



California Public Employees' Retirement System

Executive Office

400 Q Street, Sacramento, CA 95811 | Phone: (916) 795-3829 | Fax: (916) 795-3410

888 CalPERS (or 888-225-7377) | TTY: (877) 249-7442 | www.calpers.ca.gov

Ms. Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

December 18, 2020

Subject: File Number PCAOB-2020-01¹

Dear Secretary Countryman,

On behalf of the California Public Employees' Retirement System (CalPERS), we write to express our deep concern as a long-term investor at the proposed rule to weaken auditor independence standards as proposed in the Notice of Filing of Proposed Rules on Amendments to PCAOB Interim Independence Standards and PCAOB Rules To Align With Amendments to Rule 2-01 of Regulation S-X (PCAOB Rules).² As the largest public defined-benefit pension fund in the United States, we manage approximately \$430 billion in global assets on behalf of more than two million members. We are concerned about the long-term stability of the markets and systemic risk because our obligation to pay benefits extends for many decades. We believe that auditor independence rules should be strengthened rather than weakened as proposed by the PCAOB Rules.

In CalPERS' Governance & Sustainability Principles (Principles),³ we emphasize the importance of auditor independence in multiple places, including in "Section B. 10. Role of the Audit Committee" and "Section D.4. Auditor's Enhanced Reporting to Investors." We track the work of the Public Company Accounting Oversight Board (PCAOB or Board) and have commented to the PCAOB about the importance of auditor independence on numerous occasions, including in two of our recent letters to the PCAOB.⁴ In our September 10, 2018 letter, in which we commented on PCAOB strategy, we stated: "As investors, we are concerned with auditor

¹ A Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendments to PCAOB Interim Independence Standards and PCAOB Rules To Align With Amendments to Rule 2-01 of Regulation S-X, Exchange Act Release No. 90,473, 85 Fed. Reg. 76,131 (Nov. 27, 2020).

² Id.

³ CalPERS' Governance and Sustainability Principles, <https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf>.

⁴ CalPERS letter dated March 18, 2020, PCAOB Release No. 2019-003, Concept Release, *Potential Approach to Revisions to PCAOB Quality Control Standards*; CalPERS letter dated September 10, 2018, PCAOB Draft Strategic Plan 2018-2022 (stating effective financial reporting depends on rigorous independent audit).

independence which has been advanced in other jurisdictions, but the Draft Strategic Plan is light on the topic. What is the Board's view on auditor independence?"

In our letter dated March 18, 2020, we referenced our Principles, explaining that "Section D.4. of CalPERS' Governance & Sustainability Principles (Principles) states that, 'Auditors should bring integrity, independence, objectivity, and professional competence to the financial reporting process.'" Since the Enron scandal, we have had a laser focus on auditor independence, which is an important topic to fiduciaries like us. We are thus deeply concerned that the PCAOB did not provide us and others in the investment community the opportunity to fully discuss the implications of the PCAOB's decision to weaken the very standards we expected it to strengthen.

Moreover, PCAOB takes this course of action without substantial analysis or public input. In fact, it only "took notice" of the regulatory and rulemaking process completed by the Securities and Exchange Commission (SEC or Commission). The Board made no assessment of its own other than that the changes would align with the SEC's changes to auditor independence standards. Thus, all of the PCAOB's work appears to be derivative. It is clear that the PCAOB has failed to follow the appropriate due diligence process by choosing to rely solely on the SEC's work and opinions rather than hold true to its own distinct mission to protect investors. As an investor in the markets, it is an understatement to say that we expected more from the PCAOB.

We are also deeply troubled that the substance of the PCAOB Rules, like the process, is entirely inadequate. The PCAOB was established to address certain issues created by Enron and other bad actors when the audit industry failed the markets. A centerpiece of the PCAOB's intended mission is auditor independence. Despite that core mission, the investment community has had to work with interim rules on auditor independence for more than 17 years. During that entire time, investors have spoken out on the need to improve those independence rules to ensure actual auditor independence.

