

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :
: INITIAL DECISION
ERNST & YOUNG LLP : April 16, 2004
:

APPEARANCES: Stephen M. Sacks, Andrew T. Karron, Randall K. Miller, Robert J. Katerberg, Matthew Laden, and Kathy A. Ladun of Arnold & Porter LLP, and Ralph C. Ferrara and Phillip D. Parker of Debevoise & Plimpton LLP for Ernst & Young LLP

Patricia A. Connell, Associate General Counsel, Ernst & Young LLP

Larry P. Ellsworth, Craig Iscoe, Michael A. Ungar, Jon B. Jordan, J. Lee Buck, II, and Russell G. Ryan for the Securities and Exchange Commission's Division of Enforcement and the Office of the Chief Accountant¹

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

The Securities and Exchange Commission ("Commission") instituted this proceeding on November 13, 2002, pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e) of the Commission's Rules of Practice. The Order Instituting Proceedings ("OIP") charged that Ernst & Young LLP ("EY" or "E&Y"): (1) violated Rule 2-02 of Commission Regulation S-X because it was not independent when it audited the financial statements of PeopleSoft Inc. ("PeopleSoft"), a public company, for fiscal years 1994 through 1999; (2) caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange

¹ The Initial Decision refers to both the Division of Enforcement and Office of the Chief Accountant collectively as the "Division."

Act, and Exchange Act Rules 13a-1 and 14a-3 thereunder;² and (3) engaged in improper professional conduct within the meaning of Section 4C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice.

Eleven days of public hearings took place in March and April 2003. The Division called fourteen witnesses, including two experts, Douglas R. Carmichael and Walter K. Rush, III, and introduced 844 exhibits.³ Five Division witnesses were either active or retired EY employees and were represented by EY's counsel. EY called two expert witnesses, Lorin M. Hitt and William A. Mooney, Jr., and introduced 180 exhibits. The record also contains the parties' stipulations ("Stipulations"). The parties' briefs and proposed findings of fact.⁴ The final brief was filed on July 21, 2003. Preparation of the Initial Decision was stayed for about a month.

I. PRELIMINARY MATTERS

On July 31, 2003, EY filed a Motion to Supplement the Record with a three-page document and cover letter dated July 30, 2003, from the Executive Director of the Transition Oversight Staff that prepared a Report on the Independence Quality Control Systems of the Four Reviewed Firms ("TOS Report") that is in evidence as EY Ex. 1078. According to the cover letter, the three-page document addresses inaccurate representations that the Division made about the TOS Report in the Division's Reply Brief. The Division filed an opposition contending that the Motion to Supplement the Record does not comply with the Commission's Rules of Practice, and lacks any probative value.

On December 18, 2003, the Division filed a Motion to Supplement the Record. The Division seeks to put into evidence two articles from the November 20, 2003, Wall Street Journal and five documents recently unsealed from state court litigation involving claims that EY and other accounting firms overcharged clients and that EY had potential independence violations due to its relationship with its audit clients. The Division argues that these materials support its request for sanctions. EY opposes the Division's request citing the Commission's Rules of Practice 320, 323, and 326. 17 C.F.R. §§ 201.320, .323, .326. EY also claims the

² The OIP alleges that due to EY's lack of independence, PeopleSoft's annual reports on Form 10-K, for fiscal years 1994 through 2001, as well as its registration statements, prospectuses, and proxy statements filed during that period did not comply with Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Exchange Act Rules 13a-1 and 14a-3.

³ Each hearing transcript volume begins with page one so transcript references are cited by date and page as "(____, 2003, Tr. ____)." I will refer to the Division's exhibits and Respondent's exhibits as "(Div. Ex. ____)," and "(EY Ex. ____)," respectively.

⁴ I will refer to the post hearing filings as follows: Proposed Findings of the SEC's Office of the Chief Accountant and the Division of Enforcement ("Div. Findings of Fact"); Division/OCA's Posthearing Memorandum ("Div. Initial Brief"); Proposed Finding of Fact and Conclusions of Law Submitted by Respondent Ernst & Young LLP ("EY Findings of Fact"); Post-Trial Brief of Respondent Ernst & Young LLP ("EY Brief"); and the Division/OCA's Posthearing Reply Memorandum ("Div. Reply Brief").

Division is wrong to assert that the information portrays EY's current practices, as the materials indicate that the practices at issue ceased by January 2002.

The Commission has made it clear that it favors a liberal standard of admissibility. Del Mar Fin. Serv., Inc., 81 SEC Docket 1691, 1705 (Oct. 24, 2003); City of Anaheim, 71 SEC Docket 191, 193-94 & nn.4-8 (Nov. 16, 1999). Accordingly, I ORDER that the following material is received in evidence:

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|--------------|--|
| EY Ex. 1312 | July 30, 2003, letter from Jerry D. Sullivan, Executive Director, to the Parties to the TOS Memorandum of Understanding; |
| Div. Ex. 752 | <u>Wall Street Journal</u> , November 20, 2003, article, Ernst Defends Wording Choices; |
| Div. Ex. 753 | <u>Wall Street Journal</u> , November 20, 2003, article, Large Size of Travel Rebates Adds to Questions on Ernst; |
| Div. Ex. 754 | Confidential Travel Management Service Agreement; |
| Div. Ex. 755 | March 20, 1997, letter from Leslie Thompson; |
| Div. Ex. 756 | One-page document dated May 5, 1994; |
| Div. Ex. 757 | One-page document, EY 1997 Preliminary Budget; and |
| Div. Ex. 758 | Multi-page document, Airline Contract Options. |

I have given this material little weight because it is difficult to assess its significance without testimony and cross-examination of witnesses familiar with the contents.

Next, I ORDER the Stipulated Corrections To Transcript that the parties submitted jointly on February 18, 2004. 17 C.F.R. § 201.302(c).

II. ISSUE

The issue is whether EY was independent in fact and appearance when it audited PeopleSoft's financial statements for fiscal years 1994 through 1999. Specifically, did EY's business relationships with PeopleSoft, involving EY's Global Expatriate Management System for PeopleSoft and/or actions by EY's consulting group, create an identity or mutuality of interests between EY and PeopleSoft so that EY was not independent in fact and appearance when it issued audit reports on PeopleSoft's financial statements?

III. FINDINGS OF FACT

My findings are based on the record and my observation of the witnesses' demeanor. I applied preponderance of the evidence as the standard of proof. Steadman v. SEC, 450 U.S. 91 (1981). I have considered all proposed findings, conclusions, and arguments raised by the parties and accept those consistent with this Initial Decision.

EY

From at least 1994 until about May 25, 2000, when EY sold its Management Consulting Group ("Consulting"), EY was a "Big Six" accounting firm organized as a limited liability partnership that referred to itself as a leading professional services firm. (EY Findings of Fact at 2) Ernst & Young LLP, SEC No-Action Letter, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,863 (May 25, 2000). In the period 1996 to 2000, EY had 70,000 to 80,000 employees, annual revenues of \$6 to \$12 billion, and offices in 700 locations in 130 countries. (March 25, 2003, Tr. 96; Div. Exs. 169 at 032052, 413 at 036204, 514 at 040028.) EY's organizational structure was matrix-based, not hierarchical, and it operated on a very decentralized basis. (April 1, 2003, Tr. 123, April 2, 2003, Tr. 84.) The organization consisted of a management committee, a chief executive officer or senior partner, several deputy partners, separate leadership for the practice areas of audit, tax, and consulting, and, at a lower level, regional or area structures. (April 1, 2003, Tr. 127.) EY's national office was spread geographically over EY's twelve regions. (March 25, 2003, Tr. 178.)

