pp. 5, 11; Witness X (1<sup>st</sup> Interview), at p. 7.

One of the problems inherent in the Board's failure to advise PCAOB staff in advance of the nature and reasons for making these changes in senior staff is that explanations provided after-the-fact do little to allay the cynicism with which these efforts (and their justifications) were viewed by the PCAOB staff. See, e.g., Witness X Interview, at pp. 3-4; Witness X Interview, at p. 2; Witness X Interview, at pp. 12-13. This reaction is both common, and predictable. See, e.g., M. Galbraith, "Don't Just Tell Employees Organizational Changes Are Coming—Explain Why," *Harv. Bus. Rev.* (Oct. 5, 2018), available at <https://hbr.org/2018/10/dont-just-tell-employees-organizational-changes-are-coming-explain-why> ("Explain Coming Organizational Changes").

<sup>615</sup> See, e.g., Witness X Interview, at p. 14.

<sup>616</sup> See, e.g., Witness X Interview, at p. 4; Witness X Interview, at p. 14; Witness X (1<sup>st</sup> Interview), at p. 7; Witness X (1<sup>st</sup> Interview), at p. 5.

<sup>617</sup> See nn. 578-584, *supra*, and accompanying text.

senior PCAOB officials were either asked to leave, or voluntarily retired. The reasons for these departures were never explained to the PCAOB's staff, nor did the organization's staff know whether or when the last shoe, so to speak, had dropped.<sup>618</sup> This created a culture of fear (and perhaps exacerbated an existing culture of fear).<sup>619</sup>

Surveys show that many employees do not understand why significant changes are happening, and that can be detrimental to any organization trying to implement significant, or transformational, change.<sup>620</sup> When employees do not understand why changes are happening, and the parameters of those changes, that can often prove a barrier to driving ownership and commitment, and may even result in resistance to the proposed changes.<sup>621</sup> There are at least four key aspects to helping employees understand structural change:

- Inspire employees by presenting a compelling vision for the future;
- Keep employees informed and up to date by providing regular communications;
- Empower leaders and managers to lead through change; and
- Find creative ways to involve employees in the change.<sup>622</sup>

From our review, it does not appear that the Board pursued any of these efforts, much less all four. In large measure, these events were carried out by the Board unaccompanied by any type of notice or explanation to the PCAOB's employees.

Moreover, as we discussed earlier,<sup>623</sup> the new Board Members were not focused on recordkeeping, despite their duty to do so in many cases, and the benefits of doing so in others. Thus, the Board did not create any standards in

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<sup>618</sup> There would have been a clear downside to articulating concerns about individual employees to the entire PCAOB staff population, and that is not something we are suggesting should have occurred. But, the Board could have alerted the entire PCAOB staff—at the outset of its review of who should stay and who should leave—that, it was determined to institute a program of transformational change and, concomitantly, it would ask some members of the PCAOB's senior staff to depart to provide a fresh burst of enthusiasm for the difficulties associated with transformational change.

<sup>619</sup> See, e.g., Witness X Interview, at p. 28; Witness X Interview, at p. 11; Witness X Interview, at p. 2.

<sup>620</sup> See, e.g., *Explain Coming Organizational Changes*, *supra* n. 614.

<sup>621</sup> *Id.*

<sup>622</sup> *Id.*

<sup>623</sup> See nn. 376-382, *supra*, and accompanying text.

advance for assessing whether existing PCAOB senior staff were likely to be whole-heartedly supportive of the transformational change they were proposing. And yet, it is impossible to determine with any precision, or fairly, whether someone is committed to transformational change unless they are collectively solicited by the Board and there is an understood metric to be applied in determining how the Board would make those assessments.<sup>624</sup>

Similarly, although we were advised that a consensus was reached by the Board on the senior staff members who should leave,<sup>625</sup> there are no records reflecting any of the discussions that presumably were had. Nor are there any records of the positions of the various Board Members with respect to each of the senior staff members who wound up leaving, and the rationale for each decision.

In ordinary circumstances, this lack of metrics, and a lack of recordkeeping, could render an organization potentially liable for employment claims that suggest that the discharges were predicated upon impermissible bases, even if the employees are “at-will” employees.<sup>626</sup> This may be the reason that separation agreements by the Board in 2018-2019 invariably provided for the payment of exceedingly large severance payouts (approximately 50%, or six months’ worth, of each senior staff member’s annual compensation).<sup>627</sup>

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<sup>624</sup> See, e.g., R. Vance, “*Employee Engagement and Commitment: A Guide to Understanding, Measuring and Increasing Engagement in your Organization*,” SHRM Found. (2006), at pp. 6-7, available at <https://www.shrm.org/hr-today/trends-and-forecasting/special-reports-and-expert-views/Documents/Employee-Engagement-Commitment.pdf>.

<sup>625</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 13; Witness X (1<sup>st</sup> Interview), at pp. 11-13; Witness X (1<sup>st</sup> Interview), at p. 10; Witness X Interview, at pp. 10-14.

<sup>626</sup> We were told that the Board took solace from the fact that each of the employees involved was an “at-will” employee, commonly understood to mean that an employer can terminate the employee at any time for any reason, *except an illegal one*, or for no reason at all, without incurring legal liability. See, e.g., Witness X (1<sup>st</sup> Interview), at p. 13; Witness X (1<sup>st</sup> Interview), at p. 10; see also, e.g., Nat’l Conf. of State Legis., “*At-Will Employment—Overview*” (Apr. 15, 2008), available at <https://www.ncsl.org/research/labor-and-employment/at-will-employment-overview.aspx>.

<sup>627</sup> As we have discussed earlier (*see* nn. 325-330, *supra*, and accompanying text), there is an obligation on the PCAOB, as a tax-exempt nonprofit organization, to avoid running afoul of prohibitions against the private inurement of any of its employees. This issue is discussed further below, *see* nn. 654-662, *infra*, and accompanying text.

For present purposes, it is enough to note that the agreement to pay an exceedingly large severance amount to departing employees in return for a complete release—as occurred with the PCAOB’s termination of the employment of senior staff in 2018 and 2019—does not mean that the arrangements cannot be subsequently questioned, not just by the IRS in the case of a nonprofit organization, but by employees who signed the release and took the money! See, e.g., D. Merley, “*Court Says Employee Who Signed Severance Agreement Can Still Sue . . . and Keep the Money*,” FELHABER LARSON EMPL. LAW RPT. (Aug. 30, 2018), available at

Another rationale for the significant changes made in the PCAOB's cadre of senior staff officials in 2018 was the difficulty that had arisen in relationships between the prior Board and the SEC Staff.<sup>628</sup> By 2017, there were increasing tensions between the PCAOB staff and the Staff of the SEC,<sup>629</sup> and some feeling that the PCAOB Board Members and the PCAOB's staff were not always as forthcoming as they should have been with the SEC's Staff about various projects, or the direction certain issues were taking at the PCAOB.<sup>630</sup> Given the respective positions of both entities, it was logical to assume that the Board, and the PCAOB's staff, operating under the direction of the Board's Chairman, would be fully forthcoming about ongoing projects and issues.<sup>631</sup> With the advent of a new Board in 2018, the new Board Members saw this as an opportunity to improve the information flow between the PCAOB and the SEC staff, and that also militated in favor of bringing in new PCAOB senior staff members.<sup>632</sup>

Moreover, the new Board Members each understood that one principal objective underlying the appointment of an entirely new Board at the end of 2017 was to assist the PCAOB in achieving consensus among its Board Members and ensuring collaboration—both among the new Board Members, and between the PCAOB and the SEC Staff.<sup>633</sup> The new Board and the SEC Staff sought to establish—from the outset of the tenure of the new Board Members—that the two organizations would work collaboratively.<sup>634</sup>

This resulted in convening regular meetings at the PCAOB between the SEC Staff and the PCAOB's staff commencing in January 2018, as part of a conscious decision to demonstrate vividly the SEC Staff's involvement in the PCAOB's efforts, and the new sense of cooperation and collaboration between

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<https://www.felhaber.com/court-says-employee-who-signed-severance-agreement-can-still-sue-and-keep-the-money/>.

<sup>628</sup> See, e.g., Witness X Interview, at pp. 14-15. See also, nn. 5-14, *supra*, and accompanying text.

<sup>629</sup> *Id.*

<sup>630</sup> See, e.g., Witness X Interview, at p. 5.

<sup>631</sup> See *Free Enterprise Fund*, *supra* n. 62.

<sup>632</sup> See, e.g., Witness X Interview, at p. 4.

<sup>633</sup> See, e.g., Witness X Interview, at p. 13; see also, *supra* nn. 17-18, and accompanying text.

<sup>634</sup> See, e.g., Witness X Interview, at p. 14.

them.<sup>635</sup> Prior to the new Board's induction, the PCAOB's senior staff that held over had worked at the PCAOB for many years, and were perceived by some on the SEC's Staff as set in their ways when it came to interacting with the SEC Staff.<sup>636</sup> There was a sense communicated by some on the SEC's Staff to the new Board Members that the pattern of interactions on the part of these PCAOB senior staff members with the SEC and its Staff would not be easily changed or enhanced.<sup>637</sup>

## 2.11. Terminations of, and Severance Agreements for, Certain PCAOB Senior Staff Members in 2018

As previously discussed, in 2018, (b)(6)

.<sup>638</sup> From the outset of the Board's existence in 2003, there has never been a defined and formally articulated severance policy.<sup>639</sup> But, prior to 2018, there had been a process that was seemingly followed consistently, when it was thought appropriate to have an employee's job tenure terminated.<sup>640</sup>

Thus, in most cases prior to 2018, departing employees were offered severance payments in exchange for a complete release.<sup>641</sup> Severance payments typically amounted to the equivalent of two weeks of pay, plus the equivalent of one additional week of pay for each year that an individual had been employed at the PCAOB.<sup>642</sup> Typically, severance payments prior to 2018 ranged between payments equivalent to six-to-eight-weeks of salary.<sup>643</sup> During the dismissal and

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<sup>635</sup> See, e.g., Witness X Interview, at p. 14; Witness X (2<sup>nd</sup> Interview), at p. 8; Witness X (2<sup>nd</sup> Interview), at p. 16.

<sup>636</sup> See, e.g., Witness X Interview, at pp. 14-15.

<sup>637</sup> *Id.*

<sup>638</sup> See n. 26, *supra*, and accompanying text. For the reasons previously stated (*see* n. 23, *supra*, and accompanying text), (b)(6)

<sup>639</sup> See, e.g., Witness X Interview, at p. 10; Witness X Interview, at p. 30; Witness X Interview, at pp. 24-25.

<sup>640</sup> See, e.g., Witness X Interview, at pp. 3-4; Witness X (1<sup>st</sup> Interview), at pp. 4-5; Witness X Interview, at pp. 4-5.

<sup>641</sup> See, e.g., Witness X Interview, at p. 10; Witness X Interview, at p. 6.

<sup>642</sup> See, e.g., Witness X Interview, at p. 9. Severance amounts might be higher or lower, depending on an assessment of potential Board liability in individual circumstances. *Id.* See *also*, Witness X Interview, at p. 11.

<sup>643</sup> See, e.g., Witness X Interview, at p. 11.

severance process utilized in the pre-2018 period, inside counsel worked closely with outside counsel during negotiations, to lower the potential risk of litigation.<sup>644</sup>

Pursuant to this process, the PCAOB's Chairman typically did not initiate the process;<sup>645</sup> rather, it historically originated with senior staff.<sup>646</sup> Requests for action to terminate a specific employee usually were initiated in the Office or Division where the employee who might be terminated worked, and would first go to the PCAOB's HR officer.<sup>647</sup> HR would discuss the request with the initiating Office or Division, and appropriate documentation would be prepared, collecting information and employee records.<sup>648</sup>

At that juncture, a written memorandum would be prepared, setting forth the proposed action, the reasons therefor, and HR's assessment of the proposed action,<sup>649</sup> and that memorandum would then be sent to OGC for discussion.<sup>650</sup> If necessary, OGC might request additional information,<sup>651</sup> and then OGC would send the termination request and memorandum to the Chairman with its recommendation.<sup>652</sup> The Chairman might then ask additional questions before ultimately deciding whether to approve the termination.<sup>653</sup>

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<sup>644</sup> *Id.*, at p. 10; Witness X Interview, at pp. 4-5.

<sup>645</sup> The fact that Board Chairmen typically did not initiate the process of job terminations prior to 2018 is not surprising, and our reference to that fact is not intended to suggest any questions or concerns about that aspect of the 2018 series of senior PCAOB staff job terminations. In the normal case, an employee usually becomes the subject of job termination consideration due to performance or fact-specific issues, and those most logically are raised by the employee's direct supervisors. In 2018, as we have seen, the Board, acting *qua* Board, decided—as a matter of policy and strategy—to replace existing senior staff members who the Board felt might not be wholly enthusiastic about changing the way the PCAOB went about the task of fulfilling its important mission. Given their purpose, those job terminations logically had to emanate from the Board and, in particular, the Chairman.

<sup>646</sup> *See, e.g.*, Witness X Interview, at p. 3; Witness X (1<sup>st</sup> Interview), at p. 5.

<sup>647</sup> *Id.*

<sup>648</sup> *See, e.g.*, Witness X Interview, at p. 3.

<sup>649</sup> *Id.*

<sup>650</sup> *See, e.g.*, Witness X Interview, at p. 3; Witness X (1<sup>st</sup> Interview), at p. 5.

<sup>651</sup> *See, e.g.*, Witness X Interview, at p. 3.

<sup>652</sup> *See, e.g.*, Witness X Interview, at p. 3; Witness X (1<sup>st</sup> Interview), at p. 5.

<sup>653</sup> *Id.*

When employees of a nonprofit organization depart, the question of whether severance payments can be made a part of the termination of individual employment status, is a frequent topic of consideration.<sup>654</sup> Severance payments can be made to departing employees, unless they constitute the grant of private inurement—in other words, an improper private benefit.<sup>655</sup> Tax-exempt public charities are legally prohibited from allowing anyone to receive financial benefits from the organization’s resources except through either

- A *quid pro quo* arrangement (for example, reasonable wages paid for work performed);<sup>656</sup> or
- Other payments in furtherance of the organization’s tax-exempt status.<sup>657</sup>

The operative question for a nonprofit, in light of its privileged tax-exempt status, is whether the severance pay proposed (or paid) is an *objectively* reasonable use of its nonprofit assets.<sup>658</sup> The answer depends on the nonprofit’s *due diligence* evaluation of a variety of factors, including

- Longevity of employment;
- Quality of his/her service;
- Reasons for the termination;
- Risk management considerations;
- Absence of available unemployment benefits; and
- Comparable practices among other organizations.<sup>659</sup>

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<sup>654</sup> See, e.g., Wagenmaker & Oberly, “Severance Pay for Employees of Nonprofit Organizations,” p. 1 (Jan. 31, 2017), available at [http://www.ecfa.org/Documents/SeverancePay\\_WagenmakerOberly\\_NP.pdf](http://www.ecfa.org/Documents/SeverancePay_WagenmakerOberly_NP.pdf) (“Severance Pay for Nonprofit Employees”) (“Severance pay should be considered whenever an employee is laid off, terminated . . . or resigns from employment”).

<sup>655</sup> See, e.g., *Severance Pay for Nonprofit Employees*, *supra* n. 654, at p. 3.

<sup>656</sup> For purposes of the IRS, severance pay would qualify as a *quid pro quo* arrangement if it is paid for the employee’s prior work for the organization. See, e.g., *Severance Pay for Nonprofit Employees*, *supra* n. 654, at p. 3. Severance pay cannot be justified as a gift, benevolence, or assistance. *Id.*, at p. 2.

<sup>657</sup> *Id.*, at p. 2.

<sup>658</sup> *Id.*, at p. 3.

<sup>659</sup> One of the best forms of due diligence is to examine what other organizations have done. The website known as GuideStar.org contains the IRS Form 990 filings made by most tax-exempt nonprofit organizations. See <https://www.guidestar.org/profile/74-3073065>. Notably, with respect to the PCAOB, the GuideStar website states:

As a general proposition, there should be a case-by-case analysis of whether to provide severance pay (and how much should be paid) to specific employees.<sup>660</sup> That analysis should include, among other things, the following types of considerations, with a record created of the actual consideration of each of these aspects of the question:

- The circumstances of the employment termination;
- Whether it is likely the terminated employee might later cause problems for the organization, perhaps by disparaging statements, or disclosing confidential information;
- Whether the employee's cooperation may be needed in the future, such as to maintain confidentiality, surrender passwords, complete a long-term project, or assist in internal reviews;
- Whether any valuable personal property needs to be returned by the employee, such as a computer;
- The likelihood that the employee might later assert contract, tort, or other claims against the organization;
- Whether the employee falls within one or more legally protected classifications, such as age (over forty), race, national origin, disability, or religion; and
- The possibility of a retaliation claim may exist under discrimination, whistleblower, or other work-related laws.<sup>661</sup>

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This organization is not required to file an annual return with the IRS because it is an arm of a state or local government.

That statement, of course, is contradicted by the plain language of S-Ox. It appears that this statement originated with GuideStar.org. *See* IRS, Letter to C. Smith (PCAOB) (Nov. 8, 2016) (Confirming a determination made in March 2004 that the PCAOB is not required to file IRS Form 990 because of its status under S-Ox as a statutorily-created nonprofit corporation). Nonetheless, the published information is erroneous, and the PCAOB should correct this statement. *See* Section 3.6.9., *infra*.

In any event, we have confirmed that the PCAOB is not required to, and does not, file an annual Form 990 with the IRS. *See* K. Lench, Email to H. Pitt re PCAOB IRS Filings (Dec. 23, 2020); *and see* E. Horton, Email to H. Pitt re PCAOB IRS Filing Status (Jan. 6, 2021).

<sup>660</sup> The IRS tends to look at the question of severance payments on a case-by-case basis. But that does not mean that the Board was somehow precluded from considering a group of employees together, based on broad policy grounds. It is the actual and considered exercise of judgment, and the creation of a record reflecting that consideration, that are of paramount importance in ensuring that the organization can justify its payment of severance to departing employees and avoid the inference that it is conferring a private benefit.

<sup>661</sup> *See, e.g., Severance Pay for Nonprofit Employees, supra* n. 654, at pp. 4-5.

As we have seen,<sup>662</sup> the Board—both currently and throughout its history—has not typically generated the necessary recorded justifications needed for payments made, given its tax-exempt status.

In any event, even prior to 2018, the PCAOB had, *on occasion, but not in all instances*, provided severance payments to departing employees.<sup>663</sup> Our review of those severance agreements demonstrated that—when the PCAOB did provide severance payments to departing employees—it provided departing PCAOB employees with between two and sixteen weeks of severance pay, depending on the circumstances of the departure.<sup>664</sup> More specifically, when severance payments were provided, departing PCAOB employees received, *on average*, little more than eight weeks of yearly salary.<sup>665</sup> Moreover, prior to 2018, the highest amount in severance that had ever been paid out to a single departing PCAOB employee was \$83,779.20.<sup>666</sup>

Starting in 2018, the current Board, under Chairman Duhnke, adopted a different approach to employee terminations. First, with respect to senior PCAOB staff members, *the Board* initiated the process of terminating their employment in 2018, rather than reacting to recommendations that might have flowed from PCAOB staff members.<sup>667</sup> There is, in our view, nothing inappropriate about the fact that these employment decisions originated with the PCAOB’s Chairman or

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<sup>662</sup> See nn. 348-349, *supra*, and accompanying text.

<sup>663</sup> We asked for, and received, what we believe are all the severance agreements entered into by the PCAOB since its formation. In considering the issues set forth in this Section of our Report, we reviewed each of those agreements.

<sup>664</sup> See PCAOB, Severance Agreement with (b)(6), and see PCAOB, Severance Agreement with (b)(6).

<sup>665</sup> See PCAOB, Severance Agreements with (b)(6)  
(b)(6)  
(b)(6)

This average is somewhat misleading. In all, there were eleven pre-2018 severance agreements. Of those, one employee paid the PCAOB money; one did not receive any money but had debt forgiven; and one was a flat rate payment. Calculating the average for the eight employees who received severance in the form of weeks of pay, the average works out to 8.25 weeks.

<sup>666</sup> See PCAOB, Severance Agreement with (b)(6). This amount reflected approximately twelve weeks of (b)(6) annual salary, who had served at the PCAOB as its (b)(6). See also, LinkedIn, Profile of (b)(6).

<sup>667</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at p. 9; Witness X Interview, at p. 14.

the Board, given that they reflected the implementation of a broad policy determination, rather than a decision to terminate the employment of specific individuals based solely on the characteristics of those individuals' job performance.<sup>668</sup>

As previously noted, while these senior PCAOB staff job terminations apparently were discussed among all Board Members,<sup>669</sup> and a consensus reached, in most instances there is no written record either that these consultations occurred, or what the substance of them was.<sup>670</sup> And, as already discussed, this lack of documentation is problematic, given the PCAOB's status as a tax-exempt nonprofit corporation registered as such with the IRS.<sup>671</sup>

Unlike the process for pre-2018 employment terminations, no rationale for the 2018 employment terminations was provided to HR or the terminated employees.<sup>672</sup> In this respect, the Board largely relied on the fact that PCAOB employees are "at-will" employees.<sup>673</sup> In addition, unlike the pre-2018

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<sup>668</sup> In that respect, these employment decisions were most analogous to reductions in force. *See, e.g.*, SHRM, "How to Conduct a Layoff or Reduction in Force," (Dec. 22, 2020), available at <https://www.shrm.org/resourcesandtools/tools-and-samples/how-to-guides/pages/conductlayofforrif.aspx>.

<sup>669</sup> *See* n. 625, *supra*, and accompanying text.

<sup>670</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at p. 9; Witness X Interview, at p. 14.

There were, apparently, two exceptions to the Board reaching a consensus on terminations effected in 2018. The first, involved the decision to terminate the employment of the PCAOB's former <sup>(b)(6)</sup>. *See* Witness X (1<sup>st</sup> Interview), at p. 12. *See also*, <sup>(b)(6)</sup>

<sup>(b)(6)</sup> The second apparently involved the decision to terminate the employment of <sup>(b)(6)</sup>. It appears that Board Member Brown was out of the office at the time the issue arose and learned about <sup>(b)(6)</sup> departure upon returning to the office. *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 13; Witness X Interview, at pp. 9-10.

<sup>671</sup> *See* nn. 348-349, *supra*, and accompanying text.

<sup>672</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 20; Witness X Interview, at p. 17; Witness X Interview, at p. 14.

<sup>673</sup> *See, e.g.*, Witness X Interview, at pp. 7-8; Witness X (1<sup>st</sup> Interview), at p. 12; Witness X (2<sup>nd</sup> Interview), at p. 23.

Employment relationships are presumed to be "at-will" in all states except Montana. *See* Nat'l Conf. of State Legis., "At-Will Employment—Overview," (Apr. 15, 2008), available at <https://www.ncsl.org/research/labor-and-employment/at-will-employment-overview.aspx>. In essence, "at-will" means that an employer can terminate an employee at any time for any reason, *except an illegal one*, or for no reason, without incurring legal liability. *Id.*

employment termination process, consultation with OGC with respect to each employment termination was either curtailed or nonexistent,<sup>674</sup> and to the extent counsel was involved, reliance was placed on the advice of outside employment counsel.<sup>675</sup> Because the underlying rationale for these terminations was said to be a determination that certain senior employees were unlikely to embrace the Board's commitment to strategic change,<sup>676</sup> the decision not to follow prior employment termination protocols is understandable, albeit problematic at least in the respect that no contemporaneous documents were created.

Consistency in the practices and procedures utilized in employment terminations, especially for nonprofit corporations, is a key to avoiding unnecessary litigation over dismissals, and also to ensuring that the employees who remain do not become disgruntled, and therefore is an important component of good governance.<sup>677</sup> Even if, in the case of PCAOB employees, those whose employment is being terminated are "at-will" employees, governance experts note that it is always wise to cite a business reason for employment terminations, and to have counsel directly involved.<sup>678</sup> In addition, in the case of the PCAOB, having its OGC involved is a means of protecting the organization from unintentional deviations from prior practices and procedures that could give rise to litigation claims.<sup>679</sup> (b)(6)

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<sup>674</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 10; Witness X Interview, at p. 11.

