

**SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-58121; File No. PCAOB-2008-03)**

**July 9, 2008**

**Public Company Accounting Oversight Board; Notice of Filing of Proposed Changes Regarding Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence, Amendment to Interim Independence Standards, and Amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles**

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on April 24, 2008, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rule changes described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

**I. Board's Statement of the Terms of Substance of the Proposed Rule Change**

On April 22, 2008, the Board adopted Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence, an amendment to the Board's Interim Independence Standards, and an amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles. The proposed rule change text is set out below. Language deleted by the amendment to Rule 3523 is in brackets. Language that is added by the amendment to Rule 3523 is italicized.

**RULES OF THE BOARD**

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**SECTION 3. PROFESSIONAL STANDARDS**

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**Part 5 – Ethics**

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## **Subpart I – Independence**

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### **Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles**

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the [audit and] professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless –

(a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

(b) the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited –

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are

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(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

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#### **Rule 3526. Communication with Audit Committees Concerning Independence**

A registered public accounting firm must –

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and

(3) document the substance of its discussion with the audit committee of the issuer.

(b) at least annually with respect to each of its issuer audit clients –

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and

(4) document the substance of its discussion with the audit committee of the issuer.

### **Amendment to PCAOB Interim Independence Standards**

Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB Standard No. 1"), ISB Interpretation 00-1, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, and ISB Interpretation 00-2, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1, are superseded by Rule 3526.

#### II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### (a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish "ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Moreover, Section 103(b) of the Act directs the Board to establish such rules on auditor independence "as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, Title II of th[e] Act."

The Board adopted Rule 3526, Communication with Audit Committees Concerning Independence, because it believed that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any relationships the accounting firm has with the issuer that may reasonably be thought to bear on its independence. The rule is intended to build on the communication requirements in Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB No. 1") and provide the audit committee with information – including information about the firm's relationships with persons in financial reporting oversight roles ("FROR") at the company – that may be important to its determination about whether to hire the firm as the company's auditor. The rule also requires a registered firm on at least an annual basis after becoming the issuer's auditor to make a similar communication and also affirm to the audit committee of the issuer, in writing, that the firm is independent. The Board intends for these communications to provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion

between the firm and the audit committee. The rule also includes a new requirement for the firm to document the substance of its discussion with the audit committee.

The Board adopted amendments to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles, to exclude the portion of the audit period that precedes the beginning of the professional engagement period. The Board believes that it is not necessary for the rule to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period. The Board also added a note to Rule 3523 that states that in an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to persons covered by Rule 3523 before the earlier of the date that the firm (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

The proposed rule changes also amend the PCAOB interim independence standards because Rule 3526 will supersede the Board's interim independence requirement, ISB No. 1, and two related interpretations.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms.

C. Board's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2007-008 (July 24, 2007). The Board received 16 written comments. A copy of PCAOB Release No. 2007-008 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at [www.pcaobus.org](http://www.pcaobus.org). The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rule change, as discussed below.

**Rule 3526. Communication with Audit Committees Concerning Independence**

Under Section 301 of the Act, "[t]he audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer...for the purpose of preparing or issuing an audit report or related work..."<sup>1/</sup> PCAOB interim independence standards require the auditor to provide certain information to the audit committee about independence that could assist

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<sup>1/</sup> The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.



the audit committee in fulfilling these oversight responsibilities. Specifically, ISB No. 1 requires, among other things, firms to disclose at least annually to the audit committee all relationships between the auditor and its related entities and the company and its related entities that, in the auditor's professional judgment, may reasonably be thought to bear on the auditor's independence. ISB No. 1 does not, however, require the firm to provide information to the audit committee about the firm's independence in connection with becoming the issuer's auditor (i.e., before the person or firm becomes the issuer's auditor).

As discussed in the proposing release, the Board proposed Rule 3526 because it believed that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any relationships the accounting firm has with the issuer that may reasonably be thought to bear on its independence. The proposed rule was intended to build on the communication requirements in ISB No. 1 and provide the audit committee with information – including information about the firm's relationships with persons in FRORs at the company – that may be important to its determination about whether to hire the firm as the company's auditor. The Board also proposed to include in the rule a new requirement for the firm to document the substance of its discussion with the audit committee.