EY's audit revenues increased at a much slower pace than revenues from both tax and consulting as shown by figures for two years, 1994 and 1999.

	<u>Audit</u>	<u>Tax</u>	<u>Consulting</u>	<u>Total</u>
1994	\$1,225 million	\$ 543 million	\$ 775 million	\$2,543 million
1999	\$2,205 million	\$1,436 million	\$2,459 million	\$6,100 million

(Stipulations.)

EY was PeopleSoft's auditor from at least 1994 until June 2000, and audited PeopleSoft's financial statements for the year ended December 31, 1994, through the year ended December 31, 1999. (March 25, 2003, Tr. 11; EY Findings of Fact at 3.) EY sold its Consulting practice on or about May 25, 2000, to Cap Gemini Group, S.A. ("Cap Gemini"), and EY was to have no ownership interest in Cap Gemini within five years after the closing. (April 1, 2003, Tr. 9, 15, April 2, 2003, Tr. 66) Ernst & Young LLP, SEC No-Action Letter, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,863 (May 25, 2000).

PeopleSoft

PeopleSoft, founded in 1987 and headquartered in Pleasanton, California, is a leading provider of software applications that assists companies in managing business activities, such as

human resources management systems (“HRMS”), financials, distribution, manufacturing, and supply-chain and higher education.⁵ (March 31, 2003, Tr. 8, 201; EY Ex. 1310 at 5-7.) PeopleSoft’s common stock is registered with the Commission and is publicly traded.

As is general industry practice, PeopleSoft’s software is licensed not sold. However, the term sale is used and the licensee is referred to as a purchaser, but it cannot make and resell copies because of the need to protect the creator’s intellectual property. (March 27, 2003, Tr. 200-01, March 28, 2003, Tr. 81-82.) In 1999, PeopleSoft was a leading vendor in integration applications for human resource management, financial management, and enterprise performance analysis. (Div. Ex. 182 at 032253.) Larger business units with at least \$250 million in sales were interested in acquiring PeopleSoft products. (EY Ex. 1310 at 22.) These business firms, including health-care providers, generally retain system integrators (“SIs”) or implementation consultants to, among other things, install, implement, customize, and configure their new sophisticated software programs or significant upgrades.⁶ (March 27, 2003, Tr. 203, March 31, 2003, Tr. 9-10; EY Ex. 1310 at 5-6.)

From 1994 through 1996, PeopleSoft was included in Fortune magazine’s list of the fastest growing companies. (Div. Ex. 299, Tab H at 034802.) PeopleSoft’s revenues increased from about \$113 million in 1995 to about \$1.4 billion in 1999. (March 25, 2003, Tr. 18-19.)

EY’s Independence Policies on Engagements in Association With Audit Clients

All EY professionals received a multi-page document effective April 29, 1991, titled “Independence and Related Matters.” It appears that this material is in EY’s Policy and Practice Statement (“PPS”) AA 7502. One paragraph, headed “Engagements in Association with Clients” states:

As provided for in Policy and Practice Statement *Management Consulting Engagement and Client Acceptance* (SCORE Retrieval File No. PP7500), when a proposed cooperative agreement would potentially jeopardize our independence or place us in a potential conflict of interest with an audit client, the regional managing partner, a national director of [Consulting] operations, and the vice chairman of [Consulting] must approve the arrangement before entering into such an alliance. Any cooperative agreement with an SEC audit client is referred to the regional managing partner, the regional director of accounting and auditing, a national director of [Consulting] operations, and the vice chairman of [Consulting] for approval. Cooperative agreements with SEC audit clients may be appropriate in some cases involving separate contracts and separate fee

⁵ One expert described the PeopleSoft system as having two parts: a PeopleSoft platform that acts like an operating system and PeopleSoft modules that provide specific business capabilities. He characterizes PeopleSoft’s products as enterprise software, “applications that are meant to provide a set of capabilities for managing business activities and access to shared data to multiple users in a business.” (EY Ex. 1310 at 5, 7-9.)

⁶ In this context, the term “implementation” includes, among other things, installing, configuring, customizing, and consulting on software licensed by third parties. (April 2, 2003, Tr. 187.)

arrangements. However, each situation must be considered on a case-by-case basis.

(EY Ex. 1160 at 003292.) A version marked “1995 draft” sent to Victor Vagar of EY in the Netherlands on February 5, 1996, contains one additional sentence, “Review by the General Counsel’s Office also is required in certain circumstances.”⁷ (March 27, 2003, Tr. 49-50; Div. Ex. 134 at 031961) In its brief, EY refers to additional written policies.⁸ (EY Brief at 132.)

Each EY employee was ultimately responsible for ensuring that EY observed the rules on auditor independence as to its audit clients, and EY relied heavily on its culture of consultation to assure compliance. (March 25, 2003, Tr. 14, 180-81, March 26, 2003, Tr. 86-87, 90-92, 96-97, 99-100, 115.) “[E]very professional was encouraged to consult with the appropriate people in the firm that had more expertise in the area of independence.” (March 25, 2003, Tr. 45.) Two policies were “at the heart” of EY’s independence system:

1. independence was the responsibility of every professional at E&Y; and
2. because the independence rules were general and depended on facts and circumstances, the firm placed heavy emphasis on the need for every professional – accountant or consultant – to consult with independence experts when questions arose.

(EY Brief at 131.) Edmund Coulson has been EY’s senior person on independence issues in EY’s national office since January 1991, when he left the position of Chief Accountant at the Commission to become a partner in EY’s professional practice group.⁹ (March 26, 2003, Tr. 5-6, 9.) Consultations on independence matters are a very heavy focus of Mr. Coulson’s work. (March 26, 2003, Tr. 81.) Unlike his predecessor, Mr. Coulson kept no logs or any other written record of the independence advice that he has provided. (March 26, 2003, Tr. 81.) Mr. Coulson represented that EY considered the necessity of consultation a very important responsibility for

⁷ Mr. Coulson testified that his staff began working on this material in 1994 and put together “do’s” and “don’ts” that were circulated to EY partners. (March 27, 2003, Tr. 49-50.)

⁸ EY Ex. 1159, EY Policies and Practice Statement: Management Consulting Engagement and Client Acceptance; EY Ex. 1160, EY Independence and Related Matters: Independence; EY Ex. 1161, EY Policies and Practice Statement: EY Independence and Related Matters; EY Ex. 1162, EY Policies and Practice Statement: Management Consulting Client and Engagement Acceptance; EY Ex. 1163, EY Information Release: Management Consulting Engagement Acceptance Guidelines; and EY Ex. 1164, An Addendum to the Independence Policy and Practice Statement, Independence and Related Matters.

⁹ Mr. Coulson received the title “national director of independence” in the late 1990s. (March 26, 2003, Tr. 5-6.) Mr. Coulson holds a bachelor’s degree in accounting from the University of Maryland and is licensed as a certified public accountant in Maryland and New York. (March 27, 2003, Tr. 159-60.) According to Mr. Coulson, he is “considered to be quite reputable amongst the firms, probably the most knowledgeable” on the issue of independence, and the American Institute of Certified Public Accountants recognized his status in 2001. (March 26, 2003, Tr. 84, March 27, 2003, Tr. 158-59.)

every EY employee. (March 26, 2003, Tr. 86-100.) Mr. Coulson knew of only one or two instances where EY fired an employee for failing to consult on an issue of auditor independence. (March 26, 2003, Tr. 101-06.)