<sup>675</sup> See, e.g., Witness X Interview, at p. 11; Witness X (1<sup>st</sup> Interview), at p. 10; Witness X Interview, at p. 13.

<sup>676</sup> See nn. 613-614, *supra*, and accompanying text.

<sup>677</sup> See, e.g., J. Auvin, "How to Fire an Employee: What US Nonprofits Need to Know," (June 6, 2019), available at <https://www.missionbox.com/article/217/how-to-fire-an-employee-what-us-nonprofits-need-to-know>.

<sup>678</sup> *Id.* (Noting that providing a rationale for each dismissal will help protect the organization "should the [at-will] worker file a complaint or suit claiming illegal termination").

<sup>679</sup> The use of outside counsel is entirely appropriate, but outside counsel only see a small subsection of any organization's employment terminations and cannot necessarily protect the organization from the consequences of deviations from prior practices. That is, and should be, a role for the PCAOB's OGC.

Our recommendations for the PCAOB in this respect are set forth below. See Section 3.6.8., *infra*.

680 (b)(6)

Another principal difference from pre-2018 employment termination practices is the fact that, starting in 2018, the amount of severance paid to each of the departing senior PCAOB staff members that received a separation agreement<sup>681</sup> was much higher than previously—invariably the equivalent of six full months of pay.<sup>682</sup> This is a large amount of money, especially in the case of senior PCAOB officials.<sup>683</sup> In essence, then, by virtue of the current Board’s uniform adoption of a six-month severance payment, departing employees received larger severance payouts than would have been the case under the severance practices employed prior to 2018, for the entirety of the PCAOB’s existence.<sup>684</sup>

The starting point in any analysis of severance pay is the fact that employers are not obligated to give severance pay, especially nonprofit employers.<sup>685</sup> Nonetheless, severance payments are well-recognized as having

(b)(6)

<sup>681</sup> Of the seven senior PCAOB staff members whose employment ended in 2018, six received separation agreements. Barbara Hannigan, the PCAOB’s Chief Ethics Officer, who retired, apparently did not seek, and in any event was not given, a severance agreement.

<sup>682</sup> See (b)(6) Separation Agreement (b)(6) see also, Witness X Interview, at p. 9; Witness X (1<sup>st</sup> Interview), at p. 16; Witness X Interview, at p. 14.

<sup>683</sup> For example, (b)(6), received nearly \$300,000 as his severance pay, see PCAOB, (b)(6) Separation Agreement (b)(6), nearly four times as much as the amount of severance pay given to (b)(6)—the largest severance payment made prior to 2018—of \$83,000. See n. 666, *supra*. (b)(6) severance was paid in 2017, while (b)(6) severance was paid in 2019, so the passage of time, and concepts of salary inflation, cannot, and do not, explain the disparity in the magnitude of the severance provided.

<sup>684</sup> See, e.g., Witness X Interview, at p. 9; Witness X Interview at p. 11; Witness X (1<sup>st</sup> Interview), at pp. 37-38.

<sup>685</sup> See, e.g., Maryland Nonprofits, “How Much Severance Should My Nonprofit Organization Give?” (Jul. 17, 2018), available at <https://www.marylandnonprofits.org/how-much-severance-should-my-nonprofit-organization-give/>.

An employer may be required to give severance if severance has been promised in a contract, has been stated as a facet of employment in an employee handbook, or if there is an established pattern of giving severance to other employees in similar circumstances. *Id.* In the case of the PCAOB, it is possible that future employees whose employment is terminated may argue, based on the events of 2018, that six months’ salary as a severance payment has become an “established pattern.” In our view, that makes it even more imperative that the PCAOB codify its separation practices and policies.

benefits for all corporations, including nonprofit corporations.<sup>686</sup> Of course, once the decision to provide severance is made, it is separate and distinct from the decision that follows—how much money and what other benefits should be provided as part of a severance package?<sup>687</sup>

At the PCAOB as of 2018, the amount of severance—an absolute and invariable six months of annual salary—was apparently agreed upon informally by the Board Members in service as of April 2018.<sup>688</sup> How or why this amount was agreed upon is unclear; equally unclear is why the Board apparently decided that the same amount of severance pay (six months) should—automatically—be provided to each of the terminated employees. The Board generated no paperwork explaining or justifying this amount of severance, or why everyone whose employment was terminated should be treated exactly the same, and the Board Members could not really explain how they arrived at this decision.<sup>689</sup>

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<sup>686</sup> *Id.* For example, severance payments soften the blow of involuntary terminations and are a means of avoiding future lawsuits by having the terminated employee sign a release in exchange for the severance. *Id.*

<sup>687</sup> Common benefits in severance packages frequently include the following:

- Salary continuation;
- Insurance benefits;
- Uncontested unemployment benefits;
- Outplacement services; and
- References.

*Id.*

<sup>688</sup> *See, e.g.,* Witness X (1<sup>st</sup> Interview), at pp. 20-21; Witness X (1<sup>st</sup> Interview), at p. 16; Witness X Interview, at p. 14.

<sup>689</sup> The Board did not have any codified rationale, as reflected by the recollections of certain of its Members. *See, e.g.,* Witness X (1<sup>st</sup> Interview), at p. 19:

My recollection is, we certainly talked about the term of the severance. I think subject to audit, I think generally it has been six months, but I wouldn't bet my life on that that everyone was exactly the same. My recollection coming in was that is what had been done in the past.

*See also,* Witness X Interview, at p. 14 (emphasis supplied):

So, we started to have discussions about how we're going to separate senior leaders, which include not escorting them out, being given severance. Discussion back and forth on what that might be. The Chairman discussed three months, but given the level and time served, what was the appropriate severance. And I think eventually 6 months was arrived as an appropriate *generous* way to separate people who had spent a substantial part of their career rebuilding the organization.

*And see* Witness X (1<sup>st</sup> Interview), at p. 16:

During the 2018 terminations, the Board also extended terminated employees an opportunity to have a press release issued.<sup>690</sup> Additionally, the 2018 severance agreements were structured to permit the dismissed employees to continue to receive health insurance for seven months.<sup>691</sup> And, as part of the severance agreements, departing employees were effectively placed on paid administrative leave so that, publicly, they could continue to present themselves as PCAOB employees, as a means of assisting them in transitioning to private sector employment.<sup>692</sup>

The six-month administrative leave or severance period was limited, and was qualified by the proviso that, if the terminated employee found other employment within the six-month period, the severance payments would cease,<sup>693</sup> but the PCAOB was unable to demonstrate that any employee did not receive the entire six months' amount of severance. Although we were told that there had been a vigorous process used to determine what packages the senior level employees who were terminated in 2018 should be given, and what was reasonable,<sup>694</sup> the PCAOB was unable to provide us with any paperwork detailing this process.

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What I recall from that, for me given the unusual nature of this experience, I personally was very concerned about the treatment of the people leaving, who had worked for the PCAOB for a long time. I do recall having discussions regarding a severance package and I think it was six months, but it was done in a way whereby month seven, their health care would still be provided for. We provided a non-demeaning period of time, we discussed shorter periods of time vaguely, but we ended up at six months, because [after consultations with counsel,] this was [understood by the Board to be] standard practice.

To the best of our ability to ascertain, there was no presentation prepared for the Board Members on duty in April 2018 about prior severance packages (as discussed above, *see* nn. 688-689, *supra*, we had to develop our own statistical analysis), and the “recollection” that this was what had been done in the past was, flatly, incorrect, as was the understanding that six months’ severance pay is somehow “standard practice.”

<sup>690</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 17; Witness X Interview, at p. 9; Witness X (1<sup>st</sup> Interview), at p. 18; Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at p. 14; Witness X (1<sup>st</sup> Interview), at p. 36.

<sup>691</sup> *See, e.g.*, Witness X Interview, at p. 10; Witness X (1<sup>st</sup> Interview), at p. 16; Witness X (1<sup>st</sup> Interview), at p. 10.

<sup>692</sup> *See, e.g.*, Witness X Interview, at pp. 6-7; Witness X (1<sup>st</sup> Interview), at p. 16; Witness X (1<sup>st</sup> Interview), at p. 10.

<sup>693</sup> *See, e.g.*, Witness X Interview, at pp. 9-10.

<sup>694</sup> *See, e.g.*, Witness X Interview, at p. 7; Witness X (1<sup>st</sup> Interview), at pp. 37-38.

We believe that the PCAOB needs a well-defined, and clearly articulated severance policy, going forward, and one that meets the advisory standards laid out by the IRS.<sup>695</sup>

## 2.12. Communications about Board Policies, Perspectives, and Transformational Change

Good governance [for nonprofit organizations] requires the right ingredients (the right mix of board members!), a chef to provide leadership and accountability, and careful mixing and stirring of candid discussions, *transparent practices*, and governance policies.<sup>696</sup>

One core effort in connection with the preparation of this Report was an examination of the current Board’s communication practices—specifically, with each other and with the PCAOB’s staff—the same subject that was, effectively, a major component of the May and September Whistleblower complaints.<sup>697</sup> For nonprofit boards, strategic communications are critical, and are the means by which nonprofit boards ensure that their organizations are perceived correctly by both internal and external constituencies.<sup>698</sup> This is especially true where, as here, the PCAOB’s new Board proposed transformational changes with respect to the way the PCAOB traditionally had approached its mandate.<sup>699</sup>

At the outset, the new Board members apparently engaged in internal conversations about the specific steps the PCAOB would need to take to achieve transformational change.<sup>700</sup> The Chairman made clear that the new Board would review how everything was historically handled at the PCAOB.<sup>701</sup> This top-to-

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<sup>695</sup> Our recommendations in this regard are set forth below. *See* Section 3.6.7., *infra*.

<sup>696</sup> Nat’l Council of Nonprofits, “*Good Governance Policies for Nonprofits*,” (Dec. 22, 2020) (emphasis supplied), available at <https://www.councilofnonprofits.org/tools-resources/good-governance-policies-nonprofits>.

<sup>697</sup> *See* Exs. 5 & 6, *supra* nn. 34 & 48, respectively, and accompanying text.

<sup>698</sup> *See, e.g., Nonprofit Governance Handbook, supra* n. 482, at p. 211; Deloitte®, THE EFFECTIVE NOT-FOR-PROFIT BOARD (2013), at p. 30, available at <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/public-sector/ca-en-public-sector-effective-npo-board.pdf>.

<sup>699</sup> *See* nn. 20-25, *supra*, and accompanying text.

<sup>700</sup> *See, e.g.,* Witness X Interview, at p. 11; Witness X (1<sup>st</sup> Interview), at p. 15; Witness X Interview, at p. 12. As we have noted, however, there are no records reflecting the number of these discussions, the substance of what was discussed or any resolutions that were forthcoming as a result of these discussions. *See* nn. 20-25, *supra*, and accompanying text.

<sup>701</sup> *See, e.g., Duhnke 2019 Keynote, supra* n. 316; M. Cohn, “PCAOB Considering Further Overhaul,” Accounting Today (Nov. 11, 2019), available at

bottom review was appropriate in light of events preceding the appointment of a new complement of Board Members effective at the beginning of January 2018.<sup>702</sup> Unfortunately, we found that many PCAOB staff members felt that the Chairman and the other Board Members had not adequately informed the organization of their plans and, in particular, their plans to change the PCAOB’s staff leadership, or the reasons for those plans.<sup>703</sup>

For an organization like the PCAOB, internal communications are, and should be, an essential or high priority focus.<sup>704</sup> A thoughtful and active internal communications program unifies everyone in the organization around what are—or should be—shared organizational goals.<sup>705</sup> It also provides the big picture context for important strategic decisions, which in turn can assure a smooth process in implementing changes within the organization.<sup>706</sup> And, it can enable leadership expeditiously to align and update priorities, as these change over the course of time.<sup>707</sup>

There are no one-size-fits-all solutions for elevating internal communications,<sup>708</sup> especially since different leaders have different leadership

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<https://www.accountingtoday.com/news/pcaob-considering-further-overhaul/>; see also, e.g., Witness X Interview, at p. 27; Witness X (1<sup>st</sup> Interview), at pp. 6-7.

<sup>702</sup> See nn. 15-18, *supra*, and accompanying text.

<sup>703</sup> See, e.g., Witness X Interview, at pp. 27-28; Witness X Interview, at pp. 11-12; Witness X Interview, at p. 2.

<sup>704</sup> See, e.g., E. Hajric, “*Improve Your Nonprofit’s Internal Communication and Collaboration*,” NONPROFIT PRO MAGAZINE, (Feb. 26, 2020), available at <https://www.nonprofitpro.com/article/improve-your-nonprofits-internal-communication-and-collaboration/>; K. Miller, “*Goals for Internal Communications at Nonprofits*,” NONPROFIT MARKETING GUIDE BLOG (June 18, 2019), available at <https://www.nonprofitmarketingguide.com/blog/2019/06/18/goals-for-internal-communications-at-nonprofits/> (“*Internal Communications Goals*”); Sociabble™, “*The Missing Link in Your Employee Communications*,” (Sept. 2018), available at <https://assets-www.sociabble.com/wp-content/uploads/2018/09/sociabble-publication-the-missing-link-in-your-employee-communications-1.pdf>.

<sup>705</sup> See, e.g., *Internal Communications Goals*, n. 704, *supra*.

<sup>706</sup> *Id.*

<sup>707</sup> *Id.*

<sup>708</sup> See, e.g., F. Trompeter, “*Tips to Manage Your Nonprofit’s Communications*,” BIG DUCK INSIGHTS (Mar. 23, 2020), available at <https://bigduck.com/insights/nonprofit-communications-during-the-covid-19-crisis/> (Noting that “There is no one-size-fits-all solution so apply what makes sense to your organization”); Glint Inc., “*What Is Employee Engagement*,” (2020), available at <https://www.glintinc.com/resource/employee-engagement-101/> (Noting that “There’s no one-size-fits-all solution for how to best improve employee engagement”).

skills, and exhibit different comfort levels with various means of communications.<sup>709</sup> The important thing is to find a set of mechanisms that keep the organizations board and its employees informed—in real time—of important strategic developments.<sup>710</sup>

With respect to communications among the Chairman and the other four Board Members, we found a logical dividing point—for purposes of our analysis—roughly equivalent to the timing of the full impact of the Covid-19 pandemic.<sup>711</sup>

### 2.12.1. Pre-COVID Board Interactions

Pre-COVID-19, Board Members engaged in both formal and informal meetings, as well as in *ad hoc* discussions, among themselves, with the original 2018 Board Members all indicating that the majority of their meetings with the Chairman, and each other, were *ad hoc*. The Chairman employs an “open door” policy<sup>712</sup> and, pre-COVID-19, two Board Members occasionally availed themselves of the opportunities that policy afforded, while two others would not.<sup>713</sup> And that, in essence is one problem with such a policy—it requires others

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<sup>709</sup> See, e.g., S. Schooley, “What Kind of Leader Are You? Nine Leadership Types and Their Strengths,” *Bus. News Daily* (Sept. 29, 2019), available at <https://www.businessnewsdaily.com/9789-leadership-types.html>; C. McNamara, “Basics in Internal Organizational Communications,” *FREE MANAGEMENT LIBRARY* (Dec. 22, 2020), available at <https://managementhelp.org/organizationalcommunications/internal.htm>.

<sup>710</sup> See, e.g., *Internal Communications Goals*, *supra* n. 704.

<sup>711</sup> Beginning in mid-March 2020, the PCAOB suspended its employees’ international travel, and moved to mandatory remote work. See PCAOB, “Update on Operations in Light of COVID-19,” (Mar. 18, 2020), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-update-on-operations-in-light-of-covid-19-724>.

<sup>712</sup> An “open door” policy, in the organizational context, means the manager’s door is open to everyone, and is intended to encourage transparency, trust, openness, communication, feedback and discussion. See, e.g., S. Heathfield, “Open Door Policy,” *THE BALANCE* (Nov. 23, 2019), available at <https://www.thebalancecareers.com/open-door-policy-1918203>; K. Francis, “Open Door Policy in Business,” *HOUSTON CHRON.* (Jan. 28, 2012), available at <https://smallbusiness.chron.com/difference-between-undermanagement-micromanagement-34904.html>; L. Ikram, “Open Door Policy at the Workplace—Purpose, Pros and Cons,” *VANTAGE CIRCLE BLOG* (Oct. 9, 2020), available at <https://blog.vantagecircle.com/open-door-policy/>.

<sup>713</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 23 (Noting that there was regular discussion among the four Board Members (other than the Chairman), and that two of the Board Members had discussions from time-to-time with the Chairman, *albeit solely at their initiative*, while the other two did not).

to assume the initiative.<sup>714</sup> Being available is a critical facet of governance leadership, but good governance also requires organizational leaders to *initiate conversations* with board members and employees, as well.<sup>715</sup>

Pre-COVID-19, the Board met formally in two distinct types of meetings—public (or open) Board meetings and closed Board meetings. As noted above, the PCAOB’s original Bylaws required the Board to convene at least one open meeting each month,<sup>716</sup> but those provisions were subsequently revised—in 2004—to require the Board to convene one open meeting each calendar quarter.<sup>717</sup> At the beginning of the PCAOB’s operations, public meetings were, roughly, held at a frequency rate of a little more than once a month;<sup>718</sup> after the PCAOB’s Bylaws were amended, the Board convened public meetings at least quarterly.<sup>719</sup> Starting in 2018, however, the Board did not convene many open

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<sup>714</sup> See, e.g., K. Kruse, “*Why Successful Leaders Don’t Have an Open Door Policy*,” FORBES (Apr. 24, 2016), available at <https://www.forbes.com/sites/kevinkruse/2016/04/24/why-successful-leaders-dont-have-an-open-door-policy/?sh=180b316c31ef>.

<sup>715</sup> See, e.g., B. Groysberg & M. Slind, “*Leadership Is a Conversation*,” Harv. Bus. Rev. (June 2012), available at <https://hbr.org/2012/06/leadership-is-a-conversation>.

<sup>716</sup> See *PCAOB Proposed Bylaws*, at §5.2., *supra* n. 185.

<sup>717</sup> See nn. 228, *supra*, and accompanying text.

<sup>718</sup> The Board held a total of fifteen open meetings in the PCAOB’s first year of existence, or an average of 1.25 open Board meetings per month. See the Board’s First Formal Meeting, Hosted by the SEC (Jan. 9, 2003); Open Board Meeting to Hear Expert Advice (Feb. 4, 2003); Open Board Meeting to Propose Auditor Registration System (Mar. 4, 2003); Open Board Meeting to Propose Public Company Billing System (Mar. 13, 2003); Open Board Meeting to Consider on Auditing and Related Professional Standards, Funding Rules, Ethics Code (Apr. 16, 2003); Open Board Meeting to Consider Auditor Registration, 2003 Budget, and SEC Request for Determination under Section 101(d) of the Sarbanes–Oxley Act (Apr. 23, 2003); Open Board Meeting to Consider Bylaw Amendments (Apr. 25, 2003); Open Board Meeting to Consider Policy on Auditing Standards, Ethics Code, and Criteria for Advisory Groups (Jun. 30, 2003); Open Board Meeting to Propose Rules for Investigations, Inspections and Withdrawal from Registration (Jul. 28, 2003); Open Board Meeting to Adopt Rules on Investigations, Registration Withdrawal (Sep. 29, 2003); Open Board Meeting to Adopt Final Rules for Inspections of Accounting Firms, and Propose Standards on Internal Control, and Use of Certain Terms in Audit Standards (Oct. 7, 2003); Open Board Meeting to Propose Two Auditing Standards, Amendments to Interim Auditing Standards (Nov. 12, 2003); Open Board Meeting to Consider PCAOB 2004 Budget (Nov. 25, 2003); Open Board Meeting to Propose Rules on Oversight of Non-U.S. Accounting Firms, Registration Deadline (Dec. 9, 2003); Open Board Meeting to Adopt First Auditing Standard, Technical Amendments (Dec. 17, 2003).

<sup>719</sup> Following the 2004 amendments to the Bylaws that required public meetings to be convened quarterly, in the period from 2005-2007 there were twelve open Board meetings, averaging four per year. See Open Board Meeting to Consider Reporting on the Elimination of a Material Weakness (Mar. 31, 2005); Open Board Meeting to Consider Remediation of Material Weaknesses, Auditor Independence and Tax Services (Jul. 26, 2005); Open Board Meeting to

meetings at all, in apparent breach of its own Bylaws, a point that has not escaped public attention.<sup>720</sup>

- Public Board meetings, pre-COVID-19, were:
  - Held when deemed necessary;
  - Devoted to formal discussions, of matters such as enforcement, retention of auditors, etc., and they were used, for example, formally to approve the Board’s proposed budget;<sup>721</sup> and
  - In attendance at these public Board meetings were the Board Members, the Secretary, General Counsel, and involved PCAOB staff.<sup>722</sup>
- Closed Board meetings, pre-COVID-19:
  - Intended to occur every other Thursday;<sup>723</sup> and

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Consider 2006 Budget and Certain Technical Amendments Concerning Independence and Tax Services (Nov. 22, 2005); Open Board Meeting to Consider Rules for Periodic Reporting and Succeeding to the Registration Status of a Predecessor Firm (May 23, 2006); Open Board Meeting to Consider 2007 Budget (Nov. 30, 2006); Open Board Meeting to Consider Revised Internal Control Standard (Dec. 19, 2006); Open Board Meeting to Consider Proposal on Evaluating Consistency of Financial Statements and Concept Release on Rule 3523 Concerning Tax Services for Persons in Financial Reporting Oversight Roles (Apr. 3, 2007); Open Board Meeting to Adopt New Standard for Audits of Internal Control and Consider Amendments to PCAOB Rule 4003 (May 24, 2007); Open Board Meeting to Consider Proposing New Ethics and Independence Rule And Amendment to Existing Tax Services Rule (Jul. 24, 2007); Open Board Meeting to Consider on Amendments Regarding Inspection Frequency for Firms that Do Not Regularly Issue Audit Reports (Oct. 16, 2007); Open Board Meeting to Consider Proposed Policy Statement on PCAOB Rule 4012 Implementation (Dec. 5, 2007).

<sup>720</sup> See, e.g., F. McKenna, “U.S. Audit Regulator Fails to Hold Public Meetings as Required by Bylaws,” MARKETWATCH (Sept. 19, 2019), available at <https://www.marketwatch.com/story/us-audit-regulator-fails-to-hold-public-meetings-as-required-by-bylaws-2019-09-19>; J. Bramwell, “The PCAOB Hates Meetings as Much as We Do,” GOING CONCERN (Sept. 19, 2019), available at <https://www.goingconcern.com/the-pcaob-hates-meetings-as-much-as-we-do/>.

It is inconsistent, and denigrating reputationally, for an organization mandated to require audit firms to operate in accordance with applicable internal and external requirements to fail to honor its own internal mandates. Our recommendations to correct this facet of the current Board’s governance practices are set forth below. See Section 3.2.5., *infra*.

<sup>721</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 21; Witness X (1<sup>st</sup> Interview), at p. 20.

<sup>722</sup> See, e.g., Open Board Meeting to Consider 2020 Budget and Five-Year Strategic Plan (Nov. 19, 2019), available at [https://pcaobus.org/news-events/events/event-details/open-board-meeting-to-consider-2020-budget-and-five-year-strategic-plan\\_1145](https://pcaobus.org/news-events/events/event-details/open-board-meeting-to-consider-2020-budget-and-five-year-strategic-plan_1145).

<sup>723</sup> See, e.g., Witness X Interview, p. 30; *but see*, Board Schedule 2019-10-01, reflecting closed Board meetings occurring on differing days of the week every month.

- Utilized to take official action with respect to matters requiring a formal vote of the Board
- Board Working Hours Meetings, pre-COVID-19:
  - Meetings where the real work of the PCAOB was often conducted;<sup>724</sup>
  - Occurred one-two times per week;<sup>725</sup>
  - Formal calendar meetings;<sup>726</sup>
  - Board would schedule different topics to discuss with Division Directors, for example, policies regarding day-to-day operations;<sup>727</sup>
  - Division Directors made presentations using set PowerPoint® templates for Board discussion;<sup>728</sup>
  - These meetings provided each Board Member an opportunity to interact with the PCAOB's staff and one another; and
  - Notes of these meetings are mostly hand-written, and largely illegible to anyone other than the author.<sup>729</sup>
- Bi-weekly Lunches, pre-COVID-19

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<sup>724</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 6; Witness X (1<sup>st</sup> Interview), at pp. 22-23; Witness X (1<sup>st</sup> Interview), at p. 45.