All commenters were generally in favor of the Board adopting the proposed rule, and, as discussed more fully below, some recommended modifications. Commenters stated that Rule 3526 would assist audit committees in fulfilling their responsibilities and would aid them in their decision-making process. After carefully considering the comments, the Board is adopting Rule 3526 with one modification, as described below. If

approved by the SEC, Rule 3526 will supersede ISB No. 1 and two related interpretations.<sup>2/</sup>

### **Scope of the Required Communication**

The Board proposed in Rule 3526(a) to require the registered firm, prior to accepting an initial engagement pursuant to the standards of the PCAOB, to describe in writing to the audit committee<sup>3/</sup> all relationships between the accounting firm or any

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<sup>2/</sup> ISB Interpretation 00-1, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, and ISB Interpretation 00-2, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1. The interpretations state that the responsibility to comply with ISB No. 1 rests solely with the primary auditor, but that the primary auditor should include in its report to the audit committee all of its relationships and those of its domestic and foreign associated firms that could reasonably bear on the independence of the primary auditor. Under these interpretations, if the primary auditor is relying on the work of secondary auditors not associated with the primary auditor's firm, the report of the primary auditor should either describe any such secondary auditors' relationships, or it should state that it does not do so. The treatment of secondary auditors under Rule 3526 will be similar to the treatment of secondary auditors under ISB No. 1 and the two interpretations. Secondary auditors will not need to comply with Rule 3526, but the primary auditor will need to disclose to the audit committee any relationships of the firm's affiliates that could reasonably be thought to bear on the independence of the primary auditor. As under ISB No. 1 and the related interpretations, the scope of any communications about secondary auditors under Rule 3526 should be clear to the audit committee. Accordingly, the Board expects the primary auditor's report to either include any covered relationships of any secondary auditors not affiliated with the firm or state that it does not do so. One commenter recommended that the Board consider providing an exemption for secondary auditors. Because the rule does not require communications by secondary auditors, an exemption is not necessary.

<sup>3/</sup> One commenter recommended the Board provide guidance in situations in which an issuer does not have an audit committee. Under Section 2(a)(3) of the Act, "[t]he term 'audit committee' means – (A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Accordingly, under Rule 3526, if an audit client does not have an audit committee, the auditor would be required to make the communications to the entire board of directors.

affiliates of the firm<sup>4/</sup> and the potential audit client or persons in FRORs at the potential audit client that may reasonably be thought to bear on independence. The Board also proposed to require the firm to discuss with the audit committee the potential effects of those relationships on the firm's independence. In Rule 3526(b), the Board proposed to require a registered firm on at least an annual basis after becoming the issuer's auditor to provide the same information described above and also affirm to the audit committee of the issuer, in writing, that the firm is independent in compliance with Rule 3520, Auditor Independence.<sup>5/</sup> As described in the proposing release, the Board intended for these communications to provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion between the firm and the audit committee.

Commenters generally believed that the scope of the required communications was appropriate. Several commenters noted that, to a large extent, firms are already making the kinds of communications that would be required by proposed Rule 3526. One commenter acknowledged, however, that existing communications between the firm and a potential new audit client do not include the disclosure of tax services to a person in a

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Additionally, one commenter recommended that audit committees provide better disclosure, through the proxy, when approving non-audit services performed by the auditor. The commenter stated that providing this type of transparency will permit investors a greater ability to evaluate audit committee's fiduciary performance of shareholders. The Board does not have statutory authority to require disclosure by audit committees.

<sup>4/</sup> One commenter recommended that the Board adopt a definition of affiliate of the firm. This term is already defined in Rule 3501.

<sup>5/</sup> Rule 3520 states that a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

FROR or his or her immediate family member. Additionally, some registered firms noted that communications regarding the auditor's independence currently vary in content and timing and may, in some instances, occur only orally.

Most commenters did not believe that it was necessary for the Board to expand the scope of the required communication to include any additional matters. One commenter, however, recommended requiring the firm to confirm its independence in writing to the audit committee prior to accepting an initial engagement. Another commenter recommended revising Rule 3526(a) to require the firm to make the communications in its initial proposal to the company's audit committee.

As discussed above, the Board proposed to require firms to affirm their independence annually but did not propose a similar requirement that would apply before the firm is initially engaged as the company's auditor. Rule 3526(a) requires registered firms to make certain communications about relationships that may reasonably be thought to bear on independence before accepting an initial engagement pursuant to the standards of the PCAOB. Rather than prescribing a particular time before that point when the communications must occur, however, the rule allows registered firms and audit committees the flexibility to make that determination. The Board understands that, in some cases, firms need time before a new engagement begins to resolve any matters that could impair their independence. If a firm were required to affirm its independence prior to accepting a new engagement, it would need to wait until it has resolved any independence issues to make the required communications. These communications are intended to assist the audit committee in fulfilling its responsibility to hire the auditor – their usefulness for that purpose may diminish if they are left until immediately before

the engagement begins. Accordingly, the Board does not believe a requirement for auditors to affirm that they are independent before accepting a new engagement is appropriate.

Other commenters recommended certain exclusions from the scope of the required communications. For example, one commenter asserted that the auditor cannot be expected to know about all relationships that may reasonably be thought to bear on its independence, and recommended that the written communication to the audit committee state that the auditor's assessment is based on information provided to the auditor by the issuer. The Board does not believe that allowing auditors to include such a limitation in the communication would be appropriate. Complying with the Board's independence requirements is the responsibility of the auditor.<sup>6/</sup> To fulfill this responsibility, as well as their related responsibility under the SEC's independence rules, auditors need to ascertain what relationships with the issuer and persons in FRORs at the issuer may reasonably be thought to bear on their independence. Moreover, some of the information the auditor must assess in order to assure its independence and that may need to be communicated under Rule 3526 – such as the firm's or its associated persons' financial interests in the audit client – can be more readily obtained by the auditor than its audit client.