In December 1998, John Fridley, a consulting partner who joined EY in 1990 and who was in charge of EY's PeopleSoft Service Line from 1998 to 1999, distributed two pages of informal independence guidance, Relationship Considerations with E&Y Audit Clients and Audit Relationship Guidelines ("Guidelines") to participants at an EY planning meeting. (April 1, 2003, Tr. 136; Div. Ex. 201.) On January 1, 1999, Mr. Fridley circulated the Guidelines to additional people at EY. (March 25, 2003, Tr. 109-11; Div. Ex. 201.) In his investigative testimony, Mr. Fridley stated that he obtained the Guidelines from his predecessor Mr. Lindeman and that Mr. Lindeman did not know who created them.¹⁰ (April 1, 2003, Tr. 133-35.) At the hearing, Mr. Fridley testified that Mr. Lindeman told him the Guidelines came from EY's national office headed by Mr. Coulson. (April 1, 2003, Tr. 134-38.) The Guidelines contained the following prohibitions:

- Cannot have a joint marketing program.
- Cannot have client and E&Y names appear on a marketing/promotional brochure prepared by either organization.
- Cannot jointly host a seminar on a product/service topic. (Can participate on same program with a client without referencing a relationship.)
- Cannot make joint calls on multiple prospective clients/customers. (Can respond to individual client/customer request for information.)
- Cannot be subcontractor to each other.
- Cannot have article(s) published which perceptively endorses/supports either client and/or E&Y services/products.
- Cannot have E&Y identified as "preferred" or "partner" or announce that we have an "alliance" or a "relationship."
- Cannot take advantage of demo products, education, or technical documentation discounts unless offered broadly to other "Big 6" firms.
- Cannot have client reference E&Y services specifically in a client's proposal to a prospective customer.
- Cannot participate in any structured Consultant Relations or Partnering program of a client.
- Cannot provide to the other organization extensive quantities of the other organization's brochures and other marketing materials for mass mail or trade show distribution to the other party's clients or customers.

¹⁰ Thomas Lindeman was in charge of EY's PeopleSoft Consulting from 1997 until November 1998. Mr. Fridley was the PeopleSoft Service Line Leader from November 1998, until October-November 1999. (April 1, 2003, Tr. 31, 33.) Lynn E. Anderson, an EY partner, claims that Mr. Fridley also headed the PeopleSoft Service Line from 1995 to 1997, but Mr. Fridley did not mention this in his testimony. (April 2, 2003, Tr. 194.) Mr. Fridley retired from Cap Gemini Ernst & Young in 2002. (April 1, 2003, Tr. 13-14.)

The selection of one party's products or services may not be contingent on the other, and the pricing of one party's products and services cannot be dependent on the other.

CANNOT

Sub/Prime to each other

Submit joint proposals

Refer to E&Y as a "partner," "exclusive," "preferred," or that we have an "alliance" or a "relationship"

Have a joint marketing program, participate in events where the relationship is mentioned, or where E&Y endorses the product

Have the vendor's and E&Y's name or logo appear together on marketing or promotional material

Make joint calls on multiple prospective clients

(Div. Ex. 201.) EY never adopted the Guidelines, which many EY witnesses used as guidance on independence issues. (March 25, 2003, Tr. 116, April 1, 2003, Tr. 52-53, 122.) Much of EY's conduct described in the evidence was contrary to the Guidelines.

Mr. Fridley gave conflicting testimony on procedures that EY had in place so that consulting proposals did not violate the independence standards. Mr. Fridley testified under oath during the investigation that the partner involved was responsible and it was a very decentralized process. (April 2, 2003, Tr. 83-84.) At the hearing, he testified that responsibility was with the engagement partner who had to seek approval from the quality assurance partner, EY legal department, and perhaps the deal review board depending on the size of the proposal. (April 2, 2003, Tr. 82-85.) Mr. Fridley also testified that EY followed procedures described in the document, "Management Consulting Engagement and Client Acceptance," and a question and answer form, and that the number of people who had to approve a consulting contract depended on the nature, size, and risk of the engagement.¹¹ (April 2, 2003, 100-02, 123; EY Ex. 1159 at 3264.) Mr. Fridley estimated that EY submitted between one hundred and two hundred fifty consulting proposals during the period he headed the PeopleSoft Service Line and he reviewed a half dozen of them. (April 2, 2003, Tr. 103.)

EY audited PeopleSoft's financial statements for the year ended December 31, 1994, through the year ended December 31, 1999. (EY Findings of Fact at 3.) Richard Frick was EY's lead engagement partner on the audits of PeopleSoft's financial statements that were included in Commission filings from 1995 through 2000. Mr. Frick certified that EY was independent, and that each audit was conducted in accordance with Generally Accepted Auditing Standards

¹¹ The "Management Consulting Engagement and Client Acceptance," is the SCORE Retrieval File No. PP 7500 referenced previously. It lists certain types of engagements for SEC registrants as a type of consulting engagement that requires additional reviews or approvals than the document specifies and cites Appendix I for details. (EY Ex. 1159 at 003263.) The Appendix states, "Any cooperative agreement with an SEC audit client is referred to the regional managing partner, the regional director of accounting and auditing, a national director of [Consulting] operations, and the vice chairman of [Consulting] for approval." (EY Ex. 1159 at 003269.)

("GAAS"). (March 25, 2003, Tr. 18, 36.) Mr. Frick was also EY's coordinating partner for PeopleSoft from the fall of 1995 until June 2000. (March 25, 2003, Tr. 11.) As the coordinating partner, Mr. Frick was responsible for overseeing all EY services provided to PeopleSoft, and was expected to have a comfort level that all business relationships did not raise independence concerns before signing the audit report.¹² (March 25, 2003, Tr. 36; March 26, 2003, Tr. 113-14.) According to Mr. Frick:

I don't think it was necessary to have these kind[s] of guidelines for people to address independence issues. Our people are educated on independence issues. The firm has extensive policies and procedures that are issued to all employees with respect to independence, and in fact, they have to confirm annually their adherence to the firm's policies and procedures regarding independence.

(March 25, 2003, Tr. 115.) Mr. Frick also testified that the independence rules were pretty vague and not easy to understand. (March 25, 2003, Tr. 44.)

Mr. Mooney¹³ opined that:

E&Y established, maintained and monitored independence processes and procedures governing (a) consulting services involving the implementation of computer software developed and sold by its audit clients and (b) the formation of business relationships with audit clients, that were sufficient to provide reasonable assurance that the firm retained its independence from its audit clients and complied with the independence rules and regulations promulgated by the profession and the SEC. . . .

E&Y . . . established an extensive system of controls to educate its partners and staff as to what types of activities were prohibited and what types were of such a nature that they required consultation before proceeding. . . .

The evidence clearly demonstrates that in the case of the subjective arrangements and relationships with PeopleSoft, the system operated effectively. Consultation was initiated when required and the advice given was sound. Furthermore, partners and staff were knowledgeable of what kinds of relationships were prohibited, and they made sure PeopleSoft personnel were also aware of them.

¹² Mr. Frick was not responsible for overseeing the implementation services that EY provided to third persons. (March 25, 2003, Tr. 11-12.)

¹³ Mr. Mooney, a former certified public accountant in Massachusetts, New York, and Connecticut, was a PriceWaterhouseCoopers partner from 1981 to 2001. He was with the predecessor firm of PriceWaterhouseCoopers for thirty-one years, and a firm partner for twenty years. From 1994 until 1998, Mr. Mooney was the senior technical partner for the firm. Mr. Mooney managed PriceWaterhouseCoopers's response to the Commission's investigation of independence in 1998 and 1999. He was the firm's Global Independence Leader in 1999 and 2000, and he was in the Office of the Chairman in 2000 and 2001. (EY Div. 1311, Appendix A.)

(EY Ex. 1311 at 5-6, 26.)

