

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 55523 / March 26, 2007

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 2580 / March 26, 2007

ADMINISTRATIVE PROCEEDING

File No. 3-12600

In the Matter of

ERNST & YOUNG LLP,

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Ernst & Young LLP ("Respondent" or "E&Y") pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.¹

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over E&Y and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public

¹ Rule 102(e)(1)(ii) provides, in pertinent part, that:

The Commission may censure a person . . . who is found by the Commission . . . to have engaged in unethical or improper professional conduct.

Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds² that:

A. SUMMARY

This action concerns violations of auditor independence standards by E&Y. During 2001, E&Y, through one of its National Office partners, compromised its professional independence by assisting one client, American International Group, Inc. ("AIG"), in its development and marketing of an accounting-driven financial product and then advising an audit client, The PNC Financial Services Group, Inc. ("PNC"), on the accounting treatment for a version of that product in PNC's financial statements, without E&Y performing a meaningful analysis of the accounting separate from the analysis that the National Office partner had performed.³

The accounting-driven financial product purported to enable a company to transfer volatile financial assets to a special purpose entity ("SPE") and thereby to remove those assets from the company's financial statements. AIG sold three such products to PNC in 2001, and as a result, PNC improperly excluded certain assets from its consolidated financial statements. E&Y advised PNC on the accounting for each transaction. In January 2002, PNC announced that it would restate its financial statements for the second and third quarters of 2001, and revised its previously announced financial results for the fourth quarter and year-end of 2001, to include the previously excluded assets.

Through the National Office partner, E&Y advised PNC, in connection with E&Y's work as PNC's auditor, on the appropriateness of the accounting treatment of the SPE product that the National Office partner had assisted AIG to develop and market. Accordingly, as a result of the actions of the National Office partner, E&Y compromised its auditor independence required by generally accepted auditing standards ("GAAS") and Regulation S-X of the Commission's rules and regulations. Additionally, the reporting provisions of the federal securities laws require that quarterly financial statements be reviewed by an independent accountant. Because E&Y was not

² The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

³ The Commission previously brought settled proceedings against PNC, AIG, Thomas F. Garbe, and Michael S. Joseph, the National Office partner, related to their roles in these matters. PNC Financial Services Group, Inc., Securities Act Release No. 8112, Securities Exchange Act Release No. 46225, Accounting and Auditing Enforcement Release No. 1597 (July 18, 2002); SEC v. American International Group, Inc., No. 1:04CV02070 (GK) (D.D.C. judgment entered Dec. 7, 2004); In the Matter of Thomas F. Garbe, Securities Exchange Act Release No. 54906, Accounting and Auditing Enforcement Release No. 2522, Administrative Proceeding No. 3-12501 (Dec. 11, 2006); In the Matter of Michael S. Joseph, CPA, Securities Act Release No. 8759, Securities Exchange Act Release No. 54907, Accounting and Auditing Enforcement Release No. 2523, Administrative Proceeding No. 3-12502 (Dec. 11, 2006).

independent in its review of PNC's financial statements for the second and third quarters of 2001, E&Y was a cause of PNC's violations of the reporting provisions.

B. RESPONDENT

Ernst & Young LLP is a national accounting firm with its headquarters in New York, New York. At all relevant times, E&Y provided auditing services to PNC. Specifically, E&Y was responsible for, among other things, the audit of PNC's consolidated financial statements, interim reviews of quarterly financial statements, and reviews and consultations pertaining to filings with the SEC. While serving as auditor for and advisor to PNC, E&Y also was employed as an advisor to AIG with responsibility for assisting AIG in addressing generally accepted accounting principles ("GAAP") compliance issues during the design stage of an SPE product, a version of which was used in transactions between AIG and PNC.

C. OTHER RELEVANT ENTITIES

American International Group, Inc. is a Delaware corporation with its principal place of business in New York, New York. Through its subsidiaries, AIG is engaged in a broad range of insurance-related and asset management activities in the United States and abroad.

The PNC Financial Services Group, Inc. is a Pennsylvania corporation with its principal place of business in Pittsburgh, Pennsylvania. PNC is a bank holding company that is regulated by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Cleveland (together the "Federal Reserve") and has a national bank subsidiary that is regulated by the Comptroller of the Currency.

D. FACTS

1. Development and Marketing of C-GAITS Product

In early 2001, AIG engaged one of E&Y's National Office partners to assist it in developing an accounting-driven financial product, known as a Contributed Guaranteed Alternative Investment Trust Security ("C-GAITS"). The C-GAITS product purported to enable a public company to reduce the earnings impact of troubled or other potentially volatile financial assets by transferring those assets from the public company's balance sheet to an SPE established by AIG. Under the C-GAITS structure, the SPE was to be consolidated onto AIG's balance sheet.