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<sup>6/</sup> Another commenter suggested that the audit committee should be able to rely on the firm to determine and resolve any independence issues, and that a requirement for the auditor to discuss these matters with the audit committee would increase the responsibilities of the audit committee with respect to independence. This commenter recommended that the Board not adopt these requirements. As discussed above, the rule is intended to provide audit committees with information to assist them in carrying out their responsibilities to oversee the audit engagement, but auditors remain responsible for complying with the independence requirements. Nothing in the rule adds to, or otherwise modifies, the responsibilities of the audit committee.

Another commenter recommended that the Board exclude tax services to a person in a FROR from the required communications because the commenter believed that compliance with Rule 3523, as amended, should adequately address any independence concerns regarding such services. As discussed in the proposing release, Rule 3526 is intended to require disclosure of not only whether the firm provided any specifically prohibited services or maintained any specifically prohibited relationships, but also whether any of the firm's relationships or services may reasonably be thought to bear on independence under the SEC's general standard of auditor independence<sup>7/</sup> and AU sec. 220, Independence.<sup>8/</sup> Because auditors will need to consider the relevant facts and circumstances in order to make such a determination, the Board does not believe that per se exemptions are appropriate.

Some commenters suggested that, in certain circumstances, firms would be restricted in the information they could provide to the audit committee about relationships

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<sup>7/</sup> 17 CFR 210.2-01(b). Under that standard, an accountant is not independent 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 considering this general standard, the SEC "looks in the first instance to whether a relationship or the provision of service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client." 17 CFR 210.2-01, preliminary note.

<sup>8/</sup> AU sec. 220, Independence, requires that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor..." AU sec. 220 notes that "[i]t is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors" and that public confidence in the auditor's independence "would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence."

with persons in FRORs due to legal limitations imposed by confidentiality and privacy laws. Specifically, one commenter was concerned that the auditor would not be able to disclose to the audit committee information about tax services rendered to a person in a FROR prior to obtaining a consent from that person. Another commenter recommended that the Board address the need for obtaining such a consent in its final release, while another recommended that the Board provide an exemption in circumstances where applicable legal restrictions impede an auditor's ability to comply fully with the disclosure requirement.

Under ISB No. 1, auditors have been required to disclose to the audit committee relationships with the company and its related entities and to discuss the auditor's independence with the audit committee. Accordingly, the required communications could include discussion of tax or other services provided to an entity or person other than the company itself. The Board understands that firms are subject to certain confidentiality requirements in the tax context<sup>9/</sup> and that other restrictions could arise outside of that context, depending on the facts and circumstances that a particular relationship presents. The Board is not, however, aware that firms have encountered difficulty in communicating with audit committees, as required by ISB No. 1 or any other professional practice standard, as a result of such privacy requirements.

As described above, Rule 3526 is a general requirement that, like ISB No. 1, requires disclosure of certain relationships that may be relevant to the audit committee's

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<sup>9/</sup> See 26 U.S.C. 7216; 26 CFR 301.7216-3 (prohibiting disclosure or use of tax return information without written consent of taxpayer that meets specified requirements); 26 CFR 301.7216-1 (defining "tax return information" to mean "any information, including, but not limited to a taxpayer's name, address, or identifying number, which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer").

oversight of the engagement. It does not set forth a list of relationships that must always be disclosed or mandate specific information that must be communicated when disclosure is required. Rather, Rule 3526 allows firms significant flexibility to determine how to comply with the requirements to describe a covered relationship and discuss the potential effects of that relationship on the firm's independence. Accordingly, while the Board will monitor the application of the rule in this regard, it does not believe that the recommended exception is necessary or appropriate at this time.

The Board also received several comments on its proposal not to include the words "in the auditor's professional judgment" in the rule's description of the scope of the required communications. ISB No. 1 requires disclosure of certain relationships that "in the auditor's professional judgment may reasonably be thought to bear on independence." In the proposing release, the Board explained that it believed that omitting the reference to the auditor's professional judgment would clarify the requirement by reminding auditors of the need to focus on the perceptions of reasonable third parties when making independence determinations.