<sup>725</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 20.

<sup>726</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 6.

<sup>727</sup> See, e.g., *id.*; Witness X (1<sup>st</sup> Interview), at p. 16.

<sup>728</sup> See, e.g., Witness X Interview, at p. 26; Witness X Interview, at pp. 7-8.

<sup>729</sup> See, e.g., 2019.11.04 Board Working Hours Meeting Notes.

We believe a more formal note-taking process should be employed for meetings this significant, and our recommendations are set forth below. See Section 3.2.3.-3.3.5., *infra*.

- These lunches occurred at the initiative of the Chairman’s Office;<sup>730</sup>
  - Although originally intended to occur every other week, in practice they did not occur on a consistent basis;<sup>731</sup> and
  - Not all Board Members attended these bi-weekly lunches.<sup>732</sup>
- Periodic Meetings with SEC Chairman Clayton, pre-COVID-19<sup>733</sup>
    - SEC Chairman Clayton would present the Board, in advance, with a list of topics he wished to discuss;
    - Board Members were free to suggest additional topics of conversation; and

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<sup>730</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 24; Witness X (1<sup>st</sup> Interview), at p. 23.

<sup>731</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 20.

<sup>732</sup> *Id.* It is unfortunate that some Board Members were unwilling to take advantage of the bi-weekly lunches, or to take the Chairman up on his open-door policy. These are potentially symptoms of a problematic board culture. Those symptoms often include:

- Board members who seem unwilling to devote time or effort to assuring the *satisfactory* completion of work;
- Differences of opinion that do not seem resolvable;
- Lack of effective methods of handling members’ differences of views;
- Board and members’ failure to assess/change their performance; and
- Little effort to help members know each other and develop “team spirit.”

See V. Murray & Y. Harrison, GUIDELINES FOR IMPROVING THE EFFECTIVENESS OF BOARDS OF DIRECTORS OF NONPROFIT ORGANIZATIONS, *Ch. 9: The Informal Culture of the Board*, available at <https://courses.lumenlearning.com/suny-guidelines-for-improving-the-effectiveness-of-boards-of-directors-of-nonprofit-organizations/chapter/chapter-9-the-informal-culture-of-the-board/>.

Our recommendations for dealing with these cultural difficulties are set forth below. See Section 3.2.5., *infra*.

<sup>733</sup> We were told these meetings occurred quarterly (*see* Witness X (2<sup>nd</sup> Interview), at p. 6) or twice a year (*see* Witness X (2<sup>nd</sup> Interview), at p. 16).

The lack of a consistent understanding among Board Members of how frequently meetings occur is something the Board should be able to address. See Sections 3.2.5., *infra*, for our recommendations in this regard.

- Board Members were also free to ask questions about other matters during the meeting.
- **Regular Meetings between the Board’s Chairman (with certain staff) and the SEC’s OCA, pre-COVID-19**
  - Certain Board Members believe Chairman Duhnke and his team met regularly with the SEC’s OCA;<sup>734</sup>
  - Concerns were expressed by some Board Members that the SEC’s OCA might not always receive the “full picture,” because the meeting is not with the full Board;<sup>735</sup> and
  - We were not advised of these meetings specifically by the Chairman’s Office or any PCAOB staff members.

#### **2.12.2. Board Interactions During COVID-19**

- **Open Meetings During COVID-19**
  - Notwithstanding the Board’s lack of open meetings pre-COVID-19, since the onset of the pandemic, the Board has convened one open meeting.<sup>736</sup>
- **Board Working Hours Meetings During COVID-19**
  - As was the case pre-COVID-19, these are formal calendar meetings; and
  - They are now being held telephonically.
- **Twice-weekly Board Phone Calls During COVID-19**

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<sup>734</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 16.

<sup>735</sup> *Id.*

<sup>736</sup> See Open Board Meeting to Consider Adoption of Budget, Strategic Plan, and Amendments to PCAOB Independence Standards and Rules (Nov. 19, 2020), available at <https://pcaobus.org/news-events/events/event-details/open-meeting-to-consider-adoption-of-budget-strategic-plan-and-amendments-to-pcaob-independence-standards-and-rules>.

- One weekly phone call is just between the Board Members and the Chief of Staff;<sup>737</sup>
  - These serve as a replacement for the bi-weekly lunches;<sup>738</sup>
  - Various Board Members noted that, unlike the bi-weekly lunches, the phone calls consistently take place every Tuesday;<sup>739</sup>
  - A constant purpose of these Tuesday calls is to provide updates on the impact of COVID-19 on the work of the PCAOB;<sup>740</sup> and
  - Board Members have utilized these calls to bring up questions, concerns, etc. beyond COVID-19.<sup>741</sup>
- The second weekly call is with Division leaders.<sup>742</sup>
  - It is treated as an update call, where the Division leaders can walk through their issues and on what matters they have been working.<sup>743</sup>
- Periodic Meetings with SEC Chairman Clayton during COVID-19<sup>744</sup>
  - These interactions are apparently continuing similarly to the manner in which they occurred pre-COVID-19.<sup>745</sup>

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<sup>737</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 2.

<sup>738</sup> *Id.*

<sup>739</sup> *Id.*

<sup>740</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 2-3.

<sup>741</sup> *Id.*

<sup>742</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 2.

<sup>743</sup> *Id.*

<sup>744</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 6.

<sup>745</sup> *Id.*

The general impression we received from our interviews is that, during the COVID-19 pandemic, the Board has been doing a better job of regularly meeting and discussing important issues, and communicating better with one another.<sup>746</sup>

### 2.12.3. Board Communications with the PCAOB Staff

Prior to the appointment of a new Board in 2018, the former Board relied upon a variety of communication mechanisms between the Board Members and the PCAOB staff, with special attention to so-called “town hall” meetings.<sup>747</sup> Town Hall meetings allow an organization’s leadership to keep employees up to date on important information, and permit employees to ask questions of the leadership, as well as provide feedback.<sup>748</sup> These meetings have many advantages, including:

- Permitting everyone to learn of important developments at the same time;<sup>749</sup>
- Promoting visible leadership;<sup>750</sup>
- Fostering teamwork and collaboration;<sup>751</sup> and

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<sup>746</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 2-3; Witness X (2<sup>nd</sup> Interview), pp. 1-3; Witness X (2<sup>nd</sup> Interview), at pp. 2-3.

Our recommendations regarding communications among and between Board Members are set forth below. See Section 3.2.5., *infra*.

<sup>747</sup> See, e.g., Witness X Interview, at p. 29; Witness X Interview, at p. 11; Witness X Interview, at pp. 29-30.

<sup>748</sup> See, e.g., EPM, “Town Hall Meetings: Definition, Advantages and Disadvantages,” (Nov. 2017), available at <https://expertprogrammanagement.com/2017/11/town-hall-meetings/> (“Town Hall Meetings”).

<sup>749</sup> *Id.* By having everyone participate at the same time, employees hear firsthand about important updates, eliminating the development of secondhand communication sharing among employees which can create a variety of misunderstandings. *Id.*

<sup>750</sup> *Id.* The importance of visible leadership cannot be overstated, especially since a “message delivered in-person from the CEO will have more impact than one delivered by email.” KLS’ CEO, Harvey Pitt, characterizes leadership that eschews personal interaction with employees in real time, as the “Wizard of Oz” syndrome—that is, leadership that hides behind a curtain, remains largely invisible to employees and, when the curtain is finally lifted, seems rather ordinary and not much of a problem solver. Cf. J. Stutz, “The Yellow Brick Road of Leadership: Leadership Lessons from the Wizard of Oz,” City Univ. of Seattle (Mar. 23, 2014), available (by registration) at <https://www.academia.edu/RegisterToDownload/BulkDownload>.

<sup>751</sup> See, e.g., *Town Hall Meetings*, *supra* n. 748.

- Reinforcing culture and values.<sup>752</sup>

To the extent that town hall meetings—with their direct give-and-take between leaders and employees—are not perceived as the ideal manner of communication due to the personal leadership style of the current Board Chair,<sup>753</sup> there are alternatives.<sup>754</sup> But, actual visibility, at least in addition to communication by emails, memoranda or text messages, is recommended strongly by governance experts,<sup>755</sup> and something the current Board should attempt to institute.<sup>756</sup>

Notwithstanding these observations, recent steps have been taken to improve the PCAOB’s internal (as well as external) communications. Among other things, the Chairman created the position of Director of External Affairs—consisting of the former Offices of Government Relations, Outreach, Small Business Liaison and Public Affairs.<sup>757</sup> Although labeled “External Affairs,” this group also handles internal communications, and has taken steps to improve and increase the amount and frequency of internal communications from Board Members to PCAOB employees.<sup>758</sup> For example, the PCAOB has implemented the following periodic communications:

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<sup>752</sup> *Id.*

<sup>753</sup> In our interviews, we learned that Chairman Duhnke does not favor town hall meetings as a communication methodology. *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at p. 3; Witness X Interview, at p. 39; Witness X Interview, at pp. 16-17; Witness X Interview, at p. 16.

These interviewees indicated to KLS that the Chairman does not believe the level of staff participation during these meetings would be sufficient enough for town halls to be a meaningful tool for communication. These interviewees also stated that the Chairman prefers meetings with smaller groups and had been utilizing those meetings to engage with staff, participate in dialogue, and answer questions.

<sup>754</sup> *See, e.g.*, *Town Hall Meetings*, *supra* n. 748 (recommending “Management by Wandering Around”). *See also, e.g.*, EPM, “*Management by Wandering Around*,” (July 2017), available at <https://expertprogrammanagement.com/2017/07/management-by-wandering-around/>.

<sup>755</sup> *See, e.g.*, *Town Hall Meetings*, *supra* n. 748; “*Management by Wandering Around*,” *supra* n. 754.

<sup>756</sup> Our recommendations in this respect are set forth below. *See* Section 3.4.2., *infra*.

<sup>757</sup> *See, e.g.*, Witness X Interview, at p. 2. Although this position is an important one for the PCAOB, the hiring of its first occupant, Ms. Mateus (now the Chief of Staff) was accomplished without consultation with the other Board Members by the Chairman. *Id.*, at p. 2.

<sup>758</sup> One of the first steps taken after this new position was created was for the new Director to hire an internal communications specialist. *See, e.g.*, Witness X Interview, at p. 6; Witness X Interview, at pp. 3-5; Witness X Interview, at pp. 7-8.

- “Chairman’s Notes.”<sup>759</sup> These are brief statements from the Chairman to the entire organization, sent out on an *ad hoc* basis as a tool for the Chairman to touch on important issues such as news articles about the PCAOB or the organizational response to the COVID-19 pandemic.<sup>760</sup> They include overviews of current operations, building assessments, employees, etc., at all the regional offices, challenges that employees could be facing, and a summary of the Chairman’s messages to date;<sup>761</sup>
- Monthly Newsletter.<sup>762</sup> These are notices drafted by the Office of External Affairs that communicate changes the Board is undertaking at any given moment,<sup>763</sup> including matters such as updates in leadership positions, listing of key priorities and progress being made on those priorities, links to Board Members’ speeches and panel discussion participations, and a section on Division and Office plans for upcoming months.
- Strategic Insights. These emails provide updates or information about specific programs, initiatives, new hires, training, and update the organization on the Transformation Projects, the changes implemented, and the results.<sup>764</sup> Originally, the Secretary’s Office was tracking the progress of the Transformational Projects, but there were difficulties with that tracking mechanism, and it is no longer maintained.<sup>765</sup> At present, there unfortunately is no regular reporting mechanism for the status of Transformation Projects, but the PCAOB is in the process of updating that process.<sup>766</sup> A streamlining of the description of Transformational Projects has been necessary, given that there were two lists of these projects that various PCAOB staff had been working

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<sup>759</sup> See, e.g., Witness X Interview, at p. 15; Witness X Interview, at p. 16; Witness X Interview, at pp. 9-10.

<sup>760</sup> See 2020.02.26 Chairman's Note; 2020.03.09 Chairman’s Notes, 2020.03.10 Chairman’s Notes; 2020.03.13 Chairman’s Notes; 2020.03.19 Chairman’s Notes; 2020.03.25 Chairman’s Notes, 2020.04.03 Chairman’s Notes; 2020.04.10 Chairman’s Notes; 2020.04.17 Chairman’s Notes.

<sup>761</sup> *Id.*

<sup>762</sup> See Office of External Affairs, Email to Board Groups re Monthly Newsletter and Internal Communications Plan (Feb. 4, 2020).

<sup>763</sup> See, e.g., Witness X Interview, at p. 17; Witness X Interview, at p. 8; Witness X Interview, at p. 5.

<sup>764</sup> See, e.g., Witness X Interview, at p. 37; Witness X Interview, at pp. 3-5; Witness X Interview, at p. 8.

<sup>765</sup> See, e.g., Witness X Interview, at p. 10.

<sup>766</sup> *Id.*

with, and the existence of two lists created undue confusion.<sup>767</sup> We believe there is a need at the PCAOB for a more disciplined system of gathering and reporting data regarding progress on the Transformational Projects the Board has previously announced.<sup>768</sup>

- **Weekly Newsletters.**<sup>769</sup> These are distributed by the Chairman’s Office, and during COVID-19, they began to share briefing slides from Office and Division leaders each week with the entire staff.

These efforts have been a positive development for the PCAOB, but we believe more is needed. The PCAOB should have a clearly defined, written communication plan that guides both internal and external communications and supports the comprehensive organizational plan.<sup>770</sup> Organization-wide communications should address the PCAOB’s objectives, internal control policies/procedures necessary to meet said objectives, and the expectation of staff at all levels to communicate significant internal control matters to appropriate parties.<sup>771</sup>

Consideration should be given to the method used to disseminate information (*e.g.*, in-person meetings versus email), in relation to the importance of the information being shared.<sup>772</sup> While the Chairman’s office has implemented

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<sup>767</sup> See, *e.g.*, Witness X Interview, at p. 11. At the time of this interview, the PCAOB’s then-existing technology did not support such a tracking mechanism, but the hope was that the organization would be able to adopt such technology later in the year. Unfortunately, there were no specific plans adopted to implement that decision at that time. *Id.*

It currently appears, however, that the selected project management tools (a part of the Microsoft 365® suite) were part of a technology upgrade that occurred in Quarters 3 and 4 of 2020, as led by the Office of Data, Security, and Technology. See (b)(6), Email to KLS (Dec. 29, 2020). In addition, all Directors provided updates on current Transformation Project in December 2020. *Id.* We were advised that, in the first quarter of 2021, there will be a Consolidated Transformational Projects list as well as documentation of initiative milestones. *Id.* It is anticipated that information at the portfolio-level will be documented within the Microsoft 365® Suite by the 3<sup>rd</sup> Quarter of 2021, allowing for progress updating by Directors and their staff, as well as more real-time reporting on the Transformational Projects initiatives status. *Id.*

<sup>768</sup> Our recommendations in this regard are set forth below. See Section 3.4.5., *infra*.

<sup>769</sup> See, *e.g.*, Witness X Interview, at pp. 3-4; Witness X (2<sup>nd</sup> Interview), at pp.7-8.

<sup>770</sup> See, *e.g.*, F. Haddad, “*Make Effective Internal Communications a Priority*,” NonProfit Pro (Mar. 29, 2019), available at <https://www.nonprofitpro.com/post/make-effective-internal-communications-a-priority/>.

<sup>771</sup> See, *e.g.*, A. Solar, “*Best Practices for your Internal Communication Strategy*,” Sprout Social Blog (Sept. 23, 2019), available at <https://sproutsocial.com/insights/internal-communications-guide/>.

<sup>772</sup> See, *e.g.*, J.R. Dingwall, C. Labrie, T. McLennon, & L. Underwood, “*Professional Communications: Communication Channel*,” Olds College (2019), available at

these mechanisms of information sharing described above, the upward exchange of information is as critical as the downward exchange.<sup>773</sup> As such, the Chairman’s office and those charged with PCAOB governance oversight should discuss any significant internal control matters at appropriate intervals directly with staff.<sup>774</sup> The PCAOB’s staff should have the opportunity directly to access those charged with governance.<sup>775</sup> This will also help to encourage communication of matters employees may not typically be comfortable communicating to management.<sup>776</sup>

In addition, the Board should attempt to present a single voice in communications with the PCAOB staff.<sup>777</sup> While the aforementioned initiatives are a great first step to improve communications, it is imperative for both staff morale

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<https://ecampusontario.pressbooks.pub/profcommsontario/chapter/communication-channel/>; *Workplace Communication: Twenty Ways to Effectively Communicate with Your Employees*, SMARP (May 22, 2020), available at <https://blog.smarp.com/workplace-communication-20-ways-to-effectively-communicate-with-your-employees> (Choosing the appropriate communication channel is crucial in effective internal communication and sharing important information through email can be lost or misunderstood by the recipient because of email overloads many corporate employees face); R. Miller, *Four Different Types of Workplace Communication and How to Improve in Each Area*, SANDLER BLOG (Oct. 18, 2018), available at <https://www.sandler.com/blog/4-different-types-workplace-communication-and-how-improve-each-area/> (Face-to-face communication should be used whenever possible to eliminate any misunderstandings that can occur from written communications, which tend to contain some ambiguity as the recipient reads between the lines).

<sup>773</sup> See, e.g., R. Reiss, *America’s Five Governance Experts Share Perspective on Boards*, FORBES (May 22, 2017), available at <https://www.forbes.com/sites/robertreiss/2017/05/22/americas-five-governance-experts-share-perspective-on-boards/?sh=f928a66659ab> (“*Perspective on Boards*”) (“Communication is a two-way street, with multiple participants. The board needs to set expectations and goals for management, and management needs to execute on its strategy and provide information to the board”).

<sup>774</sup> See S. Levine, “*Crisp, Clear & Direct Communication Is an Imperative*,” FORBES (Jul. 2, 2020), available at <https://www.forbes.com/sites/forbesinsights/2020/07/02/crisp-clear-direct-communication-is-an-imperative/?sh=7aa9495519c4> (“Senior leaders must assure that a heightened level of communication flows throughout the management chain,” and leadership must, at the appropriate times, communicate directly with staff to operate effectively).

<sup>775</sup> See, e.g., *Perspective on Boards*, *supra* n. 773 (Listening to employees is critical for them to feel like they can speak up and express their thoughts and opinions and managers should build a two-way relationship to promote this environment).

<sup>776</sup> See, e.g., *id.*

<sup>777</sup> See T. Harrington & K. Smith, *Board Communication and the Staff*, TEAM RESOURCES (Mar. 6, 2017), available at <https://forteamresources.com/board-communication-and-the-staff/> (The rule of thumb is “The Board operates as a unit, within the boardroom, deciding its strategy and communicating that [strategy] when finalized” to its employees with “a unified voice”).

and clarity, that the Board engage in more open meetings and/or other methods of communicating directly with directors, the staff, and the general public, as *one*.<sup>778</sup>

### 2.13. Structural Changes at the PCAOB Since January 2018

Starting in 2018, the new Chairman and Board concluded that, in order to achieve the transformational changes they envisioned, they would be required to make a number of structural changes. These changes have, uniformly, been helpful in making the PCAOB a more efficient and effective organization, and include the following:

- *Institution of an EthicsPoint® Hotline.*<sup>779</sup> This facility allows individuals to file complaints, or raise concerns, anonymously.<sup>780</sup> Some potential issues with the viability of the Hotline are reflected by instances where complaints have been filed with the SEC Staff, rather than utilizing the Hotline.<sup>781</sup> This suggests a lack of trust in the confidentiality provided by, or the independence and fairness of, those reviewing Hotline postings, or both.<sup>782</sup> The PCAOB needs to create a culture of trust in which voluntary, good faith, reports of questionable conduct are encouraged.<sup>783</sup> If staff feedback suggests the Ethics Hotline does not inspire trust, the PCAOB should find additional and alternative channels for anonymous or confidential communications.<sup>784</sup> It is imperative that

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<sup>778</sup> Our recommendations in this regard are set forth below. See Section 3.2.5., 3.4.1., 3.4.2., *infra*, and accompanying text.

<sup>779</sup> See n. 34, *supra*. See also, e.g., Witness X Interview, at p. 14; Witness X Interview, at p. 4.

<sup>780</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 12; Witness X Interview, at p. 14; Witness X Interview, at p. 14.

<sup>781</sup> See, e.g., Witness X Interview, at p. 3. See also, n. 48, *supra*, and accompanying text.

<sup>782</sup> See, e.g., A. Dunham & S. Stout-Jough, “Are Ethics Hotlines Effective?” SHRM (Feb. 26, 2020), available at <https://www.shrm.org/hr-today/news/hr-magazine/spring2020/pages/are-ethics-hotlines-effective.aspx> (emphasis supplied):

While most employees report improprieties to their immediate supervisor, hotlines can give them another way to voice their concerns . . . Employers should encourage workers to report alleged improprieties internally so that business leaders can investigate and correct a problem as quickly as possible. When workers don’t feel comfortable speaking up, they might decide to file a lawsuit or *share their concerns with an outside [entity]*.

<sup>783</sup> See, e.g., S. Olson, “Shaping an Ethical Workplace Culture,” SHRM FOUNDATION, at p. 1 (2013), available at <https://www.shrm.org/hr-today/trends-and-forecasting/special-reports-and-expert-views/Documents/Ethical-Workplace-Culture.pdf>.

<sup>784</sup> See, e.g., L. Eisenstein, “Ethical Issues for Nonprofit Organizations,” BOARD EFFECT (Jan. 3, 2020), available at <https://www.boardeffect.com/blog/ethical-issues-nonprofit-organizations/>;

the PCAOB staff are, and feel, protected against retaliation, with the Board periodically checking in with employees who have raised concerns and investigating any instances of retaliatory conduct.<sup>785</sup> The PCAOB needs to adopt a comprehensive plan for permitting employees and others to bring potential misconduct to the attention of independent individuals, who then follow a set procedure for the review and assessment of these types of complaints.<sup>786</sup>

- *Creation of a New Position of Chief of Staff for the PCAOB.*<sup>787</sup> As noted in the PCAOB’s press release, this position was intended to serve the entire Board, and not just the Chairman.<sup>788</sup> Thus, the PCAOB’s press release indicated that “Mr. Dymond will advise the Board on all matters that come before the PCAOB, work closely with Board members and staff, and assist the chairman in his management and administration of the PCAOB.”<sup>789</sup> On paper, it sounded as if this position was intended to be similar in material respects to a PCAOB Chief Operating Officer (“COO”). The difficulty with that, however, is that few of the other Board Members, or the senior PCAOB staff, were willing to treat the position in that manner.<sup>790</sup> While there is nothing new about having a COO for nonprofit organizations, there has been a movement toward formalizing this role, and emphasizing the need for management and operations expertise to assist the CEO.<sup>791</sup> But, if there is truly a need for this position, it should be formally created, identified as a senior officer of the PCAOB, and given true COO responsibilities.<sup>792</sup> In contrast, a Chief

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E. Gloeckner, “Charity Gone Wrong: Unethical & Illegal Conduct, RISK ENEWS (2020), available at <https://nonprofitrisk.org/resources/e-news/illegal-conduct/>.

<sup>785</sup> There are systems available that permit two-way anonymous conversations with whistleblowers. See, e.g., WHISPLI, “Six Steps to Make Your Whistleblower Program Truly Anonymous,” (2020), available at <https://resources.whispli.com/blog/anonymous-whistleblower-program>. The PCAOB should utilize such a system. See Section 3.1.9., *infra*.

<sup>786</sup> Our recommendations in this regard are set forth below. See Section 3.1.8.-3.1.12., *infra*.

<sup>787</sup> See PCAOB, “Francis ‘Abe’ Dymond Named Chief of Staff for the PCAOB,” (Jan. 2, 2018), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/francis-abe-dymond-named-chief-of-staff-for-the-pcaob> 653.