The record does not support Mr. Mooney's opinion. EY relied more on "a culture of consulting" than on written guidelines. (March 25, 2003, Tr. 44-45.) There is no evidence of an extensive system of controls to educate partners; rather, the evidence shows that from 1992 through 1999, EY did not hold any regular training sessions on the subject of auditor independence and that EY's only effort at supervising independence in business relationships with clients was one paragraph in an annual self-reporting form, which was aimed at EY's business relationships with audit clients. (March 27, 2003, Tr. 10-16, April 1, 2003, Tr. 119-20.) There is considerable evidence that EY did not observe the Guidelines. I am unaware that EY submitted any evidence that it followed the directives in "Engagements in Association with Clients," PPS AA 7502, "Management Consulting Engagement and Client Acceptance," PPS 7500, or any other written policy as to its implementation activities with PeopleSoft that the Division has challenged in this proceeding.

EY's Business Relationships With PeopleSoft

In 1996, PeopleSoft described its relationship with EY as four-dimensional:

1. EY's Consulting had an Implementation Partnership with PeopleSoft. From fiscal year 1995 through fiscal year 1999, EY earned approximately \$425 million from implementing PeopleSoft software for third parties.¹⁴
2. EY's International Tax Group had an Application Software partnership with PeopleSoft for "EY/GEMS for PeopleSoft."
3. EY was PeopleSoft's auditor. EY earned almost \$1.7 million for auditing PeopleSoft's financial statements from 1994 through 1999.¹⁵
4. EY was a PeopleSoft customer and used PeopleSoft's HRMS Payroll and Financials for its internal operations.

(Div. Exs. 413 at 036205, 185.) EY's business relationships with PeopleSoft concerning software developed by its Tax Group (Number 2 above) and its consulting activities (Number 1 above) are at issue.

¹⁴ The Stipulations give a total of \$452 million but the sum of the yearly amounts is \$425 million. The yearly fees were \$10 million in 1995, \$40 million in 1996, \$75 million in 1997, and \$150 million in both 1998 and 1999.

¹⁵ The individual totals were \$136,500 in 1994, \$205,000 in 1995, \$155,000 in 1996, \$240,000 in 1997, \$372,000 in 1998, and \$578,000 in 1999.

EY's Global Expatriate Management System for PeopleSoft

EY considered itself the world leader in providing centralized, coordinated expatriate tax return preparation and consulting services. (Div. Ex. 122 at 031907.) In 1976, EY's Tax Group developed an in-house software program for assisting clients with the tax consequences of managing employees with international assignments. (March 21, 2003, Tr. 101-02.) The program had several iterations before EY began offering an Expatriate Tracking System to its customers in 1989. (Div. Ex. 238C at 032792.) In 1990, as the result of "a partnership effort with one of [its] largest clients," EY developed a Global Expatriate Management System ("EY/GEMS"), a DOS-based product. (Id.) In July 1995, EY released EY/GEMS for Windows, followed by EY/GEMS for PeopleSoft in January 1997, and in April 1998, it released EY/GEMS Client/Server ("C/S"). (Id.)

In the early 1990s, EY sought out PeopleSoft for a license to use PeopleTools to develop a new version of EY/GEMS for PeopleSoft. (March 21, 2003, Tr. 123; Div. Ex. 123.) Michael Bishko, a partner and National Director Expatriate Services, initiated the project and led it until he retired on October 1, 1999.¹⁶ (March 21, 2003, Tr. 92, 98-99, 104.) Mr. Bishko believed that an auditor could enter a business arrangement with a client as long as it was a standard industry agreement and not a sweetheart deal, but that the auditor and client could not have joint marketing and sales materials, or joint marketing seminars. (March 21, 2003, Tr. 173.) Mr. Bishko claimed to have told PeopleSoft in late 1993 or early 1994 that EY was required to remain independent from PeopleSoft because it was PeopleSoft's auditor, and that joint marketing efforts, joint sales calls, marketing brochures featuring the PeopleSoft and EY logos, and treating EY differently were all prohibited activities. (March 21, 2003, Tr. 129, 144-46.)

Mr. Bishko claimed that he informed EY's PeopleSoft auditors in the Walnut Creek, California, office and persons in EY's general counsel office that EY was entering a business relationship with PeopleSoft and they voiced no concerns about auditor independence. (March 21, 2003, Tr. 158-59, 281-83.) There are no documents or EY attorneys who can confirm Mr. Bishko's representation, and Mr. Frick, who was located in San Jose, California, was not informed. (March 25, 2003, Tr. 37; Div. Ex. 539.) In 2000, Mr. Bishko did not recall discussing the subject with EY's in-house independence expert, Mr. Coulson. However, in March 2003, after he read Mr. Coulson's investigative testimony, Mr. Bishko recalled that he talked with Mr. Coulson at least three times. (March 21, 2003, Tr. 163-66, 179, March 26, 2003, Tr. 158.)

Based on assurances from Mr. Bishko, Mr. Coulson believed that PeopleSoft routinely issued this type of license and that the arrangement was a license under conditions available to other PeopleSoft customers.¹⁷ (March 26, 2003, Tr. 156-58, 172-73.) Mr. Coulson did not

¹⁶ Mr. Bishko testified that he relinquished responsibility about a year before he retired, which would have been October 1998; however, an internal EY document generated on April 28, 1999, named Mr. Bishko as head of the project. (Div. Ex. 234 at 032727.)

¹⁷ Mr. Bishko had no first-hand knowledge that the terms and conditions of the Licensing Agreement were standard provisions. Mr. Bishko asked PeopleSoft to draft a standard form agreement and he assumed he got what he requested. (March 21, 2003, Tr. 151.) In fact, the terms and conditions in the few licenses for product development that PeopleSoft issued from

believe that the license created a direct business relationship. (March 26, 2003, Tr. 158-59.) Mr. Coulson reasoned that this was a purchase from an audit client that was not material to the auditor or the client because it was available to other customers under the same conditions.¹⁸ (March 26, 2003, Tr. 161, 172, March 27, 2003, Tr. 150-52.) Mr. Coulson “kept stressing the need to be comfortable that it was the standard kind of arrangement and it is not a sweetheart deal.” (EY Ex. 1311 at 13.) After a few phone conversations, Mr. Coulson advised Mr. Bishko that EY could proceed with the venture without impairing its independence as an auditor. (March 26, 2003, Tr. 158.)

Mr. Bishko for EY and PeopleSoft’s corporate counsel both signed a License and Distribution Agreement for PeopleTools (“Licensing Agreement”), effective October 1, 1994, that terminated in January 1999. (Div. Exs. 121, 465A.) The Licensing Agreement:

A. Allowed EY to use PeopleTools and PeopleSoft HRMS “solely for use in connection with [EY’s] development, Distribution, and provision of technical support for the Derivative Software.”¹⁹ (Div. Ex. 121 at 031894.)

B. Provided that EY would pay PeopleSoft fifteen percent of each license fee it received for the new software, thirty percent of each license renewal fee it received, and a minimum royalty of \$300,000, payable in twelve quarterly payments of \$25,000 each. (Id. at Exhibit A.)

C. Provided that EY would make PeopleSoft a third-party beneficiary of each sublicense. (Id. at 031896.)

D. Provided that PeopleSoft agreed to assist EY’s efforts by providing technical assistance for a \$15,000 quarterly fee [for five quarters]. (Id. at Exhibit A.)

E. Provided that EY shall not distribute the derivative software to PeopleSoft’s direct competitors. (Id. at 031894.)

F. Permitted EY to use PeopleSoft trademarks and tradenames in marketing materials. (Id.)

1987 to 1993, “were not specifically disclosed.” (EY Ex. 1310 at Tr. 8.) Mr. Bishko did not review any agreements that PeopleSoft had with application partners. (March 21, 2003, Tr. 206-07.) Mr. Bishko heard there were one or two other applications of PeopleSoft HRMS software that had used PeopleTools. (March 21, 2003, Tr. 152.)