Some commenters supported the proposed exclusion of the words "in the auditor's professional judgment" from Rule 3526. Other commenters, however, believed that the absence of the reference to judgment could confuse, rather than clarify, the requirement and noted that it is reasonable and appropriate for audit committees to rely on the accounting firm's judgment as to what matters should be disclosed. One of these commenters contended that this aspect of the Board's proposal is inconsistent with the Board's recent focus on the importance of the use of auditor judgment. Conversely, one commenter did not object to the absence of a reference to judgment, provided that the



adopting release contain an acknowledgement that the auditor must apply judgment in determining which matters are required to be communicated to the audit committee.<sup>10/</sup>

As the Board explained in the proposing release, auditors will need to apply judgment to determine whether a relationship may reasonably be thought to bear on independence. After considering commenters' views, the Board continues to believe that adding specific reference to the auditor's professional judgment is unnecessary and inappropriate in this instance. While the Board agrees that auditors must exercise sound judgment in carrying out their responsibilities, it does not believe that specific reference to judgment in this rule is necessary to encourage auditors to do so. Judgment is called for in applying any reasonableness standard to particular facts and circumstances, and Rule 3526 is no different. Determining what relationships may reasonably be thought to bear on independence requires consideration of how a third party – not the auditor – would view the relationship, which is consistent with the SEC's general standard of auditor independence and AU sec. 220. A reference to "in the auditor's professional judgment" could suggest otherwise, however, and therefore could discourage the necessary analysis. Accordingly, the Board has determined not to add the phrase to Rule 3526.

#### **Time Period Covered by Rule 3526(a)**

In the proposing release, the Board solicited comment on whether the initial communication in Rule 3526(a) should be limited to relationships that existed during a

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<sup>10/</sup> Additionally, one commenter recommended including the reference to judgment and also referring to the SEC's general standard of auditor independence and the preliminary note to the SEC's independence rules in the proposed rule or the adopting release. Footnote 9 of the Board's adopting release refers to the general standard and the preliminary note.

particular period, and, if so, how long that period should be. Commenters provided a wide variety of recommendations in this area. Some commenters stated that the initial communication should not be limited to relationships that existed during a particular period. Some of these commenters noted that establishing a specific period could result in arbitrary exclusion of certain relationships and recommended that the audit committee and auditor be responsible for determining the relevant time frame.

Other commenters recommended that the time period be limited to the audit and professional engagement period because, according to these commenters, the relevant relationships are those that exist currently or will continue to exist. One of these commenters stated that requiring communication of relationships that existed prior to this period would cause an unnecessary burden on the firm to identify and communicate these matters and on the audit committee to consider such information, because the firm was not subject to the auditor independence rules with respect to the audit client before the beginning of the audit and professional engagement period. One commenter recommended that the required time period should, at a minimum, be the audit period and that the rule should require auditors to consider communicating relationships that existed before that time. Finally, one commenter recommended that the time period should be no longer than two years prior to the commencement of the audit period, and two commenters recommended that the proposed rule should cover a time period of at least three years.

After considering these comments, the Board has determined that the initial communication required by Rule 3526(a) should not be limited to relationships that existed during a particular time period. While the Board agrees that a relationship that

existed during the audit and professional engagement period may be more likely to bear on independence than a relationship that ended substantially before that time, it does not believe that the passage of time is the only factor relevant to a determination of whether a relationship may reasonably be thought to bear on independence. The nature of the relationship must also be considered. For example, if the firm customized and implemented the company's financial reporting system, that relationship, depending on the circumstances, might reasonably be thought to bear on independence even if the engagement to design the system was concluded before the beginning of the audit and professional engagement period. Determining whether a particular relationship is covered by Rule 3526(a) will, therefore, depend on the relevant facts and circumstances.

The Board is making one modification to the rule in response to a comment recommending that Rule 3526 make clear that the relationships required to be disclosed are those that may reasonably be thought to bear on independence as of the date of the communication. Because the relevant relationships are those that continue to bear on independence at the time of the communication, the Board has modified the rule by adding the words "as of the date of the communication" where appropriate. This clarification should help firms distinguish relationships that are covered by the rule from those that are not.

This modification should also clarify that, if a relationship may reasonably be thought to bear on independence as of the date of the communication, it must be disclosed regardless of whether it was disclosed in a prior year. Some commenters suggested that auditors should not be required to repeat a previously made disclosure. The Board believes that an earlier disclosure may reduce the amount of information that

needs to be disclosed, but it does not obviate the need for disclosure altogether. If the nature of the relationship and the potential effects of the relationship on independence remain substantially unchanged, a reference to the earlier disclosure will generally be sufficient when disclosure is required. Moreover, as discussed above, after some amount of time, the length of which depends on the nature of the relationship, a relationship may no longer reasonably be thought to bear on independence and, therefore, would no longer need to be disclosed.

### **Timing of the Communications**

As discussed above, the Board proposed Rule 3526(a) because it believed that auditors should communicate relevant information about independence before becoming the issuer's auditor. A few commenters expressed concern that the proposed rule could cause undue burden on private companies pursuing an initial public offering if the communication were required before the auditor accepts an engagement to assist an existing private company client in going public. According to commenters, a requirement to complete the independence assessment before the auditor could commence work related to the initial public offering might disadvantage the audit client by causing delay. One commenter stated that auditors generally begin work on the initial public offering based upon an initial review of relationships between the accounting firm and the company and complete their independence assessment before the company's registration statement is filed. This commenter suggested that the Board reconsider the required timing of the communications in the context of an initial public offering.