<sup>788</sup> *Id.*

<sup>789</sup> *Id.*

<sup>790</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at pp. 21, 29; Witness X (1<sup>st</sup> Interview), at pp. 5-6; Witness X Interview, at pp. 4-5; Witness X (1<sup>st</sup> Interview), at p. 25.

<sup>791</sup> See, e.g., Bridgestar, “The Nonprofit Chief Operating Officer,” at p. 1 (2009), available at <https://www.bridgespan.org/bridgespan/images/articles/the-nonprofit-chief-operating-officer/NonprofitCOO.pdf>.

<sup>792</sup> *Id.*

of Staff is someone whose loyalty is always to the leader he/she serves, as opposed to the organization overall.<sup>793</sup> There can be overlap between the two positions, but as organizations grow, there is rarely any effort made to combine the two roles in one individual.<sup>794</sup> We believe the creation of a true COO is a structural change the PCAOB should adopt.<sup>795</sup>

- ***Creation of a New Office of External Affairs.*** As previously noted,<sup>796</sup> toward the end of 2018, the PCAOB combined the existing offices of public affairs, government relations, outreach and small business liaison, and created a new liaison staff for the investor and business communities, to form a new Office of External Affairs.<sup>797</sup> The new Office of External Affairs has functioned well in updating the frequency and quality of communications among Board Members, between the Board Members and the PCAOB Staff, and with the PCAOB’s various external constituencies.<sup>798</sup>
- ***Creation of a New Office of Enterprise Risk Management.***<sup>799</sup> This Office was created to implement the Board’s strategic objective of implementing an Enterprise Risk Management (“ERM”) program for the PCAOB.<sup>800</sup> In essence, ERM “signifies any aspiration for a form of risk management that is all-encompassing in scope, business-focused, and is suggestive of a bird’s eye view of organizational life.”<sup>801</sup> It is a

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<sup>793</sup> See, e.g., M. Niebauer, “COO vs. COS—What Is the Difference?,” vChief (Jul. 31, 2017), available at <https://www.virtualchiefofstaff.com/post/2017/07/31/difference-between-coo-and-chief-of-staff>.

<sup>794</sup> *Id.*

<sup>795</sup> Our recommendations in this respect are set forth below. See Section 3.5.2., *infra*.

<sup>796</sup> See n. 320, *supra*, and accompanying text.

<sup>797</sup> See PCAOB, “Torrie Miller Matous Named PCAOB Director of Newly Formed Office of External Affairs,” (Nov. 12, 2018), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/torrie-miller-matous-named-pcaob-director-of-newly-formed-office-of-external-affairs> 686.

<sup>798</sup> See, e.g., Witness X Interview, at p. 25; Witness X Interview, at pp. 6-7.

<sup>799</sup> See PCAOB, “PCAOB Announces New Office of Enterprise Risk Management, Names Chief Risk Officer,” (Feb. 25, 2019), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-announces-new-office-of-enterprise-risk-management-names-chief-risk-officer> 694.

<sup>800</sup> *Id.*

<sup>801</sup> See, e.g., M. Herman, “Enterprise Risk Management: The Final Frontier,” Nonprofit Risk Management Center Articles (Dec. 17, 2020), available at <https://nonprofitrisk.org/resources/articles/enterprise-risk-management-the-final-frontier/>; M.

proactive, multidimensional process of identifying, assessing, cataloguing, and preparing for potential negative organizational outcomes in order to reduce business and reputation impacts and help meet core goals.<sup>802</sup> This is a salutary development, but it requires more in the way of implementation than has occurred to date,<sup>803</sup> especially given the dependency of the Board’s five-year strategic plan on an effective system of ERM.<sup>804</sup> In addition, as previously discussed,<sup>805</sup> the position of Chief Risk Officer was created and placed under the Chairman’s Office, and the Ethics Office was moved out of the GC’s Office and placed under the CRO position. We believe this is a serious problem, and have recommended changes in that structure.<sup>806</sup>

- *Creation of a New Chief Data Officer.*<sup>807</sup> Given the PCAOB’s lack of technological innovation prior to 2018, the creation of a new position of Chief Data Officer (“CDO”), and the retention of someone exceedingly experienced in technical and data analytics, is a very positive step forward for the PCAOB. The assignment for the CDO is to advance the PCAOB’s data management strategy, and enhance the organizational approach to data management and analytics.<sup>808</sup> We have discussed above the improvements already implemented to the PCAOB’s data management process, as well as the efforts that remain to be done.<sup>809</sup>

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Power, ORGANIZED UNCERTAINTY: DESIGNING A WORLD OF RISK MANAGEMENT, Oxford Univ. Press (2007).

<sup>802</sup> See, e.g., M. Musser, “Be Prepared: Why Enterprise Risk Management is Essential for Nonprofits,” Nonprofit Accounting Basics (June 18, 2019), available at <https://www.nonprofitaccountingbasics.org/be-prepared-why-enterprise-risk-management-essential-nonprofits>.

<sup>803</sup> See, e.g., Witness X Interview, at pp. 4-6; Witness X (1<sup>st</sup> Interview), at pp. 3-6.

<sup>804</sup> See PCAOB, Strategic Plan 2018-2022, at pp. 11, available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/strategic\\_plans/pcaob-2018-2022-strategic-plan.pdf?sfvrsn=d74236b3\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/pcaob-2018-2022-strategic-plan.pdf?sfvrsn=d74236b3_0) (“PCAOB Strategic Plan”).

Our suggestions in this regard are set forth below. See Section 3.6.1., *infra*.

<sup>805</sup> See n. 42, *supra*, and accompanying text.

<sup>806</sup> See Sections 3.1.1. & 3.1.2., *infra*.

<sup>807</sup> See PCAOB, “PCAOB Names Eric Hagopian Chief Data Officer,” (Feb. 25, 2019), available at <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-names-eric-hagopian-chief-data-officer-695>.

<sup>808</sup> *Id.*

<sup>809</sup> See Sections 2.5.6.1. & 2.5.6.2., *supra*.

- **Redefined Office of Economic and Risk Analysis.**<sup>810</sup> As part of the Board’s 2018-2022 Strategic Plan, the Board committed itself to better leveraging economic and risk analysis, to assist it in more effectively setting standards, rules and guidance to its various constituencies.<sup>811</sup> This is an important function, and it will require diligence to ensure that it makes the necessary progress intended by its creation.
- **Board Champions Initiative.** As previously discussed, another structural change was Chairman Duhnke’s Board Champions Initiative.<sup>812</sup> As briefly discussed, the goal of the Initiative was for Board Member “Champions” to identify policy matters of interest and present those to the rest of the Board for discussions and eventual policymaking decisions.<sup>813</sup> However, the initiative resulted in some Board Members pursuing decisions on their own, without consulting the Chairman’s Office or other Board Members.<sup>814</sup> As previously noted, the Board Champions program was a creative and useful approach to engaging each of the four Board Members (other than the Chairman) in the PCAOB’s work.<sup>815</sup> It would, in our view, be unfortunate if the misuse of the concept by one or two Board Members leads to its permanent abandonment.<sup>816</sup>
- **The Replacement of Board Member Hamm.** As previously noted,<sup>817</sup> former Board Member Hamm was not reappointed for a second term.<sup>818</sup>

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<sup>810</sup> See PCAOB, “Dr. Nayantara Hensel Named PCAOB Chief Economist, Director of Economic and Risk Analysis,” (June 17, 2019), available at [https://pcaobus.org/news-events/news-releases/news-release-detail/dr-nayantara-hensel-named-pcaob-chief-economist-director-of-economic-and-risk-analysis\\_704](https://pcaobus.org/news-events/news-releases/news-release-detail/dr-nayantara-hensel-named-pcaob-chief-economist-director-of-economic-and-risk-analysis_704).

<sup>811</sup> See *PCOAB Strategic Plan*, *supra* n. 804, at p. 7.

<sup>812</sup> See nn. 297-298, *supra*, and accompanying text.

<sup>813</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at p. 25.

<sup>814</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 11; Witness X Interview, at p. 24.

<sup>815</sup> See nn. 308-309, & 474, *supra*, and accompanying text.

<sup>816</sup> Our recommendations with respect to the Board Champions Initiative are set forth below, see Section 3.2.4., *infra*.

<sup>817</sup> See n. 118, *supra*, and accompanying text.

<sup>818</sup> Contrary to certain news articles, it is not unprecedented for a PCAOB Board Member (or Chairman) not to be reappointed for a second term. See, e.g., M. Kelly, “PCAOB Shakeup! What It Means for You,” RADICAL COMPLIANCE (Oct. 13, 2019), available at <https://www.radicalcompliance.com/2019/10/13/pcaob-shakeup-what-it-means-for-you/> (Stating, incorrectly, that , prior to Ms. Hamm, any PCAOB board member who wanted to serve a second term was reappointed) (“PCAOB Shakeup”).

After the SEC conducted a search (which included Ms. Hamm<sup>819</sup>), it appointed Rebekah Goshorn Jurata.<sup>820</sup> This was a significant structural change, but it was not engendered by the PCAOB; rather it was a structural change engendered by the five SEC Commissioners.<sup>821</sup> Press speculation attributed political motivations to the decision not to reappoint Board Member Hamm,<sup>822</sup> as well as the decision to replace her with Ms. Jurata.<sup>823</sup> Both parts of this speculation are baseless.<sup>824</sup>

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In fact, the following PCAOB Board Members and Chairmen served only single terms (although they may have held over for a number of years): Chairman William J. McDonough; Board Member Kayla J. Gillan; Chairman Mark W. Olson; Board Member Charles D. Niemeier; Acting Chair and Board Member Daniel L. Goelzer; Chairman James R. Doty; Board Member Jeanette M. Franzel; Board Member Kathleen M. Hamm; and Board Member James G. Kaiser. See PCAOB Website, Former Chairmen and Board Members, <https://pcaobus.org/about/the-board/former-chairmen-and-board-members>.

<sup>819</sup> See SEC, “Statement on Commencement of Appointment Process for the 2019-2024 PCAOB Board Seat,” (June 24, 2019), available at <https://www.sec.gov/news/public-statement/statement-teotia-062419>.

<sup>820</sup> See, e.g., SEC, “SEC Appoints Rebekah Goshorn Jurata to PCAOB,” Press Rel. No. 2019-211 (Oct. 11, 2019), available at <https://www.sec.gov/news/press-release/2019-211>.

<sup>821</sup> See nn. 819-820, *supra*, and accompanying text. Articles critical of the appointment of Ms. Jurata attributed the action to the SEC’s Chairman—see, e.g., A. Levitt, “The S.E.C.’s Clayton Turns Oversight Partisan,” NY TIMES (Oct. 24, 2019), available at <https://www.nytimes.com/2019/10/24/opinion/clayton-sec-pcaob.html> (“Partisan Oversight”)—but that was factually wrong, since it requires the *full Commission* to select and appoint members of the PCAOB. See *Free Enterprise Fund*, *supra* n. 62. The effort to characterize these events as “partisan” or “political” are unsupported and unsupportable, but denigrate important efforts to improve the PCAOB’s governance.

<sup>822</sup> See, e.g., J. Bramwell, “The SEC Got Rid of the Only PCAOB Member Not Drinking the William Duhnke Kool-Aid,” GOINGCONCERN (Oct. 15, 2019), available at <https://www.goingconcern.com/the-sec-got-rid-of-the-only-pcaob-member-not-drinking-the-william-duhnke-kool-aid/> (Relying on a Bloomberg article describing former Board Member Hamm as a “Democrat-aligned board member”) (“Duhnke Kool-Aid”; *Partisan Oversight*, *supra* n. 821).

<sup>823</sup> See *Duhnke Kool-Aid*, *supra* n. 822 (Casting the decision to replace Ms. Hamm with Rebekah Goshorn Jurata as one motivated by her political beliefs and describing Ms. Jurata as “one more loyalist vote on the PCAOB”); *Partisan Oversight*, *supra* n. 821 (Describing Ms. Jurata as “a policy aide and Republican political regular”); *PCAOB Shakeup*, *supra* n. 818 (Describing Ms. Jurata as someone “whose LinkedIn profile checks all the boxes for devout Republican and Trump loyalist”).

<sup>824</sup> With respect to Ms. Hamm, see n. 118, *supra*, and accompanying text. With respect to Ms. Jurata, her background is steeped in substantive SEC service, including important work in the SEC’s Division of Trading & Markets from 2008 to 2011, during the Obama Administration. Unlike the SEC, there are no political considerations governing the appointment of PCAOB Board Members, which is as it should be. Ms. Jurata’s work since joining the Board amply evidences both her independence and competence. See, e.g., R. Jurata, “Statement on Concept Release on Potential Approach to Revisions to PCAOB Quality Control Standards,” (Dec. 17, 2019), available at <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-concept-release-on->

## 2.14. Recusal of the Chairman and the OGC, and Retention of Outside Counsel, in Connection with the Whistleblower Complaints

Upon the filing of the May Whistleblower Complaint,<sup>825</sup> the Board was confronted with a number of process issues that needed to be resolved rapidly in order to deal expeditiously and effectively with the substantive allegations of the Complaint—issues that the five new Board Members and the remaining, as well as the new, senior PCAOB Staff had not previously addressed. Complicating the resolution of these process issues was the fact that the PCAOB did not have a full-time, and permanent, General Counsel when the May Whistleblower Complaint was filed,<sup>826</sup> and the Acting General Counsel, as well as the entire OGC, had been recused from participating in the handling of the May Whistleblower Complaint.<sup>827</sup>

The process issues that needed to be addressed at the outset included:

- Who should handle the specific Whistleblower Complaint?
- Who, if anyone, should be recused from participating in the resolution of the matter?
- How should the Complaint be handled?

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[potential-approach-to-revisions-to-pcaob-quality-control-standards 720](#) (Expressing appropriate interest in understanding the views of investors and audit committees before moving forward with the proposal); R. Jurata, “*Statement on the PCAOB 2020-2024 Strategic Plan and 2021 Budget*,” (Nov. 19, 2020), available at <https://pcaobus.org/news-events/speeches/speech-detail/jurata-statement-on-the-pcaob-2020-2024-strategic-plan-and-2021-budget> (Discussing the importance of audit evidence as well as data and technology).

<sup>825</sup> See Ex. 5, n. 34, *supra*, and accompanying text.

<sup>826</sup> As previously noted, (b)(6)

(b)(6)

At the time the May Whistleblower Complaint was posted on the EthicsPoint Hotline, the ranking PCAOB OGC official was Acting General Counsel, John Cook. See PCAOB Website, “*John Cook, Deputy General Counsel*,” <https://pcaobus.org/about/the-board/board-bios/john-cook> (Indicating that Mr. Cook had served as PCAOB Acting GC from May 2018 to February 2020).

<sup>827</sup> At the time the May Whistleblower Complaint was posted, Ms. Sue Lee, then the Chief Risk Officer was in charge of the PCAOB’s Ethics Office, and she advised Mr. Cook that, given the fact that the May Whistleblower Complaint stated that (at least) one of its signatories was a current employee of the OGC, that the *entire* OGC should be recused from participating in the handling of that Complaint, and Mr. Cook decided to do that. See nn. 40-42, *supra*, and accompanying text.

- Should the Board retain outside counsel?
- Who would the outside counsel represent?
- Who would oversee the performance of, and interface with, outside counsel (assuming outside counsel was retained), given the broad recusal of the entire OGC?
- On what terms should outside counsel be retained?
- How would the payment for outside counsel be managed vis-à-vis the Board's current budget?
- Who would make decisions with respect to substantive issues given the Chairman's recusal?

At the time of the filing of the May Whistleblower Complaint, the Board had neither any experience in responding to matters from which the Chairman was recused, nor any specific internal rules for resolving these types of process questions.<sup>828</sup> That was unfortunate, because the Board essentially was required to respond in real time, and with no advance preparation. And the Board was required to do so without the benefit of a framework for the resolution of these types of issues. As a result, the Board found itself locked-in to what is usually the least effective way of dealing with important process issues like these.<sup>829</sup>

The PCAOB's Ethics Code contains important *general* principles regarding the types of ethical issues raised by the May Whistleblowing Complaint but lacks concrete guidance on how these types of matters should be addressed. Thus, Rule EC3(a)(1) ("General Principles") reminds Board Members and PCAOB staff of "the need for public confidence in the objectivity and deliberative process of the Board,"<sup>830</sup> and Rule EC3(b)(3) prohibits Board Members and PCAOB staff from acting in a manner that might create the appearance that they are "losing independence or objectivity with respect to [their] work for the Board," irrespective of whether that conduct is specifically prohibited by the Ethics Code.<sup>831</sup>

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<sup>828</sup> Indeed, the Board had not adopted any specific rules governing whistleblowing complaints. See PCAOB, Bylaws, Board Rules and Ethics Code (Jul. 12, 2016), available at <https://pcaobus.org/Rules/Documents/All.pdf>.

<sup>829</sup> See, e.g., Inst. of Chartered Accountants in England & Wales, "*Framework for Resolving Ethical Problems*," (2020), available at <https://www.icaew.com/technical/ethics/framework-for-resolving-ethical-problems> (Recommending, among other things, that organizations adopt, and then rely on the organization's *existing* internal procedures).

<sup>830</sup> See [https://pcaobus.org/about/rules-rulemaking/rules/ethics\\_code](https://pcaobus.org/about/rules-rulemaking/rules/ethics_code).

<sup>831</sup> *Id.*

Similarly, Rule EC8 (“Disqualification”) requires a Board Member or PCAOB staff member to “recuse himself/herself from further Board functions or activities involving or affecting a financial or personal interest” of the Board Member or employee.<sup>832</sup> The Rule requires that Board Members make disclosure of such matters to all other members of the Board, and that, in the case of the PCAOB’s professional staff, “disclosure shall be made to the Board Chair, or his or her designee.”<sup>833</sup>

Presumably, the PCAOB’s Chief Ethics Officer is the Chairman’s “designee” for purposes of PCAOB staff disclosures.<sup>834</sup> But when the Chief Ethics Officer is employed in the Chairman’s Office, and the Chairman is himself/herself disqualified, this provision does not inform staff members to whom they should make disclosure.<sup>835</sup> This is unfortunate, since it is a cardinal principle of nonprofit corporate governance that such organizations should adopt and implement policies and procedures to ensure that all conflicts of interest, or the appearance of conflicts of interest, within the organization and its board are appropriately managed through disclosure, recusal and other means.<sup>836</sup>

It is commonly acknowledged that, since conflicts of interest are inevitable, the only appropriate way to handle them is to deal with them in advance, and in an organized manner.<sup>837</sup> That means establishing a practice for responding to the

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<sup>832</sup> *Id.*

<sup>833</sup> *Id.*

<sup>834</sup> We are not aware of any formal designation by the current Chairman pursuant to this provision of the PCAOB’s Ethics Code. Rule EC11 (“Ethics Officer”) of the PCAOB’s Ethics Code (emphasis supplied) provides that “the *Board*” “shall designate an Ethics Officer.” To our knowledge, the appointment of Ms. Horton as the PCAOB Ethics Officer occurred by the act of Ms. Lee, who at the time was the PCAOB’s Chief Risk Officer, and not by virtue of a formal selection by the Board itself, although Ms. Horton apparently met with each of the Board Members before she was told by Ms. Lee that she had been hired. *See, e.g.,* Witness X Interview, at p. 2.

<sup>835</sup> Our recommendations for a more specific set of policies and procedures regarding potential conflicts of interest are set forth below. *See* Sections 3.1.13. & 3.1.14., *infra*.

<sup>836</sup> *See, e.g.,* L. Slutsky & M. Wheeler, “*Principles for Good Governance and Ethical Practice*,” PANEL ON THE NONPROFIT SECTOR (Oct. 2007), at p. 9, available at <https://www.ncfp.org/wp-content/uploads/2019/01/Principles-Guide-Independent-Sector-2007-principles-for-good-governance-and-ethical-practice.pdf>.

<sup>837</sup> *See, e.g.,* BoardSource®, “*Coming to Terms with a Conflict of Interest*,” (June 20, 2016), available at <https://boardsource.org/resources/coming-terms-conflict-of-interest/>; S. Paul & D. Kurtz, *Managing Conflicts of Interest* (2<sup>nd</sup> Ed. 2013), at p. 55 (“Managing Conflict”).

reporting or discovery of a conflict of interest, *in advance of* the actual existence of a conflict,<sup>838</sup> and codifying the practice in a formal written set of procedures.<sup>839</sup>

Here, the Board had no such codified practices, and still does not. Indeed, even the proposed revisions of the Ethics Code would not set forth such a written set of practices, even though a set of written practices should be an important component of these revisions.<sup>840</sup> A starting point should be the delineation of what types of conflicts require or suggest recusal—namely when an individual’s personal interests could compromise his/her judgment, decisions, or actions in the workplace.<sup>841</sup>

The fact that the May Whistleblower Complaint was stated to have been submitted by at least one member of the OGC should not have resulted in a seemingly automatic recusal of the Acting GC—but unfortunately it resulted not only in the Acting GC being recused, it also led to the *entire* OGC being recused from any involvement in the matter.<sup>842</sup> There was no analysis of the recusal issue—either in writing or otherwise<sup>843</sup>—and the Board was, effectively, confronted with a *fait accompli* rather than having an opportunity to reason through to a sensible analysis of the recusal question.<sup>844</sup> But, all conflicts are not

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<sup>838</sup> Managing Conflict, *supra* n. 837, at p. 55.

<sup>839</sup> *See, e.g., id.*, at p. 60.

<sup>840</sup> *See, e.g.*, Draft Revised Ethics Rules, *supra* n. 596.

<sup>841</sup> *See, e.g.*, Integrity Star, “*Understanding Conflict of Interest*,” Univ. of Central FL. (April 2016), available at <https://compliance.ucf.edu/understanding-conflict-of-interest/>; Zucker School of Medicine, “*Conflict of Interest and Recusal Policy*,” Northwell Health (2020), available at <https://medicine.hofstra.edu/policy/policy-coi-recusal.html#sectionname> (Setting forth the general and specific terms of a Conflicts and Recusal Policy).

<sup>842</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 12; Witness X (2<sup>nd</sup> Interview), at pp. 1-3. This position was wrong as a matter of law, but worse, its very breadth guaranteed that the Board would not have any internal counsel available to advise it.

<sup>843</sup> *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at pp. 1-3; Witness X (1<sup>st</sup> Interview), at p. 12.

<sup>844</sup> In essence, the Board was told that the Acting GC and the entire OGC had been recused, and it never was given, nor did it seek, an opportunity to reconsider that position. *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at pp. 23-24; Witness X (2<sup>nd</sup> Interview), at pp. 17-19; Witness X (2<sup>nd</sup> Interview), at p. 22. Even if there had been a valid issue about the need for recusal, the Board never explored what it could have done in that event. Conflicts can be waived, with full disclosure, and the Acting GC or some other member of his staff could have been permitted to provide the Board with appropriate legal guidance. It is difficult to understand the rationale for the actions with which the Board was presented, but it is even more difficult to comprehend why there was a general lack of prudent consideration of relevant recusal law. Moreover, even when the Board hired outside counsel, it is unfortunate that it never sought an opinion from the outside counsel it hired on whether the Board was required to treat the entire OGC as recused.

the same. A conflict that involves a personal financial or family interest is vastly different from a conflict that purportedly involves the fact that an anonymous person in the same division or office is involved.<sup>845</sup> In the former instance, recusal may invariably be required; in the latter, recusal may not be required, or it can be waived.<sup>846</sup>

To avoid problems like this—where the Board is left without any internal counsel to guide it—it should have been a standard procedure, established long in advance of any specific incident, for the GC, or Acting GC, to know that, if he had not been one of the signatories to the May Whistleblower Complaint, he was not required to recuse himself.<sup>847</sup> It is appropriate and, more importantly, necessary, for the Board to be fully versed on what types of connections on the part of various staff members should be deemed to lead to the necessity of a formal recusal, and these should be set forth in a written policy on conflicts of interest.<sup>848</sup>

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<sup>845</sup> See, e.g., Nat'l Council of Nonprofits, “*Conflicts of Interest*,” (2020), available at <https://www.councilofnonprofits.org/tools-resources/conflicts-of-interest>.