The National Office partner issued reports to AIG pursuant to Statement on Auditing Standards No. 50, *Reports on the Application of Accounting Principles* ("SAS 50 letters")⁴, over

⁴ A "SAS 50" letter is a report issued by an accounting firm that provides guidance to a non-audit client. A SAS 50 letter could relate to the type of opinion that may be rendered on a specific entity's financial statements, the application of accounting principles to specific proposed or completed transactions, or the application of accounting principles to hypothetical transactions. These letters frequently were used for marketing purposes by non-audit clients. SAS No. 50 was amended in June 2002 by Statement on Auditing Standards No. 97, *Amendment to Statement on Auditing Standards No.*

E&Y's firm signature, representing that the favorable nonconsolidation accounting treatment for the SPE established in a hypothetical C-GAITS transaction was an appropriate application of GAAP. As intended, AIG used the E&Y SAS 50 letters to promote the C-GAITS product. AIG also relied extensively on the E&Y National Office partner's accounting advice as it attempted to sell the product. For example, AIG referred to E&Y's accounting advice in its marketing materials and referred potential buyers directly to the E&Y National Office partner to answer accounting-related questions. The National Office partner reviewed and edited term sheets for at least two proposed C-GAITS deals. On several occasions, the National Office partner also participated in conference calls with AIG when AIG marketed the C-GAITS product to potential purchasers.

From March 2001 through January 2002, AIG marketed the C-GAITS product to several public companies, with the assistance of the National Office partner. Despite its marketing effort, AIG ultimately closed only the three C-GAITS transactions with PNC. These transactions were referred to respectively as "PAGIC I," "PAGIC II," and "PAGIC III" (and collectively as the "PAGIC transactions").

2. PNC's Second Quarter 2001

Around the beginning of June 2001, AIG marketed the C-GAITS product to PNC using a SAS 50 letter written by the National Office partner that addressed the accounting for a C-GAITS structure. Throughout its negotiations with AIG that month, PNC management consulted frequently with the E&Y audit engagement team, which, in turn, consulted with the National Office partner, to determine the accounting treatment for the transaction that PNC was contemplating. In fact, when PNC began considering PAGIC I, PNC senior management contacted the E&Y coordinating partner for the PNC audit account and requested formal written guidance on the accounting treatment for the transaction. The coordinating partner assigned the technical partner on the engagement to prepare a guidance letter. That partner then contacted the National Office partner, with the knowledge of PNC.

The National Office partner provided an existing SAS 50 letter to the technical partner for use as a template for the PNC guidance letter. The National Office partner thereafter reviewed drafts of the guidance letter and discussed accounting issues related to the PAGIC I transaction with the technical partner.

Without performing a meaningful analysis, the E&Y engagement team incorporated virtually verbatim into the guidance letter the accounting analysis and conclusions that the National Office partner had included in the SAS 50 letter.⁵ The National Office partner reviewed and approved the guidance letter before it was issued to PNC. The guidance letter was issued over the E&Y firm signature and stated that it was E&Y's view that PNC's nonconsolidation of the SPE

50, Reports on the Application of Accounting Principles. Accountants are now prohibited from providing a report on accounting principles concerning hypothetical transactions.

⁵ Each guidance letter for each of the three PAGIC transactions included a factual description of the particular transaction for which the guidance letter was written and a discussion of accounting issues. The factual descriptions in the letters differed, but the discussion of the accounting issues was largely identical to the corresponding discussion in the SAS 50 letter.

conformed with GAAP. On June 28, 2001, AIG and PNC closed the first of the three PAGIC transactions.

E&Y performed a review of PNC's financial statements for the second quarter of 2001. E&Y, however, did not perform any separate analysis of PNC's accounting for the PAGIC I transaction in the course of that review. In evaluating the accounting for the transaction, E&Y instead incorporated and relied on the National Office partner's analysis, including the written guidance letter issued to PNC, which mirrored the SAS 50 letters provided to AIG. E&Y's conclusion on the appropriateness of PNC's accounting was largely based on work performed by the National Office partner for AIG during the design of the product.

On August 14, 2001, PNC filed its Form 10-Q for the second quarter of 2001 with the Commission. The Form 10-Q included the second quarter financial statements that E&Y had reviewed. In those financial statements, PNC excluded from its balance sheet the assets it transferred to the SPE in the PAGIC I transaction. The financial statements reflected that PNC had \$374 million in nonperforming loan assets and \$16 million in other nonperforming assets. These figures did not include \$84 million in nonperforming loan assets among the \$257 million of loan assets that PNC had transferred to the SPE. PNC's second quarter Form 10-Q did not provide any disclosure concerning the PAGIC I transaction.