After considering these comments, the Board has determined that relieving a firm whose private company audit client is pursuing an initial public offering from compliance

with Rule 3526 is not necessary or appropriate. As discussed above, the rule is intended to provide audit committees with the information they need to effectively oversee the audit engagement. When a private company undertakes an initial public offering, it must, for the first time, have its financial statements audited by an auditor that is independent within the meaning of the rules of the SEC and PCAOB. Among other decisions an audit committee must make is whether to engage its existing auditor for the initial public offering or whether to retain a new auditor for that purpose. In this context, the Board believes that the communication about an existing auditor's independence – which is relevant to the existing auditor's ability to continue as the company's auditor through, and after, the initial public offering – should not be delayed until just before the registration statement is filed. Moreover, the Board believes that this evaluation will not cause an unnecessary burden because the private company is already a client of the accounting firm and therefore should already be aware of most of the relationships that would need to be communicated.

The Board also received comment on the timing of the annual communication requirement that the Board proposed in Rule 3526(b). Like ISB No. 1, proposed Rule 3526 did not specify when during the year the firm would be required to make the annual communication.<sup>11/</sup> One commenter recommended that the Board specify in Rule 3526(b) when the annual communication should take place to make sure that these critical discussions do not take place at the end of the audit engagement. The commenter recommended that the proposed rule be changed to state that firms should apply Rule

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<sup>11/</sup> The Board understands that, under ISB No. 1, the communication typically occurs at the end of the audit when the financial statements are issued.

3526 as early in the audit process as practicable, preferably during the planning stage of the audit. One commenter recommended that the communication occur before substantial planning procedures commence, while another recommended that the annual communication should take place at the time the engagement letter is signed and then again near the end of the audit. Finally, one commenter recommended adding a section to Rule 3526 requiring an auditor to update the communications when he or she becomes aware of a covered, previously unknown or new relationship.

After considering these comments, the Board does not believe it is appropriate to mandate specifically when the Rule 3526(b) annual communication take place. In most cases, the communications will be more useful if they take place near the beginning of the audit process. However, by not prescribing the timing of the communication, Rule 3526(b) will allow the auditor and audit committee to determine the timing that is most appropriate in the circumstances of the particular engagement. Similarly, the Board does not believe that it is necessary for the rule to explicitly address how a firm should correct an incomplete communication.

### **Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles**

#### **Amendment to Rule 3523 to Exclude the Portion of the Audit Period That Precedes the Professional Engagement Period**

Rule 3523, as adopted by the Board, prohibits a registered public accounting firm, or an affiliate of the firm, from providing tax services during the "audit and professional engagement period" to a person in, or an immediate family member of a person in, a FROR at the audit client. Consistent with the SEC's independence rules,<sup>12/</sup> the phrase

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<sup>12/</sup> 17 CFR 210.2-01(f)(5).

"audit and professional engagement period" is defined to include two discrete periods of time. The "audit period" is the period covered by any financial statements being audited or reviewed.<sup>13/</sup> The "professional engagement period" is the period beginning when the firm either signs the initial engagement letter or begins audit procedures, whichever is earlier, and ends when either the company or the firm notifies the SEC that the company is no longer that firm's audit client.<sup>14/</sup>

In circumstances in which a registered firm has been the auditor for an audit client for more than a year, the "audit period" is a subset of the "professional engagement period." However, when a registered firm accepts a new audit client, the audit period may cover a period of time before the commencement of the professional engagement period. In such circumstances, Rule 3523, as adopted, provides that the firm is not independent of its audit client if the firm, or an affiliate of the firm, provided tax services to a person covered by Rule 3523 during the audit period but before the beginning of the professional engagement period. This aspect of the rule therefore effectively prevents a firm from accepting a new audit client if the firm, or an affiliate of the firm, provided tax services to such a person during the period covered by any financial statements to be audited or reviewed.

In preparing for implementation of the Board's tax services and independence rules, the Board decided to revisit the application of Rule 3523 to tax services provided during the audit period. As discussed above, on April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a firm's independence of

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<sup>13/</sup> Rule 3501(a)(iii)(1).

<sup>14/</sup> Rule 3501(a)(iii)(2).

providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period, and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period. After careful consideration of comments received in response to the concept release, the Board, on July 24, 2007, proposed to amend the rule to exclude the portion of the audit period that precedes the beginning of the professional engagement period.<sup>15/</sup>

The Board received 13 comments on the proposed amendment to Rule 3523. Almost all of the commenters supported the Board's recommendation to amend Rule 3523.<sup>16/</sup> Many of these commenters reiterated their belief that the firm's independence would not be affected by the provision of tax services to a person in a FROR during the portion of the audit period that precedes the beginning of the professional engagement period. Commenters also reaffirmed their belief that, if Rule 3523 is not amended, it

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<sup>15/</sup> See PCAOB Release No. 2007-008, which includes a discussion of the comments the Board received on the concept release.