Despite this consistent message and PCAOB's mission, PCAOB's first move to amend the rules is to actually weaken them even below the inadequate standards of 2003. To highlight this issue, we turn to the Benefits section of the PCAOB Rules. The last phrase of the first bullet comment reads as follows, "thus reducing overall compliance burdens without significantly diminishing investor protections."⁵ This sentiment is significant because it constitutes an admission that the PCAOB Rules will diminish investor protections. The passage states that it would not be significant, but the PCAOB has not heard from investors. In fact, it has even shut off contact from the two investor groups it had established, so the PCAOB does not know the impact. Further, the Benefits section highlights that, rule 2-01 may lead to a potentially larger pool of auditors eligible to perform audit engagements."⁶ This is saying that the PCAOB is removing existing conflicts of interest by rule which will allow auditors that currently have a conflict of interest to engage in providing certain services that currently represent a conflict. The marketing materials read as if the purpose of the Amendment removes the exaggerated consideration of student loans. The reality is that the SEC and PCAOB are removing conflicts of interest from regulatory consideration and pushing the issue onto audit committees to see

⁵ PCAOB Rules, at 20.

⁶ PCAOB Rules at 20.

whether or not the audit committees will maintain high independence standards, or rely on the weakened standards as presented by the SEC and PCAOB and allow activities historically determined to be conflicts of interest.

Our analysis is that investor protections will suffer significant diminution. Not only do we not get the better auditor independence rules we had sought for more than a decade, but we get a worse independence rule. All of which is completed without the expected due diligence by the regulator with responsibility to protect investors. We find it highly problematic that auditors will be able to solicit new non-audit business from existing clients while by rule maintaining independence and without having to report or document such activity to the audit committees that have to monitor independence. In other words, the SEC and the PCAOB will not only make the work of investors more difficult, but this rule will make it more difficult for audit committees to meet their obligations to monitor auditor independence. Unfortunately, the PCAOB, as the most closely suited subject matter expert, has not analyzed this Amendment in the context of its own work nor has it questioned the work of the SEC, in any substantive manner. An even greater burden will fall on audit committees to maintain independence requirements given the weakened regulation. The problem is enhanced because the amendment reduces required reporting in a way that makes it less likely audit committees will have the information necessary to discover inappropriate conduct.

Among investors who comment on regulatory issues, we have found no support for the process used by the PCAOB or the outcome which will weaken a key aspect of system safety: auditor independence. By not following its normal process, including by failing to conduct its own policy and economic analysis, the PCAOB reduces trust in the system. We thus urge the Commission to send the Amendments back to the PCAOB and request that the PCAOB follow its own formal processes for making regulatory change and live up to its mission of investor protection. On this issue, following the normal due diligence process is critically important, even if the eventual outcome is essentially the same. The input from investors in a PCAOB consultation would be very different from what was received by the SEC in its consultation.

While commenting on the Enron scandal in their paper, *Enron: examining agency problems*, Arnold and deLange stated:

[t]hose seeking immediate gains placed enormous pressure on decision makers for high-risk decisions. Decisions made at the expense of longevity, at all costs and with contempt for responsibilities owed to those from whom faith had been entrusted.

We have long placed faith and trust in the work of the PCAOB and treated it as important by commenting when the opportunities were presented. Here, we have what is likely the most significant issue of all involving high-risk, but the process has been changed so that we do not have an effective opportunity to comment. There is no excuse for the PCAOB's failure to comply with its own processes that allow for direct communication with the PCAOB on issues that investors consider important. In this instance, the PCAOB has failed investors. This Amendment will diminish investor protection, as stated in the materials, without providing a corresponding benefit to investors. The adopted process reduces trust in the system at an

intensely critical time in the midst of a pandemic. It is a terrible precedent to establish that when the PCAOB makes a tough decision it will hide totally behind others, even if it is the SEC.

We do not support the rule change and urge the SEC to send the PCAOB Rules back to the PCAOB so that the PCAOB is able to conduct independent policy and economic analysis and allow investors and audit committees to comment on how the PCAOB Rules would impact them. We are concerned that the PCAOB Rules will impede the ability of regulators to monitor and address auditor independence at the proper level and make it harder on investors and audit committees to fill the oversight gap left by the regulators. It is troubling that we will be left with auditor independence rules that are essentially weaker than they were immediately after Enron.

We would welcome the opportunity to discuss the issues raised by weakening auditor independence standards. Please contact Anne Simpson, Managing Investment Director, at [REDACTED], if you have any questions or wish to continue this discussion.

Sincerely,

Marcie Frost
Chief Executive Officer

cc: Anne Simpson