¹⁸ Mr. Coulson would reach the same conclusion in 2003. (March 27, 2003, Tr. 146.)

¹⁹ According to one expert, PeopleSoft’s platform was in a “programming language, PeopleCode, which is written or modified using a set of development tools, a product called PeopleTools.” (EY Ex. 1310 at 7.) The Licensing Agreement defines “PeopleTools” as “all or any portion of PeopleSoft’s then current commercially available object code software toolset and associated documentation delivered by PeopleSoft to Licensee hereunder which is designed solely for use in application development and customization of applications.” (Div. Ex. 121 at 031893.)

G. Finally, PeopleSoft maintained a degree of control over the product. EY could not distribute it to certain PeopleSoft competitors. EY had to work with PeopleSoft to establish a reasonable suggested price list, and agreed to work closely with PeopleSoft to ensure the quality of the product. (March 28, 2003, Tr. 92-93; Div. Exs. 121 at 031895, 741 at 10-11, 748 at 5-6, EY Ex. 1310 at 13-15.)

Mr. Bishko was responsible for a January 24, 1995, press release titled “Ernst & Young Announces Licensing Agreement with PeopleSoft to Develop Global Expatriate Management System” that quoted PeopleSoft’s Director of Product Marketing as stating: “EY/GEMS for PeopleSoft will provide a seamless interface of information between PeopleSoft’s software (HRMS) and EY/GEMS, and will allow expatriate human resource managers to access existing employee information from PeopleSoft HRMS, located internationally or at corporate headquarters.” (EY Ex. 122.)

Mr. Bishko’s office submitted a “PeopleSoft Application Partner Profile Questionnaire” to PeopleSoft’s Strategic Marketing Group on March 1, 1995, which listed the target market for the new version of EY/GEMS as “the PeopleSoft market,” and the product as “integrated” with PeopleSoft’s HRMS. (Div. Ex. 600 at 043575-77.) PeopleSoft incorporated information from the questionnaire into an online database for PeopleSoft staff to enable PeopleSoft salespeople in the field immediate access to information about EY’s products and services. “Field representatives will be able to quickly respond to prospects or customers seeking applications like yours which complement the PeopleSoft environment.” (Div. Ex. 600 at 043575.) PeopleSoft’s “Partner Profile” for EY noted under “Red Flags” admonitions very similar to EY’s Guidelines.

E&Y audits PeopleSoft and must maintain an air of independence when dealing with PeopleSoft in the market place. This means that they cannot do joint marketing initiatives, create joint co-logo collateral, subcontract to each other, refer to E&Y as “a partner”, “exclusive”, “preferred” or that we have an alliance. E&Y is a Global Implementation Provider. They are not part of our Global Consulting Alliance program, but have equal capabilities to deliver services globally to our customers.

Audit Relationship

As E&Y is the auditor of PeopleSoft, Inc. certain restrictions apply to our relationship. . . .

We cannot:

Submit joint proposals.

Refer to E&Y as a ‘partner’, ‘exclusive’, ‘preferred’, or that we have an ‘alliance’

Have a joint marketing program, participate in events where the relationship is mentioned, or where E&Y endorses the product

Have the [PeopleSoft] and E&Y’s name or logo appear together on marketing material

Make joint calls on multiple prospective customers

(Div. Ex. 169 at 032052.)

In 1999, EY and PeopleSoft engaged in discussions to continue (1) the 1994 Licensing Agreement, and (2) the relationship so as to include upgraded expatriate software in an HRMS/Payroll upgrade. (March 24, 2003, Tr. 14-16, 28-29, 32, 34-35, 37-41; Div. Ex. 237A.) The proposed changes in the PeopleSoft code would eliminate the need for EY to redo coding when PeopleSoft upgraded HRMS. (March 24, 2003, Tr. 35-43.) In communications in the spring of 1999, EY and PeopleSoft discussed how they were going to position the product as PeopleSoft's "preferred solution because of the tight integration and the fact that it was written in the language." (March 24, 2003, Tr. 60-61; Div. Ex. 499E at 039148.) Janice Jane Gonzalez, who worked for PeopleSoft in negotiating with EY, did so at the 1999 PeopleSoft User Conference where she stressed that: EY/GEMS for PeopleSoft was EY's preferred solution; it was written in PeopleTools; and it provided a seamless integration with PeopleSoft software. (March 24, 2003, Tr. 78-79.) On July 19, 1999, EY's Web page had a section that was titled "Managing Your Expatriate Resources Using PeopleSoft and EY/GEMS."

[EY] has worked with PeopleSoft to provide international assignment management functionality needed by many multinational companies utilizing the PeopleSoft HRMS/Payroll System.

EY/GEMS for PeopleSoft gives clients an integrated system solution, incorporating the international assignment capabilities from [EY's] windows version into the PeopleSoft HRMS product using PeopleTools. The design utilizes our in-depth knowledge of expatriate tax, human resources and administrative issues with the most up-to-date technology.

(Div. Ex. 244.) PeopleSoft did not grant these privileges to EY's competitors and agreed to announce the new arrangement at the 1999 PeopleSoft Users Conference. (Div. Ex. 741 at 11.) PeopleSoft announced at the 1999 User Conference that it had found a solution for expatriate processing and that it had a partnership with EY. (March 24, 2003, Tr. 86-90.) Michael Fisher of EY Tax insisted that PeopleSoft inform people at the User Conference that EY/GEMS for PeopleSoft was PeopleSoft's "preferred solution for expatriate software." (March 24, 2003, Tr. 85-91.) Ms. Gonzalez believed that EY and PeopleSoft agreed to do many of the activities that EY's Partner Profile prohibited. (March 24, 2003, Tr. 84-85; Div. Exs. 201, 474.) The negotiations in 1999 did not result in a written agreement.

EY licensed a total of three copies of EY/GEMS for PeopleSoft. (March 28, 2003, Tr. 50.) It granted the last license in September/October 1999.²⁰ (March 21, 2003, Tr. 260.) EY paid PeopleSoft royalties totaling \$300,000, and technical support and maintenance payments totaling \$75,000, pursuant to the Licensing Agreement.²¹ (Stipulations.) EY earned \$767,500 from licensing fees for EY/GEMS for PeopleSoft in fiscal years 1998 through 2001. (Stipulations.)

²⁰ The licensees were Applied Materials, Anadarko, and Mobil Oil. The parties and the terms of the 1994 licensing agreement allowed a sale to occur beyond the expiration date of the Licensing Agreement. (March 21, 2003, Tr. 260-61.)

²¹ EY made consecutive quarterly royalty payments in 1996, 1997, and 1998, and consecutive quarterly support payments of \$15,000 each beginning in the last quarter of 1994 and continuing

EY's Consulting Service Implementing PeopleSoft Software

Businesses, including non-profits, often enter into separate contracts with software vendors and implementation consultants.²² Software implementation can cost two to five times more than the cost of the software, and the implementation process can extend over many months. (April 1, 2003, Tr. 197; EY Ex. 1310 at 7, 20.) According to Dr. Hitt, a "typical" business software application costs approximately \$15 million, and takes, on average, twenty-one months to complete, but installations at large firms with many sites could run into tens of millions.²³ (EY Ex. 1310 at 20.) In the 1990s, there were ten to twenty major SIs that planned software implementations, performed actual implementations, offered training on applications, and redesigned other applications for changed environment. (March 31, 2003, Tr. 196-97, April 1, 2003, Tr. 88-89; EY Ex. 1310 at 21.) In 1998, the implementation or application services market was valued at \$19 billion. (EY Ex. 1109.)