<sup>16/</sup> Only one commenter on the proposed rule objected to the amendment of Rule 3523. This commenter's objection stemmed from the contention that the terms "professional engagement period" and "a person in a financial reporting role" were not defined. Definitions for "professional engagement period" and "financial reporting oversight role" are provided under Rules 3501(a)(iii)(2) and 3501(f)(i), respectively. The same commenter, while not specifically addressing the proposed amendment, also expressed concern with Rule 3523(a), which provides an exception for tax services to a person who is in a FROR only because he or she serves as a member of the Board of Directors, and, referring to the responsibilities of directors, recommended deleting this section in its entirety. This commenter also recommended that the Board eliminate Rule 3523(b), which provides an exception, under certain circumstances, for tax services to a person who is in a FROR only because of the person's relationship to an affiliate of the entity being audited. The Board does not believe that eliminating these exceptions is warranted.



could adversely affect companies' ability to change auditors by limiting the companies' choice of auditors.

The Board has carefully considered these comments, as well as the comments on the concept release,<sup>17/</sup> and determined to adopt the amendment to Rule 3523. The Board continues to believe that it is not necessary for the rule to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period. Rule 3523 relates to services provided to individuals and not the audit client that issues the financial statements subject to audit. Additionally, registered firms would remain responsible for considering the relevant facts and circumstances of a specific tax engagement and determining whether their independence is impaired under the SEC's general standard of auditor independence.<sup>18/</sup>

One commenter objected to the discussion in the proposing release (and included here in the paragraph above) describing the firm's obligation to consider whether the firm's independence is impaired under the SEC's general standard of auditor independence. This commenter stated that the discussion sends a contradictory message by calling for firms to assess whether their independence is impaired despite the Board's conclusion that restrictions are unnecessary to preserve independence. The Board disagrees. As a result of the Board's amendment, firms will not be specifically prohibited by Rule 3523 from providing tax services to persons in a FROR during the portion of the

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<sup>17/</sup> In response to the concept release, two commenters stated that Rule 3523 should not be amended to exclude the portion of the audit period that precedes the professional engagement period. These commenters believed that providing tax services to a person in a FROR during the audit period impairs independence, and suggested that audit firms may plan for a change of auditors sufficiently in advance to avoid or minimize any problems resulting from the application of the rule to the audit period.

<sup>18/</sup> 17 CFR 210.2-01(b); see footnote 7.

audit period that precedes the professional engagement period. That does not mean, however, that such services are categorically permitted. Rather, as discussed in the proposing release, the amendment reflects the Board's belief that a more tailored approach, based on facts and circumstances and measured against the general standard of auditor independence, is preferable to a per se prohibition. Accordingly, as with any other service or relationship that is not specifically prohibited by the independence rules, firms must determine whether the service or relationship impairs independence under the SEC's general standard of auditor independence.

### **Application of Rule 3523 to New Issuers**

The Board proposed adding a note to Rule 3523 concerning the application of Rule 3523 in the context of an initial public offering in light of comments received on the concept release. The proposed note stated that, in the context of an initial public offering, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that a registered firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a firm's independence under Rule 3523. Commenters generally recommended that the Board adopt the note and encouraged the Board to consider expanding it to include other corporate life events, noting that corporate life events other than an initial public offering may also result in the need for an audit client's financial statements to be audited pursuant to the standards of the PCAOB for the first time.<sup>19/</sup>

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<sup>19/</sup> Commenters suggested the following as examples of when an audit client's financial statements would, for the first time, need to be audited pursuant to the standards of the PCAOB – mergers, reverse mergers in which a privately-held entity merges with a public company and succeeds to the public company's reporting obligations under the Securities Exchange Act of 1934, issuance of publicly traded debt,

In response to these comments, the Board determined to revise the note to Rule 3523 to describe events, other than just initial public offerings, pursuant to which a company's financial statements must be audited in accordance with the standards of the PCAOB for the first time. Specifically, the Board replaced the words "[i]n the context of an initial public offering" with "[i]n an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB." This situation may occur when a company decides to conduct an initial public offering of its securities,<sup>20/</sup> which would require the company to file, for the first time, a registration statement under the Securities Act of 1933. Additionally this situation may occur when a foreign private issuer decides to list its securities on a national securities exchange, which would require the company to register its securities, for the first time, under the Securities Exchange Act of 1934. In both cases, the company's audited financial statements would be required, for the first time, to be audited pursuant to the standards of the PCAOB.<sup>21/</sup>

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issuance of partnership or other units, inclusion of a public company's securities in an employee benefit plan, decision by a foreign private issuer to list its securities in the United States, and companies that have greater than 500 U.S. shareholders and total assets exceeding \$10 million as of the latest fiscal year-end.

<sup>20/</sup> The company may offer equity securities, debt securities, limited partnership interests, trust interests, or another type of securities in the initial public offering.

<sup>21/</sup> The Board intends the note to Rule 3523 to describe all circumstances in which a company that was not an "issuer," as defined by the Act, becomes an issuer as a result of a corporate life event or otherwise. These circumstances include those in which a private company that was once an issuer becomes an issuer again. As long as the company was not required to have its financial statements audited pursuant to the standards of the PCAOB prior to being required to do so, the Board will consider the requirement to be a "first-time" requirement for purposes of the note.