3. PNC's Third Quarter 2001

E&Y continued to assist AIG in its efforts to market the C-GAITS product. In September 2001, the National Office partner accompanied an AIG marketing team to assist in AIG's marketing of the C-GAITS product to another public company. Also in September 2001, E&Y advised PNC on the accounting for the PAGIC II transaction, which closed on September 27, 2001. PNC again relied on the National Office partner's advice in connection with its evaluation of the applicable accounting. Once again, E&Y provided PNC with a written guidance letter stating that it was E&Y's view that nonconsolidation was the appropriate accounting treatment for PAGIC II. As before, E&Y incorporated virtually verbatim into the guidance letter the accounting analysis and conclusions that the National Office partner had included in the SAS 50 letter. The National Office partner once again reviewed and approved the guidance letter before it was issued to PNC.

E&Y performed a review of PNC's financial statements for the third quarter of 2001. E&Y again, however, did not perform any separate analysis of PNC's accounting for the PAGIC II transaction in the course of that review. In evaluating the accounting for the transaction, E&Y incorporated and relied on the National Office partner's analysis, as reflected in the accounting guidance letter.

On November 14, 2001, PNC filed its Form 10-Q for the third quarter of 2001 with the Commission. The Form 10-Q included the third quarter financial statements that E&Y had reviewed. In those financial statements, PNC excluded from its balance sheet the assets it had transferred to the SPEs in the two PAGIC transactions. The financial statements reflected that PNC had \$361 million in nonperforming loan assets and \$13 million in other nonperforming assets. These figures did not include a total of \$207 million in nonperforming assets among the

\$592 million of loan assets that PNC had transferred to the SPEs in the first two PAGIC transactions. PNC's third quarter Form 10-Q did not provide any disclosure concerning the two PAGIC transactions into which PNC had entered.

4. PNC's Fourth Quarter 2001

Throughout October and November 2001, the National Office partner continued to assist in AIG's marketing efforts and on November 29, 2001, the National Office partner issued another SAS 50 letter for AIG's negotiations with yet another public company. Also at about the same time, the National Office partner conferred with another E&Y audit client regarding a potential C-GAITS transaction with AIG.

On October 23, 2001, the Federal Reserve sent a letter to PNC expressing concern about PNC's accounting for the assets transferred in PAGIC I. E&Y, including the National Office partner, reviewed and commented on PNC's proposed responses to the Federal Reserve, which defended PNC's accounting. During the same October-to-November period, the National Office partner, through E&Y's engagement team, advised PNC on the accounting treatment for a third PAGIC transaction, which closed on November 29, 2001. Again, E&Y provided PNC management with a written guidance letter stating that it was E&Y's view that nonconsolidation was the appropriate accounting treatment for PAGIC III. As before, E&Y incorporated virtually verbatim into the PNC guidance letter the accounting analysis and conclusions that the National Office partner had included in the SAS 50 letter. The National Office partner reviewed and approved the guidance letter before it was issued to PNC.

Also in November 2001, another of E&Y's banking audit clients discussed with the Federal Reserve the accounting for a C-GAITS transaction that it was contemplating. On or about December 4, 2001, the Federal Reserve informed E&Y's client of its view that the proposed accounting was not in conformity with GAAP. When consulted by AIG, the National Office partner helped AIG defend the proposed accounting for the transaction.

On January 11, 2002, the Federal Reserve directed PNC to consolidate the three PAGIC transactions in its bank holding company regulatory reports for 2001. Thereafter, on January 29, 2002, PNC announced that it would reverse the accounting for all three PAGIC transactions, restate its financial statements for the second and third quarters of 2001, and revise its previously announced fourth quarter and full-year 2001 financial results. The change in accounting and restatement resulted in a \$155 million charge to PNC's earnings and a \$0.53 per share drop (equivalent to 38%) in PNC's previously reported earnings per share for 2001.

For its work on the SAS 50 letters, the accounting guidance given to PNC, and the interim reviews and work related to the restatements of PNC's financial statements, E&Y billed AIG and PNC \$1,196,700.

E. LEGAL ANALYSIS

1. Applicable Professional Standards

Standards relating to the independence of public accounting firms are contained in GAAS and Rule 2-01(b) of Regulation S-X. Throughout the relevant time, GAAS required that “[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.”⁶ This requirement is necessary because of the importance in having the public maintain confidence in the independence of auditors.⁷ Auditors, accordingly, are required not only to be independent in fact but also to avoid the appearance of a lack of independence.⁸

Rule 2-01(b) of Regulation S-X, in pertinent part, provides as follows:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.⁹

2. E&Y Violated Independence Standards

As discussed above, the National Office partner was intimately involved in the development of AIG’s C-GAITS product and assisted in AIG’s efforts to market that product. The National Office partner provided advice on the structure, prepared four SAS 50 letters that AIG used in marketing the product, participated in conference calls with potential purchasers of the product and, on at least one occasion, accompanied an AIG marketing team to assist in AIG’s marketing of the C-GAITS product to a potential customer. The National Office partner charged AIG for his services. As a result of the activities of the National Office partner, E&Y was invested both financially and reputationally in the success of the C-GAITS product and therefore had a conflict of interest when it evaluated the accounting for that product for its audit client PNC.¹⁰

E&Y’s engagement team relied upon the National Office partner’s advice and analysis of the accounting for the PAGIC transactions, both when drafting and issuing the guidance letters to

⁶ Codification of Statements on Auditing Standards, *Statement on Auditing Standards No. 1*, § 150.02 (Am. Inst. of Certified Pub. Accountants 1972).