EY's Consulting consisted of Health Care Consulting, Financial Advisory Services, and Consulting. (Div. Ex. 165 at 32039.) In most cases, EY's Consulting assisted clients in selecting software and sometimes assisted with negotiating the contract with the vendor. In other situations, it installed and customized software that the customer had already selected. (April 2, 2003, Tr. 95, 206-08.) EY established a service line for a specific vendor when consulting contracts for a vendor's software reached approximately \$50 million annually. (April 2, 2003, Tr. 188-89.) The mission of EY's Consulting practice was:

to help their clients achieve a competitive advantage by applying technology, improving performance and managing change in a manner that adds value to their organization. Consultants in the [Consulting] practice assist clients with strategic planning, total quality management, business process improvement, cost management, information systems planning, software selection and implementation and reengineering. The [Consulting] practice competes with Andersen Consulting, Price Waterhouse, Deloitte & Touche, Coopers and Lybrand, KPMG Peat Marwick, Computer Sciences Corporation and EDS.

(Div. Ex. 413 at 036204.)

through 1995. (Stipulations.) EY disclosed to customers that the initial and renewal license fees for EY/GEMS for PeopleSoft included royalties EY paid to PeopleSoft. (March 21, 2003, Tr. 239-41.)

²² In the 1990s, major software vendors included Arbor Software, Hewlett Packard, Hyperion Software Corp., IBM, Informix, Lotus, Microsoft, Oracle, PeopleSoft, SAP, Texas Instruments, and Xerox Corp. (Div. Ex. 425 at 036532.)

²³ Dr. Hitt received his PhD from the Massachusetts Institute of Technology in 1996. He holds undergraduate and masters degrees in electrical engineering from Brown University. Dr. Hitt is presently the Alberto Vitale Term Associate Professor of Operations and Information Management at the University of Pennsylvania, Wharton School. Dr. Hitt's area of expertise is the management and economics of information systems. (EY Ex. 1310 at 1.) Dr. Hitt provided a detailed description between two types of applications software: personal productivity software and enterprise software, which requires the services of an implementer. (EY Ex. 1310 at 5-6.)

To provide service, an implementation consultant must have a license to use the particular software and associated tools. EY and PeopleSoft entered into an Implementation Partners Agreement (“Implementation Agreement”) on December 15, 1993, that was effective to February 2000.²⁴ (Div. Exs. 163, 741 at 19.) Mr. Coulson believed that there was consultation in EY on “just about anything that raises any [independence] question about an SEC audit client”; however, there is no evidence that EY consulted with Mr. Coulson and its national office on independence before entering the Implementation Agreement. (March 26, 2003, Tr. 90; Div. Ex. 741 at 23.) The Implementation Agreement:

1. Gave EY a “license, pursuant to PeopleSoft’s standard License Agreement . . . to use the Software to develop Implementation Tools solely in connection with [EY’s] provision of Services to End Users” for one year that envisioned annual renewal;
2. Designated EY as a participant in PeopleSoft’s Implementation Partner Program;
3. Required PeopleSoft to supply its “End Users” and business prospects with a one-page company profile on EY;
4. Gave EY the right to participate in PeopleSoft’s annual User Conference and participate in the product fair;²⁵
5. Granted EY technical support and training, and prohibited the disclosure of confidential information; and
6. Specified that EY performed under the agreement as an independent contractor, and that the agreement did not create a partnership, joint venture or agency relationship.

(Div. Ex. 163.) The Division began the investigation that led to this proceeding in 1998 or 1999.²⁶ Ms. Anderson, and Bill Parsons, PeopleSoft’s Alliance Vice President, signed a Software License Agreement for Global Consulting Companies effective February 17, 2000, that succeeded the Implementation Agreement.²⁷ (Div. Ex. 277 at 034438, 034442.) There is no

²⁴ The original agreement was for one year and it was renewed annually. According to Dr. Hitt, EY exited the business in 2000. (EY Ex. 1310 at 21.)

²⁵ PeopleSoft held User Conferences in various parts of the world. The one held in the United States was attended by a “huge” number of PeopleSoft customers. (March 24, 2003, Tr. 92.)

²⁶ In a Wells submission dated June 11, 2001, EY states that the Division’s charges followed a three-year investigation. (Div. Ex. 241 at 032818.) The subject of an “SEC inquiry into PeopleSoft/E&Y Relationship” was an agenda item at a meeting EY held with the new President of PeopleSoft on July 26, 1999. (Div. Ex. 232.)

²⁷ Ms. Anderson, a consulting partner, replaced Mr. Fridley as head of the PeopleSoft Service Line in October 1999. (April 2, 2003, Tr. 193-94.)

evidence that Ms. Anderson consulted with Mr. Coulson, or anyone else at EY, on independence issues before signing the new agreement.

EY's Web site contained information about the PeopleSoft Service Line and contained a link to the PeopleSoft Web site. (April 1, 2003, Tr. 159.) EY's Auditing Group, Legal Group, Marketing Services Group, and Web Services reviewed material prepared by Ms. Anderson, about EY's services that appeared on PeopleSoft's Web page. (April 2, 2003, Tr. 237.) PeopleSoft's Web site listed EY as an application alliance member and a service alliance partner. (Div. Exs. 724D, 724E.)

By 1997, EY had some 3,600 consultants globally working as implementers in software applications. (EY Ex. 1310 at 26.) By 1998, EY had a PeopleSoft Service Line with 400 consultants and twenty partners located in the United States and over 750 consultants worldwide assigned to PeopleSoft implementations. (March 25, 2003, Tr. 117, April 1, 2003, Tr. 58, 174; Div. Ex. 185.) According to a group that reports on the industry, the Gartner Group, in 1998, EY was rated as the third largest implementer of PeopleSoft globally, and the fourth largest implementer in the United States. (EY Ex. 1310 at 27.) In order of size, EY was rated fifth of the eight largest United States PeopleSoft implementers in 1998. These PeopleSoft consultants were: Andersen Consulting, PeopleSoft, Price Waterhouse, Cambridge Technology Partners, EY, Deloitte & Touche, Hunter, and KPMG Peat Marwick.²⁸ (EY Ex. 1310 at 21.) Most of EY's consulting proposals were of significant size. (April 2, 2003, Tr. 82.)

EY and PeopleSoft had a symbiotic relationship. (April 1, 2003, Tr. 86-87.) PeopleSoft wanted a lot of consultants capable of implementing its products because as a vendor, PeopleSoft needed fast, knowledgeable implementation to satisfy customers. PeopleSoft believed that EY had direct knowledge of its client accounts that would enable PeopleSoft to differentiate its software to a potential customer. (April 7, 2003, Tr. 47; Div. Exs. 169 at 032054, 306C at 034931.) EY's PeopleSoft Service Line benefited from recommending PeopleSoft products because new PeopleSoft licenses provided more consulting opportunities. A business acquiring software would often ask EY as a consultant to help select a software product, and EY believed it had a better chance of being selected to do the implementation if it had been involved in selecting the software. (April 7, 2003, Tr. 59-61; Div. Ex. 173 at 32131.) EY believed that it was better positioned to be included as a qualified implementer recommended by PeopleSoft if it had a good working relationship with PeopleSoft salespeople. (April 1, 2003, Tr. 220-22.)

PeopleSoft described the fifty to one hundred companies that offered implementation services as service or implementation partners.²⁹ (March 31, 2003, Tr. 16, 19, 50.) EY's "PeopleSoft relationship was titled an alliance, and the program of implementing PeopleSoft services was called an Alliance program and an Implementation Partner program." (April 2, 2003, Tr. 195.)