The Board does not believe it is appropriate to list in the note the various corporate life events identified by commenters, such as mergers or acquisitions, reverse mergers or other similar transactions. The relevant factor is not the name given to a transaction or event but whether the transaction or event triggers the initial requirement for an audit pursuant to the standards of the PCAOB. For example, the surviving company in a merger or acquisition transaction may be an issuer that is already filing with the SEC financial statements required to be audited pursuant to the standards of the PCAOB. The Board did not intend the note to Rule 3523 to describe such a scenario.<sup>22/</sup> By focusing on the need for a first-time audit pursuant to the standards of the PCAOB, the company and its auditors are better able to determine whether a proposed transaction or corporate life event is described by the note.

One commenter stated that, while it is easy to identify the date on which the initial engagement letter to perform an audit pursuant to the standards of the PCAOB is signed, it would be very difficult to apply the second prong of the note, which requires identification of the date that the auditor began procedures to perform an audit pursuant to the standards of the PCAOB, especially if the registered firm audited the company's prior years' financial statements.<sup>23/</sup> Another commenter similarly questioned whether this

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<sup>22/</sup> Another example is a private operating company becoming a reporting company through a reverse merger with a reporting shell company. In this scenario, even though the operating company assumes the reporting obligations of the former shell company, the surviving reporting company is the former shell company whose financial statements already were required to be audited pursuant to the standards of the PCAOB. Therefore, the note to Rule 3523 does not describe this situation.

<sup>23/</sup> The commenter noted that, when a company undertakes an initial public offering, it is required to include in the registration statement audited financial statements for its past three completed fiscal years. These financial statements may have previously been audited pursuant to generally accepted auditing standards ("GAAS"). The

period begins when the auditor begins planning for the audit. The Board recognizes that, in certain circumstances, it may be difficult to identify when a continuing auditor began procedures pursuant to the standards of the PCAOB. An auditor begins procedures for purposes of Rule 3523 when he or she begins procedures, including required audit planning procedures, to update its earlier audits to conform them to the standards of the PCAOB or begins procedures on a new audit pursuant to those standards. This point in time will depend on the facts and circumstances of the particular engagement and corporate life event, rather than on any more specific triggering event that the Board could establish by rule.

### **Transition Periods**

Rule 3523 prohibits the provision of tax services to covered persons once the professional engagement period begins. Some commenters on the concept release recommended that the Board amend Rule 3523 to allow a transition period after a company changes auditors so that the new auditor may complete any tax services in progress to any persons in FRORs affected by the issuer's change of auditors.<sup>24/</sup> Other commenters stated that tax services to persons in FRORs should, as is currently required, cease before the professional engagement period begins. The Board decided to seek

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commenter was concerned that if the company does not retain a new auditor for its initial public offering, there may be a question as to whether the auditor should consider its audits of the prior years in assessing when it "began procedures" as provided under the note to Rule 3523. An auditor should not consider work already performed on previously completed GAAS audits for determining when the auditor "began procedures" because those audits were not performed pursuant to the standards of the PCAOB.

<sup>24/</sup> Rule 3523(c) provides a time-limited transition period for an auditor to complete in-progress tax services to a person that becomes a FROR at the audit client through a hiring, promotion, or other change in employment event. That transition period is unaffected by the proposed rules changes.

further feedback on this topic in the proposing release. Specifically, the Board asked commenters to specify why they believed any transition period was necessary and how long any such transition period should be.<sup>25/</sup>

The majority of commenters on this topic recommended that the Board provide for a 180-day transition period to allow an accounting firm to complete covered tax services once the professional engagement period begins. Most of these commenters stated that, since the Board has previously determined that a 180-day transition is appropriate when a person is hired or promoted into a FROR,<sup>26/</sup> the Board should provide the same transition when an issuer changes its auditor. The commenters stated that, without a transition period, the person in a FROR could experience undue hardship because he or she may have to switch tax preparers in the middle of the personal tax services engagement. Additionally, some commenters stated that some accounting firms may not be able to terminate the in-process personal tax services engagements within a timeframe that would also allow them to submit their proposal for the new audit engagement. Conversely, some commenters stated that they believed that the Board should not provide a transition period and that it is appropriate for the firm to cease the personal tax services before the professional engagement period begins or that a transition period should only be available on a case-by-case basis where cessation of services would cause significant hardship.<sup>27/</sup>

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<sup>25/</sup> See PCAOB Release 2007-008 (July 24, 2007), at 12.

<sup>26/</sup> See Rule 3523(c).