⁷ *See id.* § 220.03.

⁸ *Id.*

⁹ 17 CFR § 210.2-01(b).

¹⁰ In determining whether an accountant is independent, the Commission “looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client: [or] places the accountant in the position of auditing his or her own work....” 17 CFR § 210.2-01 prelim. note.

PNC and during E&Y's interim reviews of PNC's Form 10-Qs. E&Y's engagement team did not perform a meaningful analysis when issuing the accounting guidance letters to PNC and did not perform any separate analysis in the course of the interim reviews, but instead relied on the National Office partner's accounting analysis. Because of the role that the National Office partner had played in AIG's development and marketing of the C-GAITS product and because of the role the National Office partner also played in evaluating and advising PNC on the PAGIC transactions in connection with E&Y's audit work for PNC, a reasonable investor with knowledge of all relevant facts and circumstances would conclude that E&Y was not impartial and lacked the requisite independence in the performance of its functions as PNC's auditor.

The departures from GAAS and failure to comply with Rule 2-01 of Regulation S-X described above constitute improper professional conduct within the meaning of Rule 102(e)(1)(ii). Regarding accountants, the term "improper professional conduct" is defined by Rule 102(e)(1)(iv) to include a "single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted" or "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."¹¹ E&Y's conduct in this matter represents improper professional conduct under either standard. At a minimum, as described above, E&Y engaged in multiple instances of unreasonable conduct resulting in independence violations. In addition, inasmuch as a reasonable investor would have concluded that E&Y, through the National Office partner, was operating on both sides of several transactions which led to auditor independence violations, E&Y engaged in highly unreasonable conduct under circumstances in which it knew or should have known warranted heightened scrutiny. As the Commission has stated, "Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence *always* merit heightened scrutiny."¹²

3. E&Y Caused PNC to Violate Reporting Provisions

As a result of its violation of the independence standards, E&Y also caused PNC to violate reporting provisions of the federal securities laws. Section 13(a) of the Exchange Act requires issuers of registered securities to file periodic reports with the Commission containing information prescribed by Commission rules and regulations. Exchange Act Rule 13a-13 requires the filing of quarterly reports on Form 10-Q, and Exchange Act Rule 12b-20 requires that, in addition to the information required by Commission rules to be included in periodic reports, such further material information as may be necessary to make the required statements not misleading also must be included. Periodic reports must be complete and accurate. Rule 10-01(d) of Regulation S-X requires that interim financial statements included in quarterly reports must be reviewed by an independent public accountant prior to filing.¹³ Because E&Y was not independent, PNC failed to

¹¹ 17 CFR § 201.102(e)(1)(iv).

¹² Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities Act Release No. 7593, at 11C. (October 19, 1998) (emphasis added).

¹³ 17 CFR § 210.10-01(d).

comply with Rule 10-01(d) of Regulation S-X and consequently violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

By its conduct described above, E&Y caused PNC's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13 thereunder.

F. REMEDIAL ACTIONS BY E&Y

In determining to accept the Offer, the Commission considered the remedial steps taken by E&Y. Since the conduct discussed in this Order, E&Y has significantly revised its independence policies and procedures. E&Y has also set forth new procedures that specifically address potential conflicts of interest that may arise when providing accounting advice to investment bankers and financial intermediaries.

G. FINDINGS

A. Based on the foregoing, the Commission finds that E&Y engaged in improper professional conduct pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

B. Based on the foregoing, the Commission finds that E&Y was a cause of PNC's violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent E&Y's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. E&Y hereby is censured; and

B. E&Y shall, within ten days of the entry of this Order, pay disgorgement of \$1,196,700 and interest of \$390,470.42, totaling \$1,587,170.42, to the victim restitution fund established pursuant to paragraph 7 of the Deferred Prosecution Agreement between PNC ICLC

Corp. and the United States Department of Justice, Criminal Division, Fraud Section signed on June 2, 2003, together with a cover letter identifying Ernst & Young LLP as the Respondent in these proceedings, identifying the file number of these proceedings, and specifying that the payment is being made pursuant to this Order. E&Y shall simultaneously transmit a photocopy of the cover letter and the document by which payment is made to Thomas D. Silverstein, Esq., Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549.

By the Commission.

Nancy M. Morris
Secretary