²⁸ The Gartner Group noted that EY "had a lower overall quality ranking in Gartner's survey than any of the other large external vendors." (EY Ex. 1310 at 27.)

²⁹ PeopleSoft had hardware partners, software partners, and implementation partners. (April 2, 2003, Tr. 148.)

PeopleSoft had an organization within its corporate marketing department whose job it was to manage PeopleSoft's relationship with its various partners. (April 2, 2003, Tr. 148.) PeopleSoft assigned a "Global Alliance Manager" to EY. One of his responsibilities was to make sure that EY was knowledgeable about PeopleSoft products. (March 31, 2003, Tr. 8.) Documents show EY as a Global Alliance Partner of PeopleSoft, but certain witnesses said EY never formally had this status. (March 31, 2003, Tr. 184; Div. Ex. 490 at 38632.) Stuart Horne, PeopleSoft's Global Alliance Manager for EY from June 1998 to July 1999, believed that PeopleSoft and EY could pursue and close business together as long as "they followed the guidelines and didn't do joint proposals or joint sales meetings." (March 31, 2003, Tr. 7, 74, 153.) Mr. Horne interpreted joint sales calls and joint presentations as occasions when PeopleSoft and EY were present physically together. (March 31, 2003, Tr. 153.) Even though Mr. Horne knew that EY had a different relationship with PeopleSoft than other SIs, Mr. Horne and others generally used the terms "partner" and "alliance member" when discussing EY's relationship with PeopleSoft. (March 31, 2003, Tr. 16, 40-41.) Mr. Horne acknowledged that auditor independence would not allow PeopleSoft to designate EY as its preferred partner. (March 31, 2003, Tr. 185.)

Mr. Fridley saw his role as increasing the business and EY's market share of PeopleSoft implementations. EY's PeopleSoft Service Line had sales of \$150 million and revenue of \$110 million in the United States in fiscal year 1998, and Mr. Fridley projected \$275 million in sales and \$160 million in revenue for fiscal year 1999.³⁰ (April 1, 2003, Tr. 213-14; Div. Ex. 199 at 032373, 032405.) In December 1998, Mr. Fridley announced that EY needed to have a partner focus on PeopleSoft, and that "I am that partner," and that the business had grown so much that three partners would spend fifty percent of their time "driving business in their area." (Div. Ex. 364 at 035533.)

At the hearing, Mr. Fridley refused to acknowledge that EY and PeopleSoft had a formal alliance, but in a 1999 e-mail, he noted that EY was one of PeopleSoft's twelve alliance partners, he praised Mr. Horne's good work as a Global Alliance Manager, and he argued that EY did not want Mr. Horne "reassigned to another or multiple Partner(s)." (April 1, 2003, Tr. 200; Div. Ex. 226 at 032654.) Mr. Fridley testified that EY could be listed as a member of PeopleSoft's global alliance program, but that EY could not be referred to as a Global Alliance Partner. (April 1, 2003, Tr. 160.) Mr. Fridley testified that EY was one of five companies in PeopleSoft's global alliance program, but he told PeopleSoft not to refer to EY as a Global Alliance Partner because EY did not sign a Global Alliance Partner agreement. (April 1, 2003, Tr. 160-61.) In February 1998, PeopleSoft created a global consulting alliance program with Andersen, Deloitte and Touche, KPMG, and Price Waterhouse as members. (EY Ex. 1310 at 30.)

³⁰ One of Mr. Fridley's first engagements at EY was the implementation of PeopleSoft's HRMS software for Bell South from 1992 through 1995. The engagement involved a total of fifty-one EY people but no more than seventeen at any one time and no subcontractors. EY, a co-project manager, earned \$10 million where the client's total implementation cost was over \$100 million. (April 1, 2003, Tr. 23-24.) Mr. Fridley considered the projected growth astronomical considering that the industry was growing at twenty percent, and EY experienced no growth in fiscal year 1999 because of the business downturn. (April 1, 2003, Tr. 218.)

An EY sales document stated, “We have been classified as a PeopleSoft Global Solutions Provider - the highest ranking of a PeopleSoft Implementation Partner – every year since 1991.” (Div. Exs. 425 at 036532, 513 at 39943, 514 at 040032.) Robert Flury, PeopleSoft’s vice president and general manager in 1998, considered EY to be a PeopleSoft global implementation partner since 1991. (March 31, 2003, Tr. 192, 234.) Ms. Anderson considered EY to be a “Global Solutions Provider Partner” like the other Big Six accounting firms. (April 2, 2003, Tr. 238.) Ms. Anderson acknowledged that EY would mention in sales solicitations that it had been a PeopleSoft global implementation partner since 1991 and that it was an alliance member. (April 2, 2003, Tr. 263-64, 273.) Ms. Anderson used the term “implementation partner” because that is what PeopleSoft called the program and it was what customers were familiar with. (April 2, 2003, Tr. 273, 275.) PeopleSoft ranked EY among its top twelve alliance partners. (Div. Ex. 226 at 032654.)

PeopleSoft sent EY draft rules of engagement, “Global Solution Provider Teaming Approach,” in December 1999. The document, which Ms. Anderson believes was sent to all PeopleSoft Global Solution Providers, stated that the “partners” first objective was to maximize revenue for PeopleSoft and its partners. According to the document, “[i]f, during account planning, a partner fails to appropriately commit to heavily influencing a software sale, PeopleSoft may select another partner or use PeopleSoft Consulting in its service strategy for that customer.” (Div. Ex. 359 at 035354.) The rules of engagement also has a diagram that shows joint activities. (Div. Ex. 359 at 035357.) In its response to PeopleSoft, EY did not mention that its status as PeopleSoft’s auditor put limitations on its activities. (April 2, 2003, Tr. 249-52.)

EY’s engaged in a wide variety of actions with PeopleSoft to secure business to implement PeopleSoft software. The Division claims that EY and PeopleSoft’s relationship “involved extensive and intricately interwoven joint activities that created a direct business relationship.” (Div. Initial Brief at 42.) The large amount of evidence can best be understood if grouped into certain subject categories although there is considerable overlap.

Joint Sales Efforts

The evidence is overwhelming that EY partnered with PeopleSoft to the maximum extent possible to accomplish sales and boost EY’s consulting revenues. In 1998, EY earned \$150 million from implementing PeopleSoft software and \$372,000 from auditing PeopleSoft’s financials. In 1999, EY earned \$150 million from implementing PeopleSoft software and \$578,000 from auditing PeopleSoft’s financials. (Stipulations.) The record contains scant mention by EY that sales and marketing activities actions might be prohibited by EY’s status as PeopleSoft’s auditor. There is no evidence that anyone in EY sought Mr. Coulson’s advice on any independence issue that arose from EY’s consulting activities or that EY complied with the provisions of PPS AA 7502, Engagements in Association with Clients. (EY Ex. 1160 at 003292.)

PeopleSoft sent EY quarterly copies of its “closed business reports,” which indicate the PeopleSoft software sales in which EY was involved. (March 31, 2003, Tr. 67, April 1, 2003, Tr. 104-05; Div. Exs. 311, 319.) From the third quarter of 1997 through the third quarter of

1998, PeopleSoft's closed business reports show that EY was involved in approximately fifty-nine PeopleSoft sales. (Div. Ex. 311.) On six occasions, the report notes that EY provided sales assistance, and on thirty occasions EY is shown as providing help in making the sale, which was rated four or five on a five-point scale, where five is the highest score.³¹ (March 31, 2003, Tr. 68-69, 71-73; Div. Ex. 311.) Some comments indicate that EY brought PeopleSoft the lead or initial information that led to the sale, or that EY co-sold with PeopleSoft. (Div. Ex. 311.)