<sup>27/</sup> Another commenter stated that Rule 3523 should be effective immediately for issuers with fiscal years ending on or after December 15, 2007, that all personal tax services in process should be allowed to continue until the filing of the applicable tax

After considering these comments, the Board does not believe that a transition period is necessary when a company changes its auditor and has determined not to amend Rule 3523 to include one. The Board adopted Rule 3523 because the provision of tax services to a person in a FROR after the accounting firm is hired as the auditor creates an unacceptable appearance that the firm lacks independence. While the Board believed a time-limited exception was warranted to accommodate persons who, through a hiring or promotion event, abruptly become covered by the rule, it does not believe that such a transition period is similarly necessary after an auditor change. In the former situation, the firm already is the issuer's auditor and has no control over whether or when the person is promoted or otherwise moved into a FROR. In contrast, the firm controls whether and when it begins a new engagement. The Board therefore believes that the firm is able to conclude, or transition to another provider, any tax services to persons in FRORs at a new audit client before beginning the engagement.<sup>28/</sup>

Some commenters also encouraged the Board to consider providing a transition period for firms to complete tax services to persons who become covered by Rule 3523 as a result of a corporate life event, such as a merger, acquisition, or initial public offering. Commenters suggested that such corporate life events present conceptually similar transition issues to those related to the hiring or promotion of a person into a

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return, and that such services, along with the related fees, should be disclosed in the issuer's filings with the SEC and documented in the minutes of meetings of the audit committee.

<sup>28/</sup> Nothing in Rule 3523 requires a firm to complete or terminate tax services to persons in FRORs at a potential audit client before submitting a proposal for a new audit engagement. Rather, the rule requires the accounting firm to complete or terminate those services by the beginning of the professional engagement period.

FROR and that Rule 3523(c) should therefore be expanded to accommodate them.

Commenters also stated that the absence of transitional relief may cause unnecessary hardship for persons in FRORs whose tax return preparation work was well underway at the point of the initial public offering, merger, or acquisition.<sup>29/</sup>

As discussed above, in the context of an initial public offering, the rule, as amended, makes clear that tax services provided to a person in a FROR do not impair independence as long as those tax services are concluded before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so. Auditors should have sufficient time before that date to conclude any tax services to persons that would be covered by the rule. Accordingly, the Board does not believe that the recommended transition period is necessary in the context of an initial public offering.

The Board also considered whether a transition period is necessary to allow a firm to conclude tax services to persons who become covered by the rule after a merger or acquisition. As discussed above, Rule 3523(c) already provides a transition period for a firm to conclude tax services to a person who was not in a FROR before a hiring, promotion, or other change in employment event. If a business combination results in a change of employer for a person in a FROR – from, for example, the acquired company

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<sup>29/</sup> The commenters further stated that, because persons in FRORs may receive tax services from a number of accounting firms, the application of the rule to the audit period may unreasonably restrict a company's ability to either continue or change auditors after a corporate life event. As discussed above, the Board has amended the rule to exclude the portion of the audit period that precedes the professional engagement period.



to the acquiring company – the existing transition period in Rule 3523 would apply.<sup>30/</sup> For example, if Company A acquires Company B, a person who was in a FROR at Company B would experience an "other change in employment event" if he or she became an employee of Company A in a FROR as a result of the acquisition. If such a person had been receiving tax services from Company A's registered public accounting firm pursuant to an engagement in process before the acquisition, the time-limited exception in Rule 3523(c) would apply.<sup>31/</sup>

In the example above, persons in FRORs at Company A would not experience a change in employment event because they were employed by Company A both before and after the acquisition, and Rule 3523(c) would, therefore, not apply. If Company B's auditor became Company A's auditor after the acquisition (replacing Company A's auditor), Company B's auditor would have to conclude any tax services to persons in FRORs (and their immediate family members) at Company A before the start of the professional engagement period. The Board believes this is appropriate because, as discussed above, the Board does not believe that a transition period is necessary to allow a newly engaged auditor to conclude in-progress tax services to persons in FRORs at the new audit client. Accordingly, the Board has determined not to expand the existing transition period in Rule 3523(c).

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<sup>30/</sup> See also Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees (April 3, 2007), Question and Answer No. 6, at 4-5.

<sup>31/</sup> Id.

### **Effective Date**

Rule 3526 establishes new requirements for registered public accounting firms. The Board believes it is appropriate to allow a reasonable period of time for such firms to prepare internal policies and procedures and train their employees to ensure compliance with these new requirements. Accordingly, Rule 3526 will become effective, and ISB No. 1 and the related interpretations superseded, on the later of September 30, 2008, or 30 days after the date that the SEC approves the rule.

The amendment to Rule 3523 would have the effect of making permanent the Board's delay in implementing the rule as it applies to tax services provided during the period subject to audit but before the professional engagement period. Accordingly, no transition period is necessary, and the amended rule will become effective immediately upon approval by the SEC.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rule change; or
- (b) institute proceedings to determine whether the proposed rule change should be disapproved.

### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with

the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number PCAOB 2008-03 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB 2008-03. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change;

we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2008-03 and should be submitted on or before **[insert date 21 days from publication in the Federal Register]**.

By the Commission.

Florence E. Harmon  
Acting Secretary