<sup>846</sup> See, e.g., A. S. Guardino, “*When Should Board Members Recuse Themselves?*,” 255 N.Y. L. J. 55 (Mar. 23, 2016), available at <https://www.farrellfritz.com/when-should-board-members-recuse-themselves/>.

<sup>847</sup> From the face of the May Whistleblower Complaint, it was more likely than not that the Acting GC had *not* been a signatory. This could be an issue that can be fraught with difficulty if handled inappropriately or cavalierly. There is a strong preference among governance experts that, when whistleblower complaints are filed, no efforts be expended to try to ascertain who the complainant is (or was). See, e.g., WHISPLI, “*Six Steps to Make your Whistleblower Program Truly Anonymous*,” WHISPLI Blog, available at <https://resources.whispli.com/blog/anonymous-whistleblower-program> (“*Six Steps*”) (Noting that, if the whistleblower is anonymous, no efforts should be made to try to identify the whistleblower’s identity).

But, in the circumstance confronting the PCAOB, it was highly unlikely that the Acting GC was a signatory to the May Whistleblower Complaint, and it should have been a previously adopted part of established policy and procedure for him to know that he was expected to volunteer that he was not a signatory to the document (if that were, in fact, the situation). The policy should, of course, permit such a senior staff official to decide, for any reason or no reason at all, not to volunteer any information about that aspect of a whistleblower complaint, simply as a matter of principle. The initial suggestion that the Acting GC recuse himself from the May Whistleblower Complaint emanated from the then Chief Risk Officer, Sue Lee, who apparently did not have specialized ethics training and who reported directly to the Chairman. Ms. Lee initially started to handle the response to the May Whistleblower Complaint, until she was asked to stop doing so by the Board. See, e.g., Witness X (1<sup>st</sup> Interview), at p. 6.

<sup>848</sup> See, e.g., N. Price, “*Conflict of Interest Policy for Nonprofit Boards*,” Board Effect Blog (Apr. 18, 2018), available at <https://www.boardeffect.com/blog/conflict-of-interest-policy-for-nonprofit-boards/> (“*Conflict of Interest Policy*”); see also, L. Eisenstein, “*Conflict of Interest: Examples for a Nonprofit Board*,” Board Effect Blog (Dec. 6, 2019), available at <https://www.boardeffect.com/blog/conflict-interest-examples-nonprofit-board/>. The IRS requires

Going forward, if the GC is personally disqualified from participating in a matter, there should be a designation of who in the OGC, under those circumstances, will provide legal advice to the Board. In most instances, this can be the Deputy GC, but the most important aspect of the codification of these practices is to have someone already designated who can prepare in advance, and be able to handle the situation in the event the GC needs to be recused from any involvement in the matter.<sup>849</sup> And, while it may be theoretically possible for the entire OGC to be recused from working on a matter, the likelihood of that occurring, or being necessary, is very slim, at best.<sup>850</sup> At present, the PCAOB currently lacks such policies, either in writing or otherwise, and in the revision to the existing PCAOB Ethics Code, there is no proposal to create such policies or procedures.<sup>851</sup>

Once the Board decided to retain outside counsel, a number of issues arose that the Board apparently did not consider. Most significantly, the utilization of outside counsel introduces, among other things, questions of cost and scope of representation. The four Board Members functioned, effectively, as a committee of the whole,<sup>852</sup> effectively making decisions collaboratively, without any formal rules or policies to guide them. Thus, a decision was made to retain the Venable law firm, largely on the theory that Venable had been doing other work for the

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nonprofit entities to state whether they have a written conflict of interest policy. *See Conflict of Interest Policy.*

<sup>849</sup> Again, these policies and procedures should be spelled out, in writing, and be a permanent part of the procedures to be employed in handling whistleblower complaints. *See, e.g., Managing Conflict, supra* n. 837, at p. 60; *Six Steps, supra* n. 847.

<sup>850</sup> *See, e.g.,* E. Carter, “*Managing Conflicts of Interest*,” *Charity Lawyer* (Feb. 10, 2014), available at <https://charitylawyerblog.com/2014/02/10/managing-conflicts-of-interest/>. Moreover, conflicts can be waived if the circumstances warrant, or the so-called “rule of necessity” requires.

<sup>851</sup> The provision for alternate stand-ins when the person normally expected to handle a matter is recused, need not be a formal part of the revised Ethics Code, but it should be formally codified, written, and readily ascertainable by all who have an interest in those matters. *See, e.g.,* Dept. of State OGC, “*Alternate Members of County and Local Planning Boards and Zoning Boards of Appeals*,” Legal Memorandum LU06 (Dec. 25, 2020), available at <https://www.dos.ny.gov/cnsl/lu06.htm>; Soc. for Psych. Anthropology, “*Conflict of Interest and Recusal Policy for Selection Committees*,” (Dec. 4, 2014), available at <http://spa.americananthro.org/welcome-to-the-spa/conflict-of-interest-and-recusal-policy-for-selection-committees/> (Including in the Policy a provision of replacing a recused official with an alternative).

<sup>852</sup> The term “committee of the whole” originated in 1689 and is defined to mean “the whole membership of a legislative house sitting as a committee and operating under informal rules.” *See* Merriam-Webster Unabridged Dictionary (2020), available at <https://www.merriam-webster.com/dictionary/committee%20of%20the%20whole#h1>.

PCAOB,<sup>853</sup> and that this could be handled as an add-on to Venable’s existing retainer agreement.<sup>854</sup>

No statement of work and no estimate of fees was requested from Venable, and none was provided.<sup>855</sup> Until KLS delved into the details of the arrangements made with the Venable firm, and sought documents concerning the payments and relationships with the Firm, the four Board Members did not know the actual amount of fees they had already expended on Venable’s representation.<sup>856</sup> The billing statements from Venable were sent to the otherwise-recused Acting GC, who reviewed and approved them for payment.<sup>857</sup> As a general matter, with no one monitoring the actual fees being paid out to Venable, there was no coordination with those on the staff of the PCAOB who monitored the organization’s expenditures to ensure compliance with the Board’s annual budget.<sup>858</sup>

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<sup>853</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 19; Witness X (2<sup>nd</sup> Interview), at p. 23.

<sup>854</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 19.

<sup>855</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 19-20; Witness X (2<sup>nd</sup> Interview), at p. 26; Witness X (2<sup>nd</sup> Interview), at pp. 22-23. At the outset of our engagement, KLS provided the Board with a statement of work. See nn. 105-107, *supra*.

<sup>856</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 26. At our last inquiry, as mentioned above (see n. 141, *supra*), the amount of fees paid to Venable for its representation amounted to \$400,000. See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 21; Witness X (2<sup>nd</sup> Interview), at p. 26.

<sup>857</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 3-5; Witness X (2<sup>nd</sup> Interview), at p. 19; Witness X (2<sup>nd</sup> Interview), at p. 26. It does not appear that any questions were raised about any of the invoices received, and all were apparently paid as presented. See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 20-21; Witness X (2<sup>nd</sup> Interview), at p. 26.

There is an inherent inconsistency in the notion that the same individual who was recused from any participation in the responses to the two Whistleblower Complaints could somehow not be recused for purposes of reviewing and approving the Venable invoices received by the Board. That inconsistency takes two forms—first, the Acting GC was recused for some matters, but not for others; and second, someone with no knowledge of (or participation in) the substantive handling of the Whistleblower Complaints could not effectively assess the appropriateness of the invoices received.

<sup>858</sup> At the outset of the relationship with Venable, the four Board Members were told that there were ample funds available to pay Venable’s fees, and that guidance was deemed sufficient during the entire process. See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 21; Witness X (2<sup>nd</sup> Interview), at p. 26; Witness X (2<sup>nd</sup> Interview), at pp. 6-7. The Board’s annual budgets for 2019 and 2020 were \$273.7 million (see PCAOB, “2019 Budget by Cost Category,” available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/fiscal\\_year\\_budgets/2019.pdf?sfvrsn=f28f3d9f\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/fiscal_year_budgets/2019.pdf?sfvrsn=f28f3d9f_0)) and \$284.7 million (see PCAOB, “2020 Budget by Cost Category,” available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/fiscal\\_year\\_budgets/2020.pdf?sfvrsn=ae193c44\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/fiscal_year_budgets/2020.pdf?sfvrsn=ae193c44_0)),

As previously noted, there was some confusion regarding precisely who Venable would represent.<sup>859</sup> Eventually, it was agreed that Venable would only represent the Board, acting *qua* Board, and would not represent any individual, either on the Board itself or on the PCAOB's staff.<sup>860</sup> At least two Board Members decided to retain individual counsel as well,<sup>861</sup> in a matter that was non-adversarial, and not designed to create a basis for pursuit of any claims of misconduct on the part of any individual.<sup>862</sup>

Finally, when the Board Members learned that the SEC's OIG would conduct a review of the two allegations in the September Whistleblower Complaint that suggested some degree of possible wrongdoing solely on the part of Board Chairman Duhnke, Venable's retention was expanded to include representation of the PCAOB in connection with those interviews, and the two Board Members who had retained their own personal counsel were also reimbursed for the representation provided in connection with the OIG's separate inquiry.

Since conflict issues are inevitable, we believe the PCAOB needs to adopt formal policies governing how it will respond when the Chairman of the Board, as well as others, are the subject of conflicts.<sup>863</sup>

## **2.15. The Board's Methodology of Responding to the May and September Whistleblower Complaints and the Bases for those Complaints' Substantive Claims**

### **2.15.1. The Board's Response Methodology**

In response to the May Whistleblower Complaint, the Board Members, excluding the Chairman, conferred with the SEC Staff.<sup>864</sup> The Chairman had

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respectively. An unforeseen item of at least \$ one-half million was sufficiently large to matter to the PCAOB.

<sup>859</sup> See n. 140, *supra*, and accompanying text.

<sup>860</sup> See Ex. 7, n. 95, *supra*.

<sup>861</sup> See, e.g., Witness X, Interviews, at pp. 1-2.

The representation by additional counsel was also covered by the PCAOB, adding to the costs of counsel. We were not provided with the amounts these additional representations incurred.

<sup>862</sup> See nn. 2-3, 139, *supra*, and accompanying text.

<sup>863</sup> Our recommendations are set forth below. See Section 3.1.13.-3.1.15., *infra*.

<sup>864</sup> See KLS, Notes of call with R. Humes & (b)(6) (Jul. 1, 2019), at p. 2.

appropriately chosen to recuse himself from the process of considering or responding to the May Whistleblower Complaint, because it specifically named him and his staff as the subjects of its allegations.<sup>865</sup> The Board lacked, but should have adopted, a detailed plan for handling whistleblower complaints,<sup>866</sup> so no pre-complaint methodology had been established for the Board and PCAOB employees to follow with respect to how the May Whistleblower Complaint would be investigated.<sup>867</sup>

There was no *formal* legal requirement—under either federal or D.C. law—that compelled the Board to have adopted a formal whistleblowing policy, but there were, and are, strong and persuasive existing legal requirements<sup>868</sup> that make having such a policy a best governance practice.<sup>869</sup> Whistleblower policies are generally recognized as part of an effective compliance program and an important part of an effective enterprise risk management and internal control

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<sup>865</sup> See Witness X (1<sup>st</sup> Interview), at pp. 33-34

<sup>866</sup> See Section 3.1.8.-3.1.12., *infra*.

<sup>867</sup> Studies have shown that whistleblower tips are more effective in uncovering improper behavior within a nonprofit organization than any other method, including strong internal controls, internal audits and external audits. See, e.g., “Whistleblowing at Your Not-for-Profit: A Leader’s Guide,” Your-Call Pty Ltd. (June 2017), at p. 6, available at <https://www.ourcommunity.com.au/files/whistleblowingbook.pdf>.

<sup>868</sup> Thus, for example, the IRS Form 990 requires IRS-registered nonprofits to respond to questions regarding the existence of a written whistleblower policy, and includes instructions regarding whistleblowing. See, e.g., P. Clolery, “NPT Study: Most Nonprofits Don’t Have Whistleblower Policies,” (Feb. 18, 2020), available at <https://www.thenonprofitimes.com/hr/npt-study-most-nonprofits-dont-have-whistleblower-policies/>. In addition, the D.C. Council adopted a Whistleblower Protection act. See D.C. Code §§1-615.51-1-615.59.

The PCAOB does not file Form 990s with the IRS. See K. Lench, Email to H. Pitt (Dec. 23, 2020).

<sup>869</sup> See, e.g., Nat’l Council of Nonprofits, “Whistleblower Protections for Nonprofits,” (2020), available at <https://www.councilofnonprofits.org/tools-resources/whistleblower-protections-nonprofits>; J. Zuckerman & K. Krems, “Whistleblower Protections for Nonprofit Employees,” The Nat’l L. Rev., available at <https://www.natlawreview.com/article/whistleblower-protections-nonprofit-employees>; Wagenmaker & Oberly, “How Nonprofit Directors Should Handle Whistleblower Complaints—Carefully!,” (Apr. 7, 2016), available at <https://wagenmakerlaw.com/blog/how-nonprofit-directors-should-handle-whistleblower-complaints-%E2%80%93carefully> (“It is now standard ‘best practice’ for responsible nonprofits to have a board-approved whistleblower policy in place”); C. Lewin & S. Salisbury, “Whistleblower Protection at Nonprofits,” (Oct. 18, 2018), available at <https://www.venable.com/files/Event/c0376c33-f37c-4ed5-9fdd-9abd22bfe0f2/Presentation/EventAttachment/af0295a2-0848-490a-8bbe-b07bc99e98b9/10-18-2018-California-Lawyers-Association--Whistleblower-Protection-at-Non-Profits.pdf>.

assessment program.<sup>870</sup> These policies should set forth all the details of how anonymous whistleblower complaints can be filed, and exactly how they will be handled—as well as by whom—when a whistleblowing complaint is submitted.<sup>871</sup> Perhaps most importantly, a formal whistleblowing program

[S]hould provide for 2-way anonymous communication. It should not provide details like location, IP address, or employment information. Additionally, it should not provide details like location, IP address, or employment information. Additionally, it should not ask an employee for their corporate username and password to submit a report.<sup>872</sup>

The importance of a two-way anonymous communication system cannot be overstated—it permits a continuing dialogue with the original whistleblower(s) and serves several beneficial purposes including, among other things:

- Keeping whistleblowers up to date on progress being made on their complaint;
- Permitting a request for additional information; and
- Learning about any efforts suggesting retaliation for the filing.

Here, after the May Whistleblower Complaint was filed, there was no way available for the Board to communicate directly with the originators of that complaint.<sup>873</sup> Although this is something that requires careful consideration, the Board could have communicated with all PCAOB employees, informing them that a complaint had been received.<sup>874</sup>

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<sup>870</sup> See, e.g., COSO, *Internal Control—Integrated Framework* (2013), available at <https://www.coso.org/documents/COSO%20McNallyTransition%20Article-Final%20COSO%20Version%20Proof%205-31-13.pdf>; NYS Att’y Gen’l, “*Whistleblower Policies under the Nonprofit Revitalization Act of 2013*,” (2015), at p. 2, available at [https://www.charitiesnys.com/pdfs/Charities Whistleblower Guidance.pdf](https://www.charitiesnys.com/pdfs/Charities%20Whistleblower%20Guidance.pdf).

<sup>871</sup> See, e.g., Nat’l Council of Nonprofits, “*Sample Whistleblower Protection Policy*,” (2010), available at <https://www.councilofnonprofits.org/sites/default/files/Sample%20WhistleblowerPolicy%2020210.pdf>; Nonprofit Network, “*Whistleblower Policy*,” (Jul. 23, 2015), available at <https://www.councilofnonprofits.org/sites/default/files/Sample%20WhistleblowerPolicy%2020210.pdf>; BoardSource, “*Sample Whistleblower Protection Policies*,” <https://www.councilofnonprofits.org/sites/default/files/Sample%20WhistleblowerPolicy%2020210.pdf>.

<sup>872</sup> See WHISPLI, “*Six Steps to Make Your Whistleblower Program Truly Anonymous*,” Blog, (Dec. 18, 2020), available at <https://resources.whispli.com/blog/anonymous-whistleblower-program>.

<sup>873</sup> This is a deficiency in the PCAOB’s current Whistleblower System. Our recommendations for correcting this deficiency are set forth below. See Section 3.1.9. & 3.1.11., *infra*.

<sup>874</sup> There are difficult—and countervailing—considerations with respect to whether the filing of a whistleblower complaint should be made a matter of organizational disclosure. First, the mere

But, after receiving the May Whistleblower Complaint, the Board did not initiate any communications with the PCAOB Staff to tell them that a complaint had been received, or what the Board Members who were not recused were doing in response to it. By the time the September Whistleblower Complaint was submitted to SEC Commissioner Roisman,<sup>875</sup> the original submitters of the May Complaint had heard nothing, and they assumed that no action had been taken on their original complaint, making it one of the items they raised in September.<sup>876</sup>

While still recused, Chairman Duhnke circulated a message in response to an article in the WALL STREET JOURNAL<sup>877</sup> reporting the existence of the September Whistleblower Complaint.<sup>878</sup> This note reaffirmed the Board's commitment to promoting audit quality and fulfilling the PCAOB's mandate and urged anyone with information to share that information "confidentially and anonymously" through the Ethics Hotline.<sup>879</sup> The Chairman assured the organization that the allegations were being taken seriously.<sup>880</sup>

This information was important, and it was appropriate for those aspects of the complaint to be made known to the full PCAOB staff. The fact that the Board Members who were not recused did not issue it is unfortunate. The Chairman,

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filing of a whistleblower complaint does not mean that anything inappropriate had occurred. Publicizing the filing of a complaint can, if handled improperly, adversely affect the subject of the filing. Second, depending on the nature of the complaint and the disclosure of its filing, the identity of a whistleblower could become known (or easier to ascertain), and that consequence is prohibited by law. On the other hand, informing the PCAOB's employees of a complaint (in generic terms) can promote confidence that the anonymous reporting system is legitimately interested in ascertaining any instances of potential misconduct. And, it could encourage others, with similar experiences, to come forward with additional information that might help the Board make an informed decision about how to handle the original complaint. A two-way anonymous communication system solves some, but not all, these problems. Another potential tool is for the Board to adopt a quarterly reporting system, in which it indicates that certain types of complaints (again, only generically) have been filed and there is an active, ongoing review of those complaints.

<sup>875</sup> See n. 48, *supra*, and accompanying text.

<sup>876</sup> See KLS Summary of September Whistleblower Complaint, Ex. 6, *supra* n. 48.

<sup>877</sup> See D. Michaels & J. Eaglesham, "Audit Watchdog Plagued by Internal Strife, Whistleblower Claims," WALL ST. J. (Oct. 15, 2019), available at <https://www.wsj.com/articles/audit-watchdog-plagued-by-internal-strife-whistleblower-claims-11571152206>.

<sup>878</sup> See Chairman Duhnke, Chairman Note (Oct. 16, 2019); and *see*, Witness X Interview, at p. 29.

<sup>879</sup> See Chairman Duhnke, Chairman Note (Oct. 16, 2019).

<sup>880</sup> See Chairman Duhnke, Chairman Note (Oct. 16, 2019).

having recused himself from the matter, should not have been the one to send out a notice to all PCAOB employees. Had there been a sensible Whistleblower Policy in place, the decision to send out a message to all PCAOB employees presumably would have been an assigned responsibility of one of the Board Members who was not recused from participation or consideration of the complaint.

### **2.15.2. Substantive Bases for the May and September Whistleblower Complaints**

As we noted at the outset of this Report,<sup>881</sup> the direct resolution of each of the specific claims made in the May and September Whistleblower Complaints was not part of our mandate. However, in the course of reviewing and assessing the PCAOB's corporate governance, we necessarily reached conclusions about the two complaints—both in general and with respect to specific allegations—that we set forth immediately below.

#### **2.15.2.1. Generic Observations on the Whistleblower Complaints**

The most troublesome aspect of both whistleblower complaints is that they appear to be caused in significant part by a lack of sensitivity on the part of the Chairman, his staff, and the other Board Members, about the need to identify, *in advance*, certain of the Board's programmatic decisions. This advance discussion was necessary to assure that the PCAOB's staff would understand the things that were about to transpire, as well as the reasons for them. Exacerbating this lack of advance knowledge was the failure of all Board Members to monitor PCAOB staff reactions to programmatic changes as they were being implemented, as well as to explain, *after the fact*, the rationale for various of the implemented programmatic decisions that had caused considerable staff unease.

A second troublesome aspect of both whistleblower complaints is that they reflect an absence, on the Board's part, of an effort to anticipate likely PCAOB staff reactions. Everyone—both on the Board and the PCAOB's staff—was aware that this was the first time since the creation of the PCAOB that all five Members would be appointed at one time.

Since this was a novel experience, some time and attention should have been given to the impact of the appointment of all five Board Members at once, as well as whatever programmatic decisions they were about to implement. Each new Board Member had available to him or her seasoned PCAOB employees, who could have been utilized to assist the Board in figuring out what aspects of their agenda were likely to create concerns among the PCAOB's staff.

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<sup>881</sup> See Section 1.3., *supra*.

Conversely, both Whistleblower Complaints seemed to reflect hostility to the impending changes in how the Board operated, and a lack of insight into how the PCAOB was being perceived in the wake of a number of troublesome events that had preceded the appointment of the new Board. It is worth noting that, at the time the May Whistleblower Complaint was filed, the entire Board had been in place for at least a full year. To some extent, the May Complaint reflected an asserted issue that really was not at the heart of the concerns of those who handled the filing.

Thus, perhaps the most worrisome thing—from the perspective of PCAOB staff members—was that the new Board replaced seven senior members of the PCAOB’s staff without warning or stated rationale. And yet, there is not a word of that in the May Whistleblower Complaint. That Complaint deals solely with the concern that the signatories to the posted complaint claimed to have been directed (or heard others being directed) not to share certain information with Board Members other than the Chairman.

While any potential violation of legal or ethical standards is surely appropriate for discussion on the Board’s hotline, the concerns expressed in May were solely claims on behalf of a class of effective third-party beneficiaries—that is, the four Board Members who were not the Chairman. That is why the purported harm cited in the May Whistleblower Complaint—the fear that the signatories’ jobs would be jeopardized if (or when) the other Board Members discovered what these signatories had purportedly been directed to do—is not credible as the real basis for the filing of this Complaint, and does not state a harm to the signatories of the May Complaint.<sup>882</sup>

Moreover, even if the truth of the allegation were assumed, it is difficult to see this as a problem. First, any of the signatories to the May Whistleblowing Complaint presumably could have communicated the concerns the Complaint expressed to one or more of the Board Members directly. Second, if Board Members were actually being deprived of information, it is inconceivable that they would have remained oblivious for very long to the fact that their deprivation was the subject of a Chairman’s directive. At some point, projects engaged in by the PCAOB’s staff would, necessarily, have come to the attention of all the Board Members. Given their backgrounds and experience, it is inconceivable that one or more, and most likely all four, would not have discovered that projects had been instituted without their knowledge or participation.

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<sup>882</sup> See n. 39, *supra*, and accompanying text.

The September Whistleblower Complaint, in contrast, was more direct than the May Whistleblower Complaint was. Its focus was largely directed at the discharge of senior PCAOB staff and the alleged politicization of the Board by its Chairman, William Duhnke, and suggests that, because the signatories viewed him as unqualified for his position, his appointment may have violated S-Ox.<sup>883</sup>

#### 2.15.2.2. Specific Observations on the Whistleblower Complaints

With respect to the principal concern originally alleged—that is, that the Chairman had directed various PCAOB staff members to withhold information from other Board Members, we found no support for that assertion. The Board Members themselves were asked directly by us about their access to information, and the sharing of information with them. They indicated that they had access to whatever information they wished and had not been aware of any directives vis-à-vis the sharing of information.

On the other hand, there were instances where, perhaps due to the absence of a Board Member, certain decisions, like the appointment, or the termination of the employment, of certain PCAOB employees was not timely brought to the attention of some of the Board Members.<sup>884</sup> Much of what we

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<sup>883</sup> As a practical matter, the appointment of PCAOB Board Members is a function performed by the five SEC Commissioners. There is no conceivable way in which our review of the PCAOB's governance could, or should, come up with recommendations for future appointments by the SEC to the PCAOB Board.

Nonetheless, the claim made in the September Whistleblower Complaint that Mr. Duhnke was not qualified to serve as Chairman is both incorrect as a factual matter, and inconsistent with the Board's past history. Mr. Duhnke, among other things, served twice as staff director and general counsel to the Senate Banking Committee, a position that provided him with a comprehensive perspective on the substantive regulation of financial services and accounting in both the U.S. and globally. His management credentials are also considerable, and he had served in a variety of roles that directly bear on his ability to manage large organizations, like the PCAOB.

The fact that Mr. Duhnke has, at times, served in positions of political significance should not gainsay his expertise or disqualify him from serving on the Board, any more than it disqualified former Board Members Gradison (who also served as Acting Chair), *see* PCAOB Website, "*Former Chairmen and Board Members: Bill Gradison*, available at <https://pcaobus.org/about/the-board/former-chairmen-and-board-members/board-bios/bill-gradison>, or Board Member Harris (who occupied the same position with the Senate Banking Committee as did Mr. Duhnke, albeit under the leadership of Senators from the opposite political party), *see* PCAOB Website, "*Former Chairmen and Board Members: Steven B. Harris*, available at <https://pcaobus.org/about/the-board/board-bios/steven-b.-harris>.

<sup>884</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p 13; Witness X Interview, at pp. 10-11.

observed was a lack of sensitivity to the requirements of the PCAOB’s Bylaws, a subject we discuss in our recommendations.<sup>885</sup>

The allegations that Chairman Duhnke intended to politicize the PCAOB or deprive it of its institutional knowledge also were unsupported after our review. It is not clear what is meant by politicizing the PCAOB, since the issues with which the PCAOB must deal do not readily translate into political issues. These claims largely seem to reflect the reaction to the discharge of seven senior PCAOB officials.

We reviewed the process of replacing these individuals, and it appears that, for the job vacancies created by the employment terminations, as well as the new positions created, independent headhunters were utilized for some vacancies, some of those ultimately hired applied through online postings, and others were recruited by someone already at the PCAOB.<sup>886</sup> The senior officers who were discharged did not appear to have been discharged for “political reasons,” and we could not detect any pattern in the terminations, other than the apparent collective desire of the new Board Members to produce a new team, with new perspectives, to implement new procedures.<sup>887</sup> As Chairman Duhnke advised the House Committee on Financial Services:

With such a significant change in the Board’s composition, came a significant opportunity. We had the chance to reflect on lessons learned over the prior 15 years, to innovate and to improve how we approach audit oversight. In 2018, we used the opportunity to perform a comprehensive assessment of the PCAOB . . . . The message we received back was loud and clear: The PCAOB was ripe for change. The PCAOB had, in many respects, lost the public’s trust . . . . It had not matured significantly since opening its doors in 2003. During that time, it developed a culture that lacked internal accountability. And, its integrity had been compromised in 2017 by employees leaking confidential inspections information to those we are charged to regulate.<sup>888</sup>

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<sup>885</sup> See Section 3.5., *infra*.

<sup>886</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 4.

<sup>887</sup> See n. 26, *supra*, and accompanying text.

<sup>888</sup> See, e.g., W. Duhnke, “*Testimony before the House Committee on Financial Services*,” Harv. L.S. Forum on Corp. Gov. (Jan. 17, 2020), available at <https://corpgov.law.harvard.edu/2020/01/17/testimony-by-pcaob-chairman-william-d-duhnke-before-the-house-committee-on-financial-services/>.

The September Whistleblower Complaint contends that, for the “vast majority” of the employee separations, the Chair did not consult with his fellow Board Members. As we have noted, the PCAOB Bylaws require consultation (but not approval) for the senior-most staff members listed in the Bylaws.<sup>889</sup> Based on our review, it appears that the Board Members were properly consulted.

The September Whistleblower Complaint, however, raises the terminations of a large number of additional individuals who were not the most senior officers of the PCAOB. While there was no requirement that the Chairman consult with his fellow Board Members, we believe that it is appropriate policy for the Chairman to consult with all Board Members in discharging a broader number of PCAOB employees.<sup>890</sup>

Similarly, the September Complaint raises the concern that the vacancies created in the positions of Director of Enforcement and General Counsel went unfilled for over fifteen months. While the Chairman has been alleged to have been responsible for that, not just in the September Complaint, but also in the press,<sup>891</sup> it appears that the Chairman’s efforts to achieve a true Board consensus on the replacements for those two positions meant that one or two Board Members were actually the ones responsible for holding the rest of the Board up in its efforts to fill those two vacancies.<sup>892</sup>

The September Whistleblower Complaint also alleged that, four months after the filing of the May Whistleblower Complaint there had been no inquiry into the substance of their complaints, and that an effort was made by the Chairman’s Office to identify the identity of the signatories to the May Whistleblower Complaint. We have already discussed the failure of the Board to adopt a meaningful Whistleblower Protection Plan, with two-way anonymous communications,<sup>893</sup> so it is understandable that those who filed the May Complaint would conclude nothing had been done with respect to the issues that were raises.

With respect to the allegations that efforts were made by the Chairman’s office to identify the signatories to the May Whistleblower Complaint, we learned

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<sup>889</sup> The Director of IOPA is an exception to this provision, and the termination of the employment of the IOPA Director requires Board approval. *See* n. 230, *supra*.

<sup>890</sup> *See* Sections 3.5.1., *infra*, for our recommendations in this regard.

<sup>891</sup> *See, e.g., Plagued by Internal Strife, supra* n. 26.

<sup>892</sup> *See, e.g.,* Witness X (1<sup>st</sup> Interview), at p. 15; Witness X (1<sup>st</sup> Interview), at pp. 17-19.

<sup>893</sup> *See* nn. 785-786, *supra*, and accompanying text.

that there were instances where one individual employed in the Chairman’s Office at the time believed that that allegation might be related to comments she made.<sup>894</sup> But, we found no evidence of an effort on the part of the Chairman or his office to learn who had been responsible for submitting the May Whistleblower Complaint.

The September Whistleblower Complaint also alleges that “significant hirings were made without board input,” specifically mentioning the Chief Risk Officer, the Compliance Officer, the Head of IOPA, the Chief Information Security Officer, the Chief Data Officer, the Director of External Affairs and the Deputy Director of External Outreach.<sup>895</sup> But, for the most part, there appears to have been meaningful consultation between the Chairman and the other Board Members with respect to the hiring of personnel to fill those positions.<sup>896</sup>

In addition, the September Whistleblower Complaint raises a concern that three former PCAOB employees had their employment terminated in retaliation for their interaction with Chairman Duhnke while employed at the PCAOB.<sup>897</sup> That issue, along with one other relating to alleged corporate waste, was referred to the SEC’s OIG, and was not within the scope of our mandate.<sup>898</sup>

### III. Recommendations

Good corporate governance is the implementation of a transparent set of rules to align the motivations of directors, senior officers and employees, and is reflected in good corporate citizenship and ethical behavior.<sup>899</sup> Written policies and procedures are necessary to achieve good governance, but they are not

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<sup>894</sup> This individual explained that her comments were made regarding conflicts of interest vis-à-vis the four offices where the individuals who authored the May Whistleblower Complaint worked—solely in connection with the potential retention of outside counsel, and not for the purpose of ascertaining who the authors of the May Complaint were. *See* Witness X (1<sup>st</sup> Interview), at pp. 6-7.

<sup>895</sup> *See* September Whistleblower Compl., at p. 4.

<sup>896</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at p. 13; Witness X (1<sup>st</sup> Interview), at p. 6.

<sup>897</sup> *See* September Whistleblower Compl., at pp. 5-

<sup>898</sup> *See* nn. 112-113, *supra*, and accompanying text.

<sup>899</sup> *See, e.g.*, *Nonprofit Governance Handbook*, *supra* n. 482, at pp. 82, 195, 201; NYSE, CORPORATE GOVERNANCE GUIDE, at pp. 63 & 134 (Dec. 2014), available at [https://www.nyse.com/publicdocs/nyse/listing/NYSE\\_Corporate\\_Governance\\_Guide.pdf](https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf); CG Lytics, “*What Is Corporate Governance?*,” BLOG (2020), available at <https://cglytics.com/what-is-corporate-governance/> (“*What Is Corporate Governance?*”).

sufficient.<sup>900</sup> Rather, an aligned concept of good governance must become an inseparable part of the corporation's permanent culture, instilled in its DNA.<sup>901</sup>

Over the past two years, the Board has made progress in developing a platform of good governance policies, procedures and practices. Many of our recommendations seek to build on that progress. In other areas, there is still a fair amount of work to be done. Accordingly, based upon the foregoing review of the PCAOB's current, and historical, governance policies and practices, we offer recommendations for improvements in the PCAOB's governance, divided into six broad categories:

- Ethics, Whistleblower Complaints and Conflicts/Recusals;
- Board Members' Roles, Duties, Obligations and Interactions;
- Recordkeeping;
- Internal Communications;
- PCAOB Bylaws; and
- Miscellaneous

### **3.1. Ethics, Whistleblower Complaints and Conflicts/Recusals**

**3.1.1. *The PCAOB should establish a separate Compliance and Ethics Office, headed by a Chief Ethics and Compliance Officer ("CECO"), that is not part of the Chairman's Office.*** Since 2018, the Ethics Office has been part of the PCAOB's Office of Enterprise Risk Management and, as a result, is part of the structure of the Chairman's Office.<sup>902</sup> Given the PCAOB's recent history vis-à-vis whistleblower complaints, having the Chief Risk Officer, who reports directly to the Chairman, be among the first to review EthicsPoint® Hotline submissions could have a chilling effect on employees' willingness to raise concerns, especially those concerning the Chairman and his/her immediate staff, and poses a threat to the perceived and actual independence of this process.

**3.1.2. *The CECO should be part of the OGC, and report to the full Board.*** For structural and administrative purposes,

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<sup>900</sup> See, e.g., *What Is Corporate Governance*, supra n. 899.

<sup>901</sup> *Id.*

<sup>902</sup> Although this was said to be temporary, this function continues to operate from the Chairman's Office.

if the Compliance and Ethics Office is not a stand-alone office, it should be part of the PCAOB's OGC, and the CECO should report to the full Board. The overarching goal should be to instill a sense of ethical behavior, and dedication to compliance, in the PCAOB's DNA, and provide a high level of comfort to PCAOB employees that it is safe and appropriate to raise ethical concerns within the PCAOB's structure. This goal is best achieved through oversight at the Board level.<sup>903</sup>

3.1.3. *For purposes of hiring and firing, the CECO should be treated the same as the IOPA Director.* The PCAOB's Bylaws appropriately carved out an exception for the IOPA Director from the Chairman's power to terminate senior officers after consultation with the other Board Members. Instead, they require formal approval by a majority of the Board of a decision to terminate the employment of the IOPA Director.<sup>904</sup> The same treatment should be provided for the CECO, given the overarching importance of that role.

3.1.4. *The PCAOB should prioritize its revision of the existing Code of Ethics and, among other things, assign additional personnel to work with the CECO on a permanent basis.* A code of ethics gives organization-specific definitions and standards of what is expected and required and defines the consequences for failures to meet these standards. As indicated earlier, the CECO was expected to revise the Code of Ethics largely on her own.<sup>905</sup> As a result, efforts to update and create the backbone of the PCAOB's compliance structure continue to this day, over three years since the KPMG matter became publicly known, and almost two years since the CECO started work at the PCAOB. To preclude

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<sup>903</sup> See, e.g., D. Boehme "Structuring the Chief Ethics and Compliance Officer and Compliance Function for Success: Six Essential Features of an Effective CECO Position and the Emergence of the Modern Compliance 2.0 Model," THE COMPLETE COMPLIANCE AND ETHICS MANUAL 2021, available at <https://compliancecosmos.org/structuring-chief-ethics-and-compliance-officer-and-compliance-function-success-six-essential#footnotes> (Noting that the CECO "must have appropriate authority within the organization, adequate autonomy from management, and sufficient resources to ensure that the company's compliance program is implemented effectively").

<sup>904</sup> See n. 222, *supra*, and accompanying text.

<sup>905</sup> See nn. 593-595, *supra*, and accompanying text.

further delays, the Board should make the completion of a revised Ethics Code the joint responsibility of the CECO, the IOPA Director and the GC, and ensure that a team of employees is assigned to the project.<sup>906</sup>

3.1.5. *The Board should not adopt the CECO's proposal to create two separate documents setting forth employee obligations, with different levels of enforcement, but should instead adhere to a single, updated, Code of Ethics, housing all the ethical standards applicable to all PCAOB personnel.* The proposal to adopt a two-tiered, two-part series of ethical rules, with varying levels of enforceability, would essentially signal to the PCAOB's staff that part of its ethical code, and adherence thereto, can be treated with less seriousness.<sup>907</sup>

3.1.6. *The PCAOB's Ethics Rules should make clear that its confidentiality provisions do not apply to valid information requests from the SEC and its Staff.* Ethics Rule EC9 prohibits PCAOB employees from disseminating or disclosing "any information obtained in the course and scope of his or her employment . . ." that has not otherwise been made public, without direct authorization from the Board.<sup>908</sup> The current application of this rule creates an unnecessary and inappropriate encumbrance on the SEC's exercise of its oversight authority.<sup>909</sup> To remedy this, the PCAOB should exclude the SEC from the intended application of its ethics rules on the disclosure of nonpublic PCOAB information.<sup>910</sup>

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<sup>906</sup> See, e.g., S. Folsom, *Role of the Board, Senior Management and the CCO*, BLOOMBERG LAW (2017), available at <https://www.bloomberglaw.com/product/health/document/X1GT2OMG000000> (Noting that, given the importance of assigning responsibility for ethics and compliance and ensuring that sufficient resources are dedicated, the U.S. Sentencing Guidelines call for a three-tiered approach that consists of delegating day-to-day operational responsibility for the program to *a specific individual with sufficient resources*, experience, independence and authority to effectively implement the program).

<sup>907</sup> See nn. 605-606, *supra*, and accompanying text.

<sup>908</sup> See Rule EC9, *supra*, n. 103.

<sup>909</sup> See nn. 58-63, *supra*, and accompanying text.

<sup>910</sup> As part of this revision, the Board and the SEC should work out a mutually acceptable methodology to ensure that requests emanating from the SEC's Staff satisfy appropriate criteria for the disclosure of information without the need for a formal Board authorization or waiver for the disclosure of that information.

3.1.7. *The CECO should, together with the IOPA Director and the GC, undertake a formal review of the Code of Ethics, and other compliance policies, no less frequently than annually.* It is important periodically to assess the effectiveness of any initiative, especially ethics and compliance programs. The Board should require a review of the staff’s commitment to ethical conduct, the impact of the ethics code, whether ethics-related goals and objectives are being met, and what challenges are emerging.<sup>911</sup> In reviewing the efficacy of the PCAOB’s Code of Ethics, the CECO should also assess—and report on—the effective internalization of the PCAOB’s values and ethics code by the staff.<sup>912</sup>

3.1.8. *The PCAOB should adopt a comprehensive written policy vis-à-vis who will handle whistleblower complaints, and how they will be handled.* It is essential for the Board to assure the PCAOB’s staff that whistleblower complaints will be treated seriously, independently, effectively, confidentially, without retaliation,<sup>913</sup> and expeditiously.<sup>914</sup> The PCAOB’s staff should understand they can bring their concerns to the

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With respect to an appropriate exclusion, the PCAOB should adopt an approach analogous to that taken under the Freedom of Information Act, which excludes Congress from the definition of the term “agency.” See 5 U.S.C. §551(1), providing that the definition of the term “agency” does not apply to the Congress. *And see, e.g.,* Cong. Res. Serv., “*The Freedom of Information Act: A legal Overview*,” (Aug. 24, 2020), at p. 4, available at <https://crsreports.congress.gov/product/pdf/R/R46238>.

<sup>911</sup> See e.g., F. Navran, “*Twelve Steps to Building a Best-practices Ethics Program*,” Workforce (Sept. 1, 1997) available at <https://www.workforce.com/news/12-steps-to-building-a-best-practices-ethics-program>.

<sup>912</sup> *Id.*, (For example, “Do [staff members] agree with [the] importance and appropriateness [of the Ethics Code]? Do [staff members] believe they apply to all employees at all levels?”).

<sup>913</sup> In addition to prohibiting retaliation, a truly comprehensive whistleblower plan will also provide consequences for those who submit unfounded claims that are reckless, malicious, or intentionally false. See, e.g., Brooks, McGinnis & Co., LLC, “*Eight Tips for Writing, or Revising, a Whistleblower Policy*,” (2017), available at <http://www.brooksmcginnis.com/news/8-tips-for-writing-or-revising-a-whistleblower-policy> (Recommending that the policy state that disciplinary action will be taken against individuals who make unfounded allegations that are reckless, malicious or intentionally false).

<sup>914</sup> See, e.g., Anti-fraud Collaboration, “*Encouraging the Reporting of Misconduct*,” (Nov. 2017) available at <https://na.theiia.org/about-us/Public%20Documents/AFC-Report-Encouraging-the-Reporting-of-Misconduct-1117.pdf>.

Director of IOPA, HR or their supervisors, at their election. Those complaints should be handled by the respective recipients. Complaints, received through the EthicsPoint® Hotline should be handled by the CECO, in consultation with HR and OGC. OGC and the CECO should be free to forward complaints to IOPA, in their discretion.

3.1.9. *The Board should adopt, as part of the PCAOB’s whistleblower process, additional features of its EthicsPoint® Hotline, especially those permitting two-way anonymous communications.* Among the factors that may discourage employees from reporting misconduct are fears that the (a) process is an unknown; (b) information submitted will not be handled anonymously or confidentially; (c) submitter’s identity will somehow be made known to others; and (d) system established is not truly independent.<sup>915</sup> One way these concerns can be assuaged is by enabling the submitter and those handling the complaint to engage in two-way conversations, without compromising the identity of the submitter.<sup>916</sup>

3.1.10. *The PCAOB’s whistleblower process should provide alternative methods for raising concerns about potential misconduct.* To encourage reporting of potential misconduct, the PCAOB should offer multiple methods of reporting.<sup>917</sup> For those who prefer to talk with a live PCAOB senior official, employees should be encouraged

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<sup>915</sup> See, e.g., *Encouraging the Reporting of Misconduct*, Anti-Fraud Collaboration (Nov. 2017), available at <https://na.theia.org/about-us/Public%20Documents/AFC-Report-Encouraging-the-Reporting-of-Misconduct-1117.pdf>.

<sup>916</sup> See, e.g., Randstad NV, “*Misconduct Reporting Procedure*,” (Jan. 2019), available at [https://www.randstad.com/s3fs-media/rscom/public/2020-02/EN\\_Randstad\\_Group\\_misconduct\\_reporting\\_procedure\\_2019.pdf](https://www.randstad.com/s3fs-media/rscom/public/2020-02/EN_Randstad_Group_misconduct_reporting_procedure_2019.pdf) (“*Reporting Misconduct*”).

<sup>917</sup> Other reporting avenues include:

- Web Portals;
- Customized Email Addresses;
- Fax; and
- Suggestion/complaint boxes in common rooms.

See, e.g., C. Patton, “*Five Ways to Encourage Employees to Report Misconduct*,” HUMAN RESOURCE EXECUTIVE (May 28, 2019), available at <https://hrexecutive.com/5-ways-to-encourage-employees-to-report-misconduct/>.

to raise concerns directly with the Director of IOPA, the CECO, OHR, and/or the General Counsel's Office.<sup>918</sup>

3.1.11. *The PCAOB's whistleblower process should permit communications with submitters, without compromising their anonymity.* To establish an investigation process that is perceived as independent, fair, and robust, the PCAOB should adopt the practice of having the recipient of a report of potential misconduct communicate back to the submitter at the outset, acknowledging receipt of the report and, thereafter, explaining whether an investigation was conducted and, if appropriate, the results.<sup>919</sup>

3.1.12. *The Board should devote one closed meeting every quarter to receiving a report on the operation of the PCAOB's whistleblowing policies.* In order for the PCAOB's whistleblowing policy to achieve maximum effectiveness, the Board should devote at least one closed meeting every quarter to learning the generic nature of the complaints received, how each complaint was handled, the dispositions, and finally, whether there is a perceived need for any revisions to the program.

3.1.13. *The Board should adopt a comprehensive written policy with respect to potential, apparent and actual conflicts of interest.* At present, Ethics Rules EC3(b)(3) and EC8 govern Board Members and PCAOB staff independence and objectivity.<sup>920</sup> However, the Board has not adopted formal policies to govern how Board Members and PCAOB staff should treat potential conflicts of interest *before* they actually arise.<sup>921</sup> Nor has

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<sup>918</sup> See *Reporting Misconduct*, *supra* n. 916.

<sup>919</sup> See *id.*

<sup>920</sup> See nn. 830-833, *supra*, and accompanying text.

<sup>921</sup> See nn. 837-841, *supra*, and accompanying text; See, e.g., L. Slutsky & M. Wheeler, "Principles for Good Governance and Ethical Practice," PANEL ON THE NONPROFIT SECTOR (Oct. 2007), at p. 9, available at <https://www.ncfp.org/wp-content/uploads/2019/01/Principles-Guide-Independent-Sector-2007-principles-for-good-governance-and-ethical-practice.pdf> (The policy should require full disclosure of all potential conflicts of interest within the organization. It should apply to every person who has the ability to influence decisions of the organization, including board and staff members and parties related to them).

the Board pre-determined who will handle certain functions, and how they will be handled, if the person who usually handles such matters is conflicted from participating. The Board should define, with clarity and precision, what constitutes a conflict, what each employee's obligations are to identify potential, apparent, and actual conflicts, to whom disclosure of potential or actual conflicts must be made, and who will assume responsibility for the performance of the functions that are the subject of the potential or actual conflict. In addition, the policy should contain a clear specification of how recusal policies are intended to work, who will monitor those policies, and the proper steps for any Board Member or PCAOB employee to achieve appropriate disclosure and/or complete recusal.

3.1.14. *The PCAOB should create and codify formal procedures to govern how matters should be handled if the Chairman is recused from participating in a specific matter. With respect to administrative matters, presumably the Chief Administrative Officer can assume the Chairman's administrative responsibilities.<sup>922</sup> For substantive matters, the Board should provide, in a formal rule, that the most senior of its Members who is not also recused would assume the Chairman's responsibilities for that particular matter.*

3.1.15. *The Board should adopt formal conflict and recusal policies that specifically prevent the entire OGC from being deemed conflicted in response to future whistleblower complaints or other matters. It may sometimes be necessary or appropriate for the Board to retain outside counsel in certain *limited* circumstances, such as special litigation or internal investigations involving allegations of misconduct that *implicate the GC*,<sup>923</sup> neither of which were present with respect to the*

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<sup>922</sup> Currently, the PCAOB's Ethics Rules provide that certain functions will be performed by the Chairman or the Chair's "designee." The assumption is that the CEO will act as the Chairman's "designee" with respect to ethics matters. See n. 834, *supra*, and accompanying text.

<sup>923</sup> *Id.* (Suggesting factors to consider when it is necessary to retain outside counsel, including if outside counsel should be hired, which outside counsel should be retained, the interview process, the engagement letter, and strategies to manage outside counsel); see also, C. Burton, J. Standing & L. McPhee, "The Role of General Counsel in Corporate Governance," Dentons (Jan. 29, 2020), <https://www.dentons.com/en/insights/alerts/2020/january/29/the-role-of-general-counsel-in-corporate-governance> (Explaining how the General Counsel's role has

May and September Whistleblower Complaints.<sup>924</sup> The Board should maintain and highlight the professional independence of its GC as the PCAOB’s corporate representative, by clearly defining the relationship between the GC, the Board, and the PCAOB’s staff.<sup>925</sup> The Board should frame the role of the GC as an agent of the PCAOB, rather than an agent of the Board, in order to facilitate the ability of all parties to achieve their mandates collaboratively and successfully.<sup>926</sup>

### 3.2. Board Members’ Roles, Duties, Obligations, and Interactions

3.2.1. *Board Members should be familiar with the PCAOB’s status as a D.C. nonprofit corporation and the obligations imposed on IRS-approved tax-exempt companies, and the fiduciary duties to which they are, as a result, subject.* To successfully serve on a nonprofit board, it is essential that board members understand the overarching purpose of a nonprofit board—that is, to ensure that their corporation fulfills the mission it embraced when it became a registered nonprofit corporation.<sup>927</sup> To that end, Board Members should receive training during their onboarding process (and subsequent periodic training), on the DCNPA, the requirements imposed by the IRS on tax-exempt, 501(c)(3) companies, and the duties that must be fulfilled by Board Members as a result.<sup>928</sup> Former and current Board Members were not briefed on their fiduciary

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“matured from strictly drafting and advising, to a complex and strategic position” that may lead to conflicts of interest requiring retention of outside counsel) (“*The Role of General Counsel*”).

<sup>924</sup> See Ex. 5, *supra* n. 34, at p. 2 (Stating generally that the authors of the May Whistleblower Complaint included one or more employees from OGC, among other divisions).

<sup>925</sup> See, e.g., *The Role of General Counsel*, *supra* n. 923.

<sup>926</sup> *Id.*

<sup>927</sup> See *Horizontal Fiduciary Duty*, *supra* n. 156, 104 Cornell L. Rev. at 804.

<sup>928</sup> See, e.g., BoardSource®, “*Roles and Responsibilities of Nonprofit Board Service*,” (2020), available at <https://boardsource.org/fundamental-topics-of-nonprofit-board-service/roles-responsibilities/> (It is impossible to do a job well if you do not know what the job is. Therefore, all boards must take the time to ensure that every board member fully understands what’s expected and needed of him/her, and then hold all members accountable if they get off track. This starts with an understanding of the fundamental legal duties of each individual board member, which include the Duties of Care, Loyalty, and Obedience).

obligations during their onboarding, nor were these duties discussed during Board Meetings.<sup>929</sup> To enable Board Members to adhere to their fiduciary duties, and ensure that their Board colleagues do so as well, Board Members should receive appropriate training during their orientation about their duties and responsibilities.

**3.2.2. *To assure that all Board Members share a common understanding of the scope and limits of their responsibilities, the Board should create a job description that sets forth a Board Member's role, with detailed leadership structures, functions and processes, and the Board's expectations. We found a nearly universal lack of understanding on the part of Board Members with respect to their specific roles and powers.<sup>930</sup> Although the PCAOB's Bylaws define the role of the Chairman, they offer no guidance on the role of the other Board Members.<sup>931</sup> A formal job description should be created for Board Members and include a break-down of the expected role, scope of responsibilities, limitations that inhere in that role, and the fundamental obligation to work collaboratively with each other, and the Chairman.<sup>932</sup>***

**3.2.3. *The Board should revise its orientation process for incoming Board Members by reducing the amount of paper materials and binders provided and, instead, limiting document production to critical documentation and implement individual presentations by Division***

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<sup>929</sup> See nn. 180-182, *supra*, and accompanying text; *see also, e.g.*, Witness X Interview, at pp. 6-8; Witness X Interview, at p. 8 (One Board Member recalled taking the initiative of asking the OGC for guidance about fiduciary duties and D.C. nonprofit law before receiving any information on the subject).

<sup>930</sup> See *supra*, nn. 280-282, and accompanying text.

Current and former Board Members reflected conflicting understandings of their responsibility vis-à-vis the Chairman. Some believe that the PCAOB should function similarly to the SEC, which vests significantly more power with the Chairman than with the other four Commissioners. *See, e.g.*, Witness X Interview, at p. 7; *see also* Reorg. Plan 10, n. 78, *supra*. Others surmised that, because S-Ox did not explicitly give the PCAOB Chairman the same powers as the SEC Chair, the intent was for Board Members to manage the PCAOB collectively. *See, e.g.*, Witness X Interview, at p. 7.

<sup>931</sup> See generally PCAOB Bylaws, Art. VI.

<sup>932</sup> See, *e.g.*, *Nonprofit Governance, supra* n. 155, at Tab 6, pp. 2-7.

**Directors.** Currently, incoming Board Members are confronted with reams of hard-to-grasp verbiage, in manuals that are cumbersome, disorganized, and not user-friendly.<sup>933</sup> The Board should reduce the binders that are provided to incoming Board Members to avoid overwhelming them.<sup>934</sup> In addition, Division and Office leaders should prepare brief in-person orientations to introduce new Board Members to each Division/Office’s scope of work and priorities.

**3.2.4. *The Board Champions initiative, or a meaningful alternative to it, should be reinstated.*** One concern raised by both current and former Board Members is that there is limited substance to Board Membership.<sup>935</sup> The Board Champions initiative was a creative approach to engaging each Board Member in a substantive area (or areas) of PCAOB operations that would utilize the skillsets of Board Members to enhance the PCAOB’s performance, while adding meaningful substance to Board Members’ roles. In both nonprofit and for-profit corporations, a similar function is served by directors’ participation in board committees. The Board Champions program lacked formal content, however, and no explanation of how the program would operate, or the precise role of Board Members, was provided.<sup>936</sup> Those deficiencies can be overcome with a written description of the initiative’s intent, the scope of each Member’s participation, and an outline of the procedure for discussing policy with Division Directors. The concept of this initiative was fundamentally sound; but the concept’s implementation was flawed.<sup>937</sup> We

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<sup>933</sup> See *supra*, nn. 563-566, and accompanying text.

<sup>934</sup> See J. Garry, “A Template For a Great Board Orientation,” JOAN GARRY CONSULTING BLOG, (2019), available at <https://blog.joangarry.com/board-orientation-template/> (The Binder should contain a history one pager, staff organizational chart, program highlights for year to date, board roles and responsibilities, list of all current board members, list of Directors and Offices, and members of each, list of upcoming meetings, any strategic planning development, approved budget for calendar year, copy of organization’s by-laws, board meeting minutes for last 3 meetings, and agenda for first board meeting).

<sup>935</sup> See n. 290, *supra*, and accompanying text.

<sup>936</sup> See Witness X (2<sup>nd</sup> Interview), at pp. 11-12; see also, Witness X (2<sup>nd</sup> Interview), at p. 9.

<sup>937</sup> See, e.g., Witness X (1<sup>st</sup> Interview), at p. 28 (“There was no definition of what Board champions were to be”). Some understood that the role was to “oversee specific initiatives” and report any issues to the Board. See e.g., Witness X (2<sup>nd</sup> Interview), at p. 17. Others viewed this as

recommend that this initiative be reimplemented as a means of assisting the PCAOB's staff to complete the growing number of Transformation Projects.

**3.2.5. *Once the PCAOB returns to its physical offices, Board Members should rigorously commit to the regular informal weekly meeting that was implemented during the COVID-19 pandemic.*** Corporate boards should meet often enough to ensure they fulfill their fiduciary responsibilities without compromising their efficiency. Prior to the COVID-19 pandemic and the concomitant subsequent closure of physical office spaces around the country, some Board Members expressed dissatisfaction with the amount of time spent as a Board and in one-on-one meetings with the Chairman.<sup>938</sup> As discussed above, one of the fiduciary obligations for all board members is the duty of care.<sup>939</sup> Without attending regularly scheduled meetings—or without receiving appropriate information to prepare for such meetings—Board Members are not necessarily equipped to engage in educated and independent decision making. While the current Chairman has an open-door policy of which Board Members and PCAOB staff may avail themselves at their discretion, the existence of that policy is not necessarily enough to ensure a consistent flow of information to, and between, Board Members.<sup>940</sup> When faced with the challenges of remote work as a result of COVID-19, the Board was compelled to set up two weekly recurring meetings<sup>941</sup>—one limited to the Board, and hosted by the Chief of Staff (“COS”), and the other held between Board Members and Division Directors.<sup>942</sup> Due to the reliable and consistent nature of these meetings, Board Members advised us that they believe

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a way for Board Members to exercise individual leadership over certain programs. *See, e.g.,* Witness X Interview, at p. 29.

<sup>938</sup> *See e.g.,* Witness X (1<sup>st</sup> Interview), at p. 20; Witness X (1<sup>st</sup> Interview), at pp. 19-20.

<sup>939</sup> *See nn. 154-156, supra,* and accompanying text.

<sup>940</sup> *See nn. 712-714, supra,* and accompanying text; *see also* Witness X (1<sup>st</sup> Interview), at p. 22.

<sup>941</sup> *See nn. 737-743, supra,* and accompanying text.

<sup>942</sup> *Id.; see also, e.g.,* Witness X (2<sup>nd</sup> Interview), at pp. 1-2; Witness X (2<sup>nd</sup> Interview), at pp. 2-3; Witness X (2<sup>nd</sup> Interview), at p. 2.

they have ample time to prepare important topics of discussion.<sup>943</sup> This level of consistent communication should persist in a post-COVID telework setting and become a permanent facet of the Board’s communication structure.<sup>944</sup> The Chairman should host an hour-long weekly meeting with each Board Member.<sup>945</sup> The COS should facilitate these weekly meetings, should provide an agenda three to five working days in advance of the meeting, and solicit each Board Member for additional topics for discussion.<sup>946</sup>

**3.2.6. *The Board should adopt a regular process of self-evaluation—both for how the Board as a whole has functioned, for how individual Board Members have functioned, and for how collaboratively the Board Members and the Chairman have worked together. Only through structured self-examination can the Board, and its individual Members, improve their collective performance and understand the extent of their individual responsibilities. Boards that practice regular self-evaluations tend to have stronger performance.***<sup>947</sup>

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<sup>943</sup> See, e.g., Witness X (2<sup>nd</sup> Interview), at pp. 1-2; Witness X (2<sup>nd</sup> Interview), at pp. 2-3; Witness X (2<sup>nd</sup> Interview), at p. 2.

<sup>944</sup> Overall, a few of the Board Members have described this new schedule of communication as a blessing that arose during challenging circumstances and have expressed the hope that this level of communication continues as a part of the in-person work schedule. See, e.g., Witness X (2<sup>nd</sup> Interview), at p. 3.

<sup>945</sup> The Chairman and all Board Members should attend these weekly sessions, unless there is some emergency or other mitigating circumstance that prevents them from attending.

<sup>946</sup> See BoardSource®, *Board Meetings—FAQs*, available at <https://boardsource.org/resources/board-meetings-faqs/> (“Staff should get appropriate materials to board members well before the meeting so that board members arrive well prepared by having a chance to familiarize themselves with agenda items and supporting materials.”) see also, Lumen Learning, “*Guidelines for Improving the Effectiveness of Boards of Directors of Nonprofit Organizations*,” Chapter 7: *Effective Board Meetings*, available at <https://courses.lumenlearning.com/suny-guidelines-for-improving-the-effectiveness-of-boards-of-directors-of-nonprofit-organizations/chapter/chapter-7-effective-board-meetings/> (“Nothing renders a board ineffective more than members scrambling to read important materials at the same time as an issue is being discussed or, worse, not having important material available for them to read beforehand . . . Except in rare emergency situations, there is really no excuse for not getting agendas into the hands of board members three to five working days before the meeting”).

<sup>947</sup> See, e.g., BoardSource®, “*Foundation Board Leadership: A Closer Look at Foundation Board Responses to Leading with Intent*” (2018), available at <https://leadingwithintent.org/wp-content/uploads/2018/03/LWI2017-Foundations-Report.pdf>.

These evaluations should occur no less frequently than annually, through written questionnaires, individual interviews, and through Board discussions.<sup>948</sup> The evaluation should assess whether each Board Member understands the duties of care, loyalty and obedience and should also reveal whether the Board understands how their fiduciary responsibilities relate to their duties of strategic planning, risk management and oversight.<sup>949</sup>

### 3.3. Recordkeeping<sup>950</sup>

3.3.1. *The Board should develop a fundamental list of all documents required for the PCAOB to satisfy its statutory, regulatory, and ethical obligations, and ensure there are sufficient processes to obtain confidence that all such information will, in fact, be created.* As noted, there are a number of functions the Board is required to undertake—for example, in connection with determining salaries or severance payments—and specific contemporaneous documents the Board is required to create.<sup>951</sup> The Board should have a comprehensive list of all such information and develop processes for ensuring that it creates those documents in accordance with its legal and fiduciary obligations.

3.3.2. *The onboarding materials for Board Members should include a brief but cogent written description of all PCAOB SharePoint® databases and other document repositories, including the type of documents stored in each, all access restrictions and allowances, editing capabilities, and any relevant interconnections and*

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<sup>948</sup> See, e.g., J. Sonnenfeld, “What Makes Great Boards Great,” Harv. Bus. Rev. (Sept. 2002), available at <https://hbr.org/2002/09/what-makes-great-boards-great> (“In individual self-assessments, board members can review the use of their time, the appropriate use of their skills, their knowledge of the company and its industry, their awareness of key personnel, and their general level of preparation”).

<sup>949</sup> See, e.g., N. Price, “The Fiduciary Responsibilities of a Nonprofit Board of Directors,” Board Effect (Mar. 12, 2018) available at <https://www.boardeffect.com/blog/fiduciary-responsibilities-nonprofit-board-directors/>.

<sup>950</sup> In connection with its recordkeeping rules, the PCAOB should make clear that none of these requirements are not intended, and should not be deemed, to create rights in any third party (including employees), and the PCAOB should make clear its right to make changes at any time.

<sup>951</sup> See *supra*, nn. 328-349, and accompanying text.

*differences between them.* The PCAOB currently utilizes four main internal document databases.<sup>952</sup> But, three of these largely contain the same information,<sup>953</sup> which has caused some confusion.<sup>954</sup> The Board should have the PCAOB identify the documents needed at each level of the organization, and limit the documents found in individual databases without repetition. In addition, the Board should have the PCAOB prepare written guidance outlining the different databases available for use, the types of documents found in each database, which staff members have access to each database, and any procedures that can be employed to obtain access to each database, including points of contact to contact for such requests.<sup>955</sup>

**3.3.3. *All meetings between the Chairman and Board Members that result in significant action decisions should be reflected in minutes created once it is clear that a significant action decision will be, or has been, made.*** The Board's Secretary is tasked with maintaining Board Minutes,<sup>956</sup> and Board Members are given drafts of these Board Minutes, with an opportunity to suggest changes.<sup>957</sup> But no minutes were prepared reflecting the Board's decisions about the 2018 senior staff employment terminations, or subsequent hiring decisions.<sup>958</sup> Records should be prepared to reflect hiring and firing decisions for PCAOB senior officers, in the form of formal written notes that are uploaded and archived on the Board Portal.

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<sup>952</sup> See *supra*, nn. 407-438, and accompanying text.

<sup>953</sup> See *supra*, n. 436, and accompanying text.

<sup>954</sup> See generally, *Repositories Memo*, Ex. 13, *supra* n. 397.

<sup>955</sup> During the course of our review, we asked for a comprehensive list of PCAOB databases, the documents found therein, a list of individuals who had access, and a list of individuals who had editing capabilities, amongst other things. The PCAOB did not have such a document in hand and, instead, had to create a chart for our use. See *Repositories Memo*, Ex. 13, *supra* n. 397. This is the type of information that everyone at the PCAOB should have.

<sup>956</sup> See *supra*, n. 376, and accompanying text.

<sup>957</sup> See *Witness X* (1<sup>st</sup> Interview), at pp. 39-40.

<sup>958</sup> See *supra*, n. 384, and accompanying text.

3.3.4. *The Secretary should designate an individual tasked with taking notes during all Board meetings when the Secretary is unavailable.* The issue of accurate record keeping and access to records is an integral part of promoting transparency and building continuity. At present, when the Secretary is unavailable, it is not always clear whether another individual has been designated to keep these records, but formal designation of a substitute should always be the case. These records should include objections made during votes, and records should be prepared for informal Board meetings, if concrete decisions are reached.<sup>959</sup>

3.3.5. *Notes of Board meetings should be prepared and maintained in a standardized format, using a digital word processor.* Since Board meetings often result in significant decisions,<sup>960</sup> the records of those meetings should not be informally created. For example, notes of Board Working Hours meetings are mostly handwritten and largely illegible to anyone other than the author.<sup>961</sup> A more formal and uniform note-taking process should be employed for meetings of this nature.<sup>962</sup>

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<sup>959</sup> This would, however, exclude informal general discussions, such as those at informal meetings. *See* nn. 730-732, *supra*, and accompanying text.

<sup>960</sup> *See, e.g.*, *supra*, nn. 21-25, and accompanying text.

<sup>961</sup> *See supra*, n. 729, and accompanying text.

<sup>962</sup> *See, e.g.*, BoardSource®, *Board Meeting Minutes—FAQs*, available at <https://boardsource.org/resources/board-meeting-minutes/>.

Boards are not required to, nor should they, record every detail or statement made at meetings. However, there should be enough information to make the minutes useful should they ever be used for reference or offered as evidence that an action was properly taken or that directors fulfilled their fiduciary duties. Board minutes should include basic information such as:

- Date and time of meeting;
- Whether the meeting is a special or regular meeting;
- Whether notice was given, or a waiver of notice signed by all directors;
- Names of directors in attendance and directors not in attendance;
- Names of other guests in attendance (and their titles or associations, if relevant);
- Whether a quorum was established;
- Any departures and re-entries of attendees; and
- Any board actions (e.g., approvals, delegations of authority, directives);
- If a board member strongly disagrees with a motion and votes against it or abstains from voting, then that vote should be recorded in the meeting minutes.

3.3.6. *The Board should implement a system to prevent anyone with access to the documents in its four main internal document databases from emailing the documents to anyone outside the PCAOB.* At present, the PCAOB utilizes Digital Guardian<sup>®963</sup> to protect itself from data breaches.<sup>964</sup> The software sends a pop-up message to anyone attempting to send an email from their PCAOB email account to an email account that is not a part of the PCAOB domain.<sup>965</sup> The pop-up message prompts the user to acknowledge that the receiver account is foreign to the PCAOB domain before allowing the user to send the email.<sup>966</sup> The Office of Data, Security, and Technology is then able to track whether the PCAOB employee sent the message and the account to which the message was sent.<sup>967</sup> While the implementation of this software is an improvement in the PCAOB's defenses against improper information sharing, it does not ultimately *prevent* the user from sending any information to non-PCAOB recipients, and therefore is not the best solution the PCAOB could and should implement.

3.3.7. *The Board should promptly adopt an express policy prohibiting the Board and PCAOB staff from forwarding nonpublic information to their personal email addresses or the personal email addresses of any other person.* While the PCAOB prohibits the dissemination of nonpublic information to anyone outside the organization,<sup>968</sup> it *does not* have a policy prohibiting Board Members or PCAOB staff from forwarding nonpublic information to their personal emails. This is a serious deficiency in the security of nonpublic PCAOB data and information, and means that the problems experienced in connection with the KPMG matter could

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<sup>963</sup> Organizations use Digital Guardian<sup>®</sup> for data loss prevention. See Digital Guardian<sup>®</sup> Website, “About,” <https://digitalguardian.com/about>.

<sup>964</sup> See *Repositories Telephone Call Notes*, *supra* n. 397, at p. 4.

<sup>965</sup> *Id.*

<sup>966</sup> *Id.*

<sup>967</sup> See Witness X Interview, at p. 7.

<sup>968</sup> See PCAOB, Ethics Rule EC9, *supra* n. 103.

recur, without immediate detection. This should be remedied immediately.<sup>969</sup>

### 3.4. Internal Communications

3.4.1. *The Board needs to assume greater responsibility for assuring that the PCAOB staff receives meaningful communications about the implementation of major programmatic policies.* Since 2018, the Board has largely adopted a passive approach to the importance of communications with PCAOB employees. That has resulted in confusion and speculation on the part of the staff. Had PCAOB employees been offered a rationale behind the Board's decision to terminate senior staff members, that would have provided the staff with greater clarity and might have helped abate the rumors and speculation that swirled around those terminations.<sup>970</sup>

3.4.2. *The Board should adopt regular and periodic usage of townhall-style meetings and/or other in-person communication strategies to interact with the PCAOB staff.* Regular organization-wide meetings provide an opportunity for the organization to reinforce its culture and values, promote collaboration, foster engagement, and enable management to share updates firsthand.<sup>971</sup> The PCAOB staff has reacted positively to past in-

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<sup>969</sup> See, e.g., L. Eisenstein, "What Are the Risks of Using Personal Email for Board Business?," Board Effect (June 22, 2020), available at <https://www.boardeffect.com/blog/what-risks-using-personal-email-board-business/> ("Unfortunately, some board directors and executives haven't gotten the word that they're putting the company's information at risk every time they [use their personal email accounts for company business](#) and some of them are aware and choose to be careless. Some directors believe that it's just easier and more convenient to use a personal email account. The reality is that when you have the right tools, it's just as convenient and easy to log into a secure corporate email platform as it is to go into your personal email account. The risks of allowing a cybercriminal to gain access to sensitive and confidential information aren't worth any amount of ease or convenience"); see also, P. Comfort, "Seven Reasons to Never Forward Company Emails to Your Personal Account," Chi Corporation (Feb. 12, 2019), available at <https://chicorporation.com/seven-reasons-to-never-forward-company-emails-to-your-personal-account/> (Noting "The convenience of forwarding work emails to your personal email is not necessary, it is not secure, sensitive emails may inadvertently be shared, users may respond to business emails from their personal account, liability issues may arise, and malicious actors can exploit users").

<sup>970</sup> See, e.g., nn. 645-653 & 703, *supra*, and accompanying text.

<sup>971</sup> See, e.g., *Town Hall Meetings*, *supra* n. 748 (Noting, "A message delivered in-person from the CEO will have more impact than one delivered by email").

person, face-to-face interactions with Board Members.<sup>972</sup> If the Chairman and/or Board Members do not favor town hall meetings,<sup>973</sup> another approach is for them to implement the “Management by Walking Around” style, where Board Members regularly walk the PCAOB’s floors and talk to the staff, asking questions, and offering to resolve issues when necessary.<sup>974</sup> Implementation of this approach must await resolution of safety concerns inherent in the current COVID-19 pandemic<sup>975</sup> but in the interim the Board could adopt this approach by using video conference calls.<sup>976</sup>

3.4.3. *Board Members should schedule yearly visits to the most significant PCAOB regional offices or host periodic video calls with regional offices.* Regular communication is the most important prerequisite for an effective workplace and, for the PCAOB, this communication should include some of its largest regional offices. While some Board Members take it upon themselves to visit regional offices and interact with the staff resident in those offices,<sup>977</sup> the Board as a whole should meet regularly with regional offices on a stated and expected time frame.<sup>978</sup> Incorporating these meetings into the PCAOB calendar would give staff time to prepare

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<sup>972</sup> For example, the staff expressed the view that the Annual Inspections Training that is conducted in a townhall-style had been very successful, and hearing from the Board as a whole was good for morale. *See, e.g.*, Witness X (2<sup>nd</sup> Interview), at pp. 4-5; Witness X Interview, at p. 7; Witness X Interview, at p. 9.

<sup>973</sup> *See* n. 753, *supra*.

<sup>974</sup> *See Management by Wandering Around, supra* n. 754.

<sup>975</sup> *See* n. 711, *supra*.

<sup>976</sup> For example, the Board/Chairman/individual Board Members could host organization-wide or Division/Offices video conference calls. The COS could, a few days in advance of the video call, solicit the staff for questions/comments for Board Members to address, providing Board Members ample preparation/coordination time.

<sup>977</sup> *See, e.g.*, Witness X (1<sup>st</sup> Interview), at pp. 10-11; Witness X (1<sup>st</sup> Interview), at p. 27.

<sup>978</sup> *See, e.g.*, J. Elvekrog, “Five Ways to Ensure Remote Employees Feel Part of the Team” *ENTREPRENEUR* (Mar. 11, 2015), available at <https://www.entrepreneur.com/article/243795> (“[L]eadership must visit remote offices regularly. Don’t make these visits feel like inspection tours, but go for a few days, work remotely yourself and make sure your teams get to know you as more than a voice on a conference line”).

relevant questions and would foster a feeling of inclusion.<sup>979</sup>

3.4.4. *The Office of External Affairs should regularize the dissemination of organization-wide weekly and monthly newsletters and strategic insights.* An important aspect of information flow is the type of information that is disseminated—the staff should receive full and fair information, including bad, as well as good, news.<sup>980</sup> To improve organizational communications and enhance transparency, the Office of External Affairs outlines Board activities and meetings in weekly and monthly newsletters, and provides organizational updates through Strategic Insights emails.<sup>981</sup> In addition, the Chairman periodically addresses the staff through Chairman’s Notes, which are included in the weekly newsletter on an *ad hoc* basis.<sup>982</sup> The implementation of weekly and monthly newsletters, Chairman’s Notes, and Strategic Insights, have contributed positively to the

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<sup>979</sup> The meetings may take the form of virtual lunches, in person events, etc. *Id.* (“This may seem obvious, but it bears repeating: If you have remote team members, invest in all of the necessary tools to ensure that they feel connected”).

<sup>980</sup> See, e.g., G. Knilans, “Using Internal Communications to Enhance Business Growth,” Trade Press Services (June 12, 2018), available at <https://www.tradepressservices.com/internal-communications/>; “The purpose [of internal communications] is to facilitate loyalty, increase retention and motivate others to work toward achieving the company’s vision, mission and stated growth goals. Examples of [internal communications] are:

- The company’s mission statement
- Employee manuals and handbooks
- Employee newsletters, e-newsletters and e-mails
- Information contained on the company intranet
- Trainings and seminars
- Webinars
- Press releases
- Unwritten communication such as corporate cultural norms
- Communication with shareholders (who may also be consumers)
- Employee forums
- Surveys and polls.”

<sup>981</sup> The weekly newsletter contains day-to-day information, such as fitness center hours, webinar schedules, and IT updates, while the monthly newsletter provides updates on current and future Division and Office projects. See nn. 762-769, *supra*, and accompanying text; see also, Witness X Interview, at p. 7. The Strategic Insights are emails that provide updates or information about specific programs, initiatives, new hires, training, and update the organization on the Transformation Projects, the changes implemented, and the results. See *supra*, nn. 764-767.

<sup>982</sup> See nn. 759-761, *supra*, and accompanying text; see also Witness X Interview, at p. 7.

PCAOB’s governance and the Office of External Affairs should regularize the dissemination of these communications.

3.4.5. *The Office of External Affairs should provide regular updates on the status of the Board’s Transformation Projects.* Prior to COVID-19, the PCAOB’s staff was not timely updated on the status of Transformation Projects.<sup>983</sup> This is critical information that everyone in the organization should receive, since it can, among other things, assist in strengthening the staff’s commitment to these important projects.<sup>984</sup> But, during the COVID-19 pandemic, the staff began to receive updates on the status of Transformation Projects through the Office of External Affairs’ dissemination of Strategic Insights.<sup>985</sup> The Board should ensure that the Office of External Affairs continues regularly to disseminate information and keep the PCAOB staff updated—not just on progress vis-à-vis the Transformation Projects, but also on organizational news and priorities.<sup>986</sup>

3.4.6. *The Office of External Affairs should periodically address the Board’s objectives, internal control policies/procedures necessary to meet those objectives, and staff expectations, in its internal communications.* Internal communications provide an important avenue to make sure the staff understands the PCAOB’s mission and are aligned with the Board’s values.<sup>987</sup> The Board should ensure that the PCAOB’s

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<sup>983</sup> See Witness X Interview, at p. 5; Witness X Interview, at p. 7

<sup>984</sup> See, e.g., G. Neilson, K. Martin, & E. Powers, “*The Secrets to Successful Strategy Execution*,” HARV. BUS. REV. (June 2008), available at <https://hbr.org/2008/06/the-secrets-to-successful-strategy-execution?registration=success> (“*Successful Strategy Execution*”) (Recommending the free flow of information across organizational boundaries as an element of strong execution; and emphasizing that the lack of this information “results in poor decisions, limited career development, and a reinforcement of structural silos”).

<sup>985</sup> See nn. 764-767, *supra*, and accompanying text.

<sup>986</sup> See, e.g., *Successful Strategy Execution*, *supra* n. 984.

<sup>987</sup> See, e.g., A. Solar, “*Best Practices for Your Internal Communication Strategy*,” SPROUT SOCIAL BLOG (Sept. 23, 2019), available at <https://sproutsocial.com/insights/internal-communications-guide/>.

staff always has a clear understanding of how their role impacts the PCAOB's success.

3.4.7. *The Office of External Affairs should periodically and formally gauge the staff's assessment of the effectiveness of the PCAOB's internal communications.* The Board should ensure that the Office of External Affairs assesses the PCAOB's internal communications regularly, and appropriately implements the results of those period assessments. It is essential that everyone at the PCAOB feels engaged.<sup>988</sup> One way to gauge feedback is through employee surveys,<sup>989</sup> which can be easily implemented, and allow the measurement of the effectiveness of internal communications in real time.

3.4.8. *The Board should provide the PCAOB staff with appropriate notice of proposed Transformational Projects, major policy changes and similar matters to generate the staff's investment in the success of these changes.* During our review, it became apparent that many of the concerns expressed in the May and September Whistleblower Complaints stemmed from the Board's failure to inform the PCAOB staff of plans for Transformational Change.<sup>990</sup> In order for transformational changes to succeed seamlessly, employees should understand what the organization has planned, if possible before, but certainly during and after, implementation commences. The best way to keep everyone apprised of impending changes is to inform the staff about strategic decisions and the

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<sup>988</sup> See, e.g., V. Jouany, "Internal Communication: Definition, Challenges, and Top Reasons Why It's More Important Than Ever," SMARP BLOG (Dec. 11, 2019), available at <https://blog.smarp.com/internal-communication-definition-challenges-and-top-reasons-why-its-more-important-than-ever> (Having an effective internal communication strategy in place does not mean having the CEO sharing company updates to the employees. Instead, employees should be involved in the strategy and encouraged to initiate discussions, since internal communications should be a two-way street).

<sup>989</sup> See, e.g., L. Li, "Twenty-five Key Employee Survey Questions to Evaluate Internal Communications," TINY PULSE® BLOG (Sept. 16, 2020), available at <https://www.tinypulse.com/blog/25-key-employee-survey-questions-to-evaluate-internal-communications>

<sup>990</sup> See *supra*, Section 2.12.

context leading to the formulation of such decisions.<sup>991</sup> These conversations should focus on the staff's specific role with respect to the implementation of the proposed changes and the availability of resources to help address any challenges that may arise in the process of implementing the change.<sup>992</sup>

3.4.9. *OHR should conduct annual employee surveys to obtain feedback for the Board on progress being made in establishing a culture and an environment that will assist the Board's governance efforts and strategies, and should memorialize the results of employee surveys in a formal memorandum detailing the extent of the review, the number of individuals who completed the survey, and the survey results.* Crucial to ensuring effective governance, and a committed workforce is the receipt of, and potential response to, employee feedback.<sup>993</sup>

3.4.10. *OHR should meet annually with the Board to discuss the results of its employee surveys.* OHR should conduct these evaluations annually, and the Board should consider the findings, as it deems appropriate, in establishing its priorities.<sup>994</sup> New policies meant to address concerns expressed by employees should be published and disseminated through the organization to

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<sup>991</sup> See, e.g., SMARP, *Business Transformation in 2020: The Guide for Successful Implementation* (Feb. 4, 2020), available at <https://blog.smarp.com/business-transformation-2020-guide> (From its inception, any business transformation project should be founded on clear and constant communication between the project team, management at all levels, and the organization as a whole).

<sup>992</sup> *Id.* (Many employees worry that business transformation projects may eliminate the need for their skills and expertise. With the proper employee communication strategy, employers can ensure that their employees feel safe).

<sup>993</sup> See, e.g., J. Sonnenfeld, "What Makes Great Boards Great" HARV. BUS. REV. (Sept. 2002), available at <https://hbr.org/2002/09/what-makes-great-boards-great> ("Behavioral psychologists and organizational learning experts agree that people and organizations cannot learn without feedback. No matter how good a board is, it's bound to get better if it's reviewed intelligently") (*"What Makes Great Boards Great"*).

<sup>994</sup> See, e.g., *id.* ("Annual evaluations led PepsiCo and Target to change their processes for reviewing strategy with their boards. Instead of the mind-numbing, back-to-back, business-unit dog and pony shows that boards often suffer, each company decided to spend a full day of each board meeting looking in depth at the strategic challenges of a single business unit").

demonstrate the Board’s responsiveness and commitment

### 3.5. Bylaws

3.5.1. *The Board should amend its Bylaws to designate at least the newly created positions of Chief Risk Officer, CECSO, and the proposed COO position (see Section 3.5.2., below) as senior officers under Article VI of the PCAOB Bylaws.* As previously discussed, the PCAOB’s Bylaws authorize the CEO to appoint senior officers with the approval of a majority of Board Members, and to remove senior officers after *consultation* with the Board Members.<sup>995</sup> The original senior officer positions are listed; however, the Bylaws permit the creation of additional senior officers by the Board.<sup>996</sup> The creation of these new senior positions represents a positive step towards good and comprehensive corporate governance practice.<sup>997</sup> Designating the most important of these new positions as senior officers will treat these important new roles on a par with those already expressly covered by the current Bylaws.

3.5.2. *The Board should create a Chief Operating Officer (“COO”) position and add it to the Bylaws as a senior staff position.* As discussed above, the 2018 press release for the COS position framed the role as one for the Board—and therefore, for the PCAOB—as a whole.<sup>998</sup> Along with the COS job description,<sup>999</sup> the role is framed as one whose responsibilities are most similar to a COO. Structurally, we recommend that the Board divide the COS’ responsibilities into two separate positions within the Chairman’s Office—the COS position should remain, but its scope and authority should be re-drafted in a manner analogous to the

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<sup>995</sup> See PCAOB Bylaws, Art. VI, §§6.2 & 6.3(b)(2) (emphasis supplied); see also nn. 219-220, *supra*, and accompanying text.

<sup>996</sup> See PCAOB Bylaws, Art. VI §6.2.

<sup>997</sup> See nn. 315-322, *supra*, and accompanying text.

<sup>998</sup> See n. 315, *supra*, and accompanying text.

<sup>999</sup> See Ex. 12, *supra* n. 356.

description for the COS to the SEC Chairman.<sup>1000</sup> A new COO position should be created, separate from the COS, and patterned after the SEC's COO.<sup>1001</sup> Duties would include overseeing the day-to-day administrative and operational functions of the PCAOB, giving directions on the Chairman's behalf, and reporting organizational updates and concerns directly to the Chairman.

3.5.3. *The Board should amend the PCAOB's Bylaws to reference the organization's status as a nonprofit corporation, subject to the DCNPA, in connection with its Mission statement.* S-Ox directs that the PCAOB is subject to the DCNPCA.<sup>1002</sup> Despite the statutorily-mandated interrelationship between S-Ox and the DCNPCA, there is no reference to the DCNPCA or its applicability in the PCAOB's Bylaws.<sup>1003</sup> As discussed, this omission has consequences for the PCAOB's structure.<sup>1004</sup> The Board is required to harmonize its responsibilities under S-Ox and the DCNPCA; it should begin by amending the PCAOB's Bylaws to reference the DCNPA explicitly, and the Board's status and responsibilities thereunder.

3.5.4. *In advance of terminating any significant PCAOB employee (even if not a senior staff member) the Chairman should, to the extent practicable, provide advance notice of his intention to do so.* Under the PCAOB's Bylaws, if dismissals of members of the PCAOB staff who are not identified by title in the Bylaws are deemed by the Board to arise by virtue of a conflict regarding the Board's general policies, the Chairman must first obtain the approval of at least two other Board Members before discharging such an employee.<sup>1005</sup> The

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<sup>1000</sup> See 17 CFR §200.16 (2020), setting for the job description for the Chairman's Executive Assistant/Chief of Staff.

<sup>1001</sup> See 17 CFR §200.13 (2020), setting for the job description for the Commission's Chief Operating Officer.

<sup>1002</sup> See S-Ox §101(b) (The PCAOB is "subject to [and has] all the powers conferred on" a nonprofit corporation by the DCNPCA, Title 29, ch. 4, D.C. Code, "except as otherwise provided in" S-Ox. 15 U.S.C. §7211(b); see also S-Ox §§101(g)(1)-(2), 15 U.S.C. §§7211(g)(1)-(2).

<sup>1003</sup> See generally, PCAOB Bylaws, available at <https://pcaobus.org/Rules/Pages/Bylaws.aspx>.

<sup>1004</sup> See generally, Section 2.4., *supra*.

<sup>1005</sup> See n. 221, *supra*, and accompanying text.

only way the Board could exercise this right is by knowing—before the termination occurs—that the termination is *about to occur*.

3.5.5. *The Board should require that there be at least an annual review performed of the Bylaws, to determine whether any changes are warranted in light of experience.* The Board’s experiences over the course of a year will inform it whether or not it needs to amend any aspect of the PCAOB’s Bylaws. While it is unlikely that there will be a frequent need to adopt significant amendments, the most appropriate thing to do is for the Board to incorporate this routine into its yearly efforts and self-evaluation process.

### 3.6. Miscellaneous Recommendations

3.6.1. *The Board should evaluate the PCAOB’s Enterprise Risk Management structure periodically throughout the year to assess whether it is effectively identifying and resolving risks as they arise.* The goal of an ERM process is to generate an understanding of the top risks that are the current most critical risks to the strategic success of the enterprise.<sup>1006</sup> With that knowledge, the organization can then evaluate whether the current manner in which it is managing those risks is sufficient and effective.<sup>1007</sup>

3.6.2. *The Board collectively should establish a schedule for semi-annual meetings to report to the SEC’s OCA on*

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<sup>1006</sup> See, e.g., M. Beasley, “What is Enterprise Risk Management?,” N.C. State Univ. Enterprise Risk Management Initiative (Jul. 17, 2020), available at <https://erm.ncsu.edu/library/article/what-is-enterprise-risk-management>.

<sup>1007</sup> *Id.* To revise its current operational framework, the Board will need to address four key issues:

1. What are the objectives for the ERM?
2. What should be the scope of the ERM Program?
3. What kind of organizational structure around ERM will work for the PCAOB?
4. What specific tools will be needed to implement ERM?

See, e.g., J. Miccolis, *Implementing Enterprise Risk Management: Getting the Fundamentals Right*, INTERNATIONAL RISK MANAGEMENT INSTITUTE, INC. (June 2003) available at <https://www.irmi.com/articles/expert-commentary/implementing-enterprise-risk-management-getting-the-fundamentals-right>.

*matters discussed, resolved, initiated or updated during the prior six months, and any individual issues that may be of significance.* Due to the need for effective SEC oversight of the PCAOB, communication channels should function smoothly and regularly. While the Chairman has frequent contact with the SEC's OCA, there should be an opportunity for all Board Members to participate in a formalized process that permits all Board Members to discuss issues of importance.

3.6.3. *Separation Agreements for departing PCAOB employees should include a contractual provision requiring former employees—as a condition of receiving and retaining appropriate severance payments—to cooperate with and assist the PCAOB in connection with ongoing or future internal or external reviews.* As noted, two former PCAOB senior staff members chose not to participate in KLS' governance review.<sup>1008</sup> One of those individuals was the recipient of a six months' salary severance payment, but nonetheless refused to participate in our request for an interview. To avoid the future possibility that other employees may receive severance payments but refuse to participate in important PCAOB reviews, the PCAOB should include a clause for post-termination cooperation in its separation agreements with individuals who have provided services or are privy to information that the individual is qualified to offer.<sup>1009</sup>

3.6.4. *Employment Agreements should be used for senior PCAOB employees and should include a contractual provision requiring those employees—as a condition of their continuing employment—to cooperate with and assist the PCAOB in connection with ongoing or future*

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<sup>1008</sup> See n. 117, *supra*.

<sup>1009</sup> See R. Harroch, "16 Key Issues in Negotiating an Employment Severance Package," FORBES (Apr. 14, 2018) available at <https://www.forbes.com/sites/allbusiness/2018/04/14/16-key-issues-in-negotiating-an-employment-severance-package/?sh=64d5829d76b2> (Explaining that it is common practice for employers to often include "a cooperation clause, obligating the employee to fully and completely cooperate with the company in connection with any litigation or investigation involving the company"); See N. Nazareth, "Employment Severance Agreements: Buying Peace of Mind With Non-Monetary Remedies," McMillan Metro, P.C. (June 26, 2019) available at <https://www.mcmillanmetro.com/articles/employment-severance-agreements/>, ("A future cooperation clause may be desirable if the employer may need the employee to assist with" transitions, investigations, or any future legal liability).

*internal or external reviews, litigation and significant projects on which these senior employees had important responsibilities.* One of the two senior employees who declined to participate in our review retired from the PCAOB and did not enter into a severance agreement with the organization upon her retirement. If a senior employee is prepared to leave the PCAOB without a separation agreement, there may be no document in which to insert a post-employment cooperation agreement—at that time.<sup>1010</sup> Accordingly, the PCAOB should require new employees, or those who are continuing, to sign an agreement relating to employment and post-employment cooperation, even in the absence of a severance agreement.<sup>1011</sup>

3.6.5. *The Board should adopt a formal process for determining whether, when and how to retain outside counsel, and implement a policy to guide the relationship between outside counsel and the organization.* Whether by the full Board, a subset of the Board, or individual Board Members, important elements of the retention of outside counsel should be clarified.<sup>1012</sup> When a corporation decides to retain outside counsel, the decision is typically driven by one of three main factors; geography, the need for specialized and independent expertise, and a lack of inside resources.<sup>1013</sup> Once outside counsel is engaged,

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<sup>1010</sup> Even in the absence of a severance agreement, payment of accumulated leave, vacation time or past-due pay may, under some circumstances, be conditioned on securing employee commitments for post-departure cooperation.

<sup>1011</sup> See, e.g., P. Panken & J. Williams, “*Drafting Executive Employment Agreements that Work for Employers: An Annotated Model Agreement*,” ALI-ABA Bus. Law Course Materials JI. (Feb. 2009), at p. 46, available at [https://www.ebglaw.com/content/uploads/2014/06/26725\\_CMJ0902-Panken.pdf](https://www.ebglaw.com/content/uploads/2014/06/26725_CMJ0902-Panken.pdf) (Setting forth provisions for an employee’s post-employment duties, including availability and cooperation in connection with any proceeding or inquiry involving the company or any director, officer employee thereof); Aramark Corp., “*Agreement Relating to Employment and Post-Employment Competition*,” available at <https://www.sec.gov/Archives/edgar/data/7032/000119312507158115/dex101.htm>; Baidu.com, Inc., “*Executive Employment Agreement*,” available at <https://www.sec.gov/Archives/edgar/data/1329099/000119312505140785/dex104.htm>.

<sup>1012</sup> See nn. 135-141, *supra*, and accompanying text (Noting that by its very nature, KLS’ review was not an adversarial one). We believe that the retention of outside counsel in connection with our governance review was unnecessary, a waste of PCAOB resources, and undermined the authority and effectiveness of the OGC.

<sup>1013</sup> See, e.g., Assoc. of Corp. Counsel, “*Role of the General Counsel*,” (Sept. 2009), available at [https://www.acc.com/sites/default/files/resources/vl/membersonly/InfoPAK/700992\\_3.pdf](https://www.acc.com/sites/default/files/resources/vl/membersonly/InfoPAK/700992_3.pdf).

the Board should outline the role of outside counsel, the scope of work, conflict waiver, process for engaging new work, responsible attorneys and lead attorney, persons qualified to handle confidential information, the objectives, methods of communication, fee arrangement, and billing guidelines along with oversight.<sup>1014</sup>

3.6.6. *The PCAOB should designate an individual (or individuals) in OGC to assist future investigations and/or internal reviews to coordinate document production.* The new CECO was tasked by the four unrecused Board Members to serve as the sole and exclusive liaison with KLS to coordinate all KLS information requests<sup>1015</sup> and schedule PCAOB interviews.<sup>1016</sup> Especially given her critical assignment of updating the PCAOB's Ethics Code,<sup>1017</sup> her relative lack of PCAOB tenure, and the absence of prior experience performing such a role, the CECO was an inappropriate selection to handle the liaison role into which she was thrust. To avoid similar problems vis-à-vis future reviews or internal inquiries conducted by outside reviewers, the PCAOB should select individuals in OGC to perform this role.

3.6.7. *The Board should adopt a comprehensive written policy, with a uniformly applied formula, to calculate employee severance agreements based on a set standard of pay scale, time served, and other relevant characteristics identified by the IRS.* To date, the Board has not followed the IRS' preferred safe-harbor methodology to justify the amount paid in severance agreements to departing PCAOB employees.<sup>1018</sup> The Board should adopt a system to evaluate the reasonableness of compensation paid to departing senior officers as outlined above.<sup>1019</sup>

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<sup>1014</sup> See *id.* (Explaining the importance of guidelines for general counsel and a process for retaining outside counsel and then maintaining sufficient oversight).

<sup>1015</sup> See n. 101, *supra*, and accompanying text.

<sup>1016</sup> See n. 139, *supra*.

<sup>1017</sup> See nn. 587-588, *supra*, and accompanying text.

<sup>1018</sup> See n. 349, *supra*, and accompanying text.

<sup>1019</sup> See nn. 333-340, *supra*, and accompanying text.

3.6.8. *The PCAOB should either reinstate its former process for handling employment terminations or adopt a new one that is comprehensive and followed in all cases.* Employment terminations should be handled in an efficient manner that provides a paper trail detailing each of the steps taken, and the reasons for them. This was the PCAOB’s methodology prior to 2018.<sup>1020</sup> While Board employees are at-will employees, this approach can assist in warding off potential lawsuits for discrimination or wrongful termination and can assure compliance with IRS regulations.<sup>1021</sup>

3.6.9. *The PCAOB should correct the erroneous listing on GuideStar.com, which characterizes the 501(c)(3) exemption as being based on the PCAOB’s status as an arm or agency of state or local government.* As noted above,<sup>1022</sup> the website maintained at GuideStar.com lists entities that are tax-exempt pursuant to 501(c)(3) but are not required to file IRS Form 990, and the reason the form is not required to be filed. In the PCAOB’s case, the reason given is that the PCAOB is an arm of state or local government. This is clearly incorrect, and the PCAOB should advise the GuideStar.com website to change that characterization.

#### IV. Conclusion

Over the past two years, the Board has made progress in developing a platform of good governance policies, procedures and practices. Many of our recommendations seek to build on that progress. In other areas, there is still a fair amount of work to be done, but we believe that our recommendations should help the Board upgrade its governance significantly.

January 10, 2021

Harvey L. Pitt  
Ninozka Rodriguez  
Jacob Huston

Kalorama Legal Services, PLLC

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<sup>1020</sup> See Witness X Interview, at pp. 3-4.

<sup>1021</sup> See nn. 389-392, *supra*, and accompanying text.

<sup>1022</sup> See n. 659, *supra*, and accompanying text.

## **V. List of Exhibits**

<b>1. KP PCAOB Review Contract Agreement</b>	<b>n. 2</b>
<b>2. 2019 Culture Survey Approach and Response</b>	<b>n. 29</b>
<b>3. 2019 Culture Survey Questions</b>	<b>n. 30</b>
<b>4. 2019 Culture Survey</b>	<b>n. 30</b>
<b>5. May Whistleblower Complaint</b>	<b>n. 34</b>
<b>6. KLS Summary of September Whistleblower Complaint</b>	<b>n. 48</b>
<b>7. Venable Memo to PCAOB Employees re Governance Rev.</b>	<b>n. 95</b>
<b>8. List of Documents provided to us by the Board</b>	<b>n. 125</b>
<b>9. PCAOB 1<sup>st</sup> Resol. Re KLS Access to Board Documents</b>	<b>n. 146</b>
<b>10. PCAOB 2<sup>nd</sup> Resol. Re KLS Access</b>	<b>n. 150</b>
<b>11. PCAOB Filings re Tax-exempt Status</b>	<b>n. 178</b>
<b>12. PCAOB Chief of Staff Job Description</b>	<b>n. 356</b>
<b>13. Memo on PCAOB Document Repositories</b>	<b>n. 397</b>
<b>14. PCAOB Job Description for GC (Jul. 27, 2018)</b>	<b>n. 543</b>
<b>15. PCAOB Job Description for GC (Aug. 3, 2017)</b>	<b>n. 544</b>
<b>16. PCAOB Organization Chart (Nov. 30, 2020)</b>	<b>n. 548</b>