On December 2, 1998, Marie Duginski, PeopleSoft's alliance manager for health care, sent several EY partners information identifying specific PeopleSoft customers in Michigan. (Div. Ex. 291.) In the same communication, Ms. Duginski mentioned the Econosystem concept, which was a concept of Hewlett Packard for a joint project with PeopleSoft and EY, and "opportunities [PeopleSoft] outlined within Henry Ford." (April 7, 2003, Tr. 35-36; Div. Ex. 291.)

On December 1, 1998, Ms. Duginski supplied Mr. Fridley with a confidential closed business report showing customer, product sold, date, the "sales partner" in a column headed "Sales Cycle," a one to five rating for help making the sale, and the system implementer. (March 31, 2003, Tr. 65, 150-51, April 7, 2003, Tr. 20-24; Div. Ex. 292.) EY is shown among the partners. (Div. Ex. 292.) Ms. Duginski's goal was to have more sales by PeopleSoft and EY. (April 7, 2003, Tr. 10-12.) Ms. Duginski urged discretion in how the information was used because she did not want PeopleSoft's other service partners to know that she had disclosed information about them to EY, one of their competitors. (April 7, 2003, Tr. 21-22.)

On June 4, 1999, Mr. Horne informed Mr. Fridley that EY helped close five PeopleSoft sales in the first quarter of fiscal year 1999. (Div. Ex. 319.) PeopleSoft's closed business report for the first quarter of 1998 through the first quarter of 1999 lists forty-six PeopleSoft sales that EY "helped out on." (Div. Ex. 319 at 35075-76.) In half the sales, PeopleSoft rated EY's assistance as either a four or five on a five-point scale. (March 31, 2003, Tr. 145-47; Div. Ex. 319 at 35076.)

In October 1996, five EY partners, including Mr. Frick, met with PeopleSoft executives as part of PeopleSoft's effort to extend its business alliances. As a result of the meeting, the focus of EY's 1997 PeopleSoft practice strategy was to "sustain a 30% practice growth and align with [PeopleSoft] vertically to go after target industries." (Div. Ex. 413 at 036203.) EY's Partner Profile advised PeopleSoft salespeople that:

E&Y has what they refer to as Target Account Leaders. They are senior level partners assigned to cover E&Y's most important clients. These partners generally have a good working relationship with the [chief] level executives and can provide insights on the organization and access to these executives. . . . It is important to identify an E&Y partner within the PeopleSoft service line to help you work with the Target Account leaders and pursuing the customer. . . . When we are in a sales cycle, it can also be helpful to know if E&Y is the audit firm for

³¹ Mr. Fridley claimed that Mr. Horne considered the reports to be of poor quality because they reflect the subjective comments of PeopleSoft's sales personnel. (April 1, 2003, Tr. 97-98.)

our prospective customer since audit firms have a strong knowledge of the company's business issues.

(Div. Ex. 169 at 032054.) In November 1996, Zeev Gur, who headed PeopleSoft's consulting relationship with EY, wrote that PeopleSoft's alliance with EY grew significantly during the past year "both in the number of [PeopleSoft] trained consultants and the number of joint deals closed." (Div. Ex. 413 at 036203.)

EY publicized its close relationship with PeopleSoft in order to promote sales. An EY document titled "1998 Global Business Case for Our PeopleSoft Solution Team" bears the PeopleSoft Global Alliance Partner logo. (Div. Ex. 420.) The document describes the EY/PeopleSoft relations in terms of EY's status as auditor, PeopleSoft Global Solutions Provider, client, and expatriate relationship – EY/GEMS. (Div. Ex. 420 at 036336.)

In 1998, EY significantly strengthened its relationships with PeopleSoft's sales representatives in the field by sharing information about business leads and prospects. (April 1, 2003, Tr. 204-05; Div. Ex. 486 at 038541.) In 1998, EY did about half the PeopleSoft health-care implementations where the licensee used a third-party consultant or implementer. (March 31, 2003, Tr. 198.) Strong sales force relationships between EY and PeopleSoft continued as an EY objective in 1999. (Div. Ex. 199 at 032373.)

On December 1, 1998, at Mr. Fridley's direction, Ms. Duginski contacted two EY partners to support PeopleSoft's request that they urge a third EY partner to stop the purchase of a PeopleSoft competitor's software. (April 7, 2003, Tr. 17-19; Div. Ex. 293.)

During a meeting of twenty-five members of EY's PeopleSoft Service Line in December 1998, the attendees considered strategies for "Leveraging EY's audit relationship with PeopleSoft." (April 1, 2003, Tr. 191; Div. Ex. 363 at 035450.) The following comments were made in a wide-ranging discussion of options:

- (1) At times, EY's auditor status precluded it from partnering with PeopleSoft;
- (2) EY should leverage its audit relationship with PeopleSoft and use it to EY's advantage; and
- (3) EY should operate as one with PeopleSoft in terms of global focus and market opportunities.

(April 1, 2003, Tr. 184-86; Div. Ex. 363 at 035392, 035427.) The meeting participants theorized that if EY should become the dominant software implementer in three years, it would be because, among other things, EY:

- (1) "Engineered & delivered (with PeopleSoft)" with solutions in a variety of business areas.
- (2) "Targeted industries & markets through focused account planning & relationship building with senior [PeopleSoft] executives."
- (3) "Audit leverage, integrated services to help [PeopleSoft]."
- (4) Aligned with PeopleSoft on global growth.

- (5) Did not accept incorrect assumption that the audit relationship would cause EY not to achieve market dominance.

(Div. Ex. 363 at 035428.) These EY partners noted with respect to health care:

We know where PeopleSoft is looking to sell work and where PeopleSoft will need to be upgraded. This is all a matter of partnering with the 11 sales representatives from PeopleSoft and to work the current account list. That way, when they go to the account, they have our credentials and solution sets and everything. In addition, we will help PeopleSoft sell their product – if we do our job right.

(Div. Ex. 363 at 035480.) At the conclusion of the meeting, Mr. Fridley advised:

Obviously, the business plan is a working document that will continue to be refined to reflect our increased understanding of how the reorganized [Consulting] practice will work and the additional opportunities to partner with our clients and work more closely than ever with PeopleSoft.

(Div. Ex. 363 at 035499.)

The goal for EY's PeopleSoft Southeast Business Strategy in 1999, a major initiative of EY's PeopleSoft Service Line in Atlanta, was "Taking It to the Limit" and supporting PeopleSoft nationally. (April 2, 2003, Tr. 230; Div. Ex. 417.) EY and PeopleSoft personnel were matched/paired for communication and helped with sales/marketing initiatives. (Div. Ex. 417 at 036231.) Ms. Anderson testified that matching EY and PeopleSoft contacts was to provide EY with the name of the right person for information, but reluctantly admitted that the matching had a sales aspect. (April 2, 2003, Tr. 231-32.)

EY paid PeopleSoft \$5,000 to sponsor a PeopleSoft Worldwide Sales meeting held on February 21-23, 1999, where EY, as one of PeopleSoft's top twelve "partners," had an opportunity to meet 1,000 PeopleSoft salespeople. (April 2, 2003, Tr. 63-64; Div. Exs. 267 at 033791, 491.) In addition, EY sponsored two PeopleSoft events annually and spoke at local PeopleSoft events, conferences, and meetings. (Div. Ex. 417 at 036231.) From 1998 to 2000, EY sponsored and/or paid for golf outings at PeopleSoft health care conferences. (Div. Ex. 267 at 033780-82, 033790, 033792-93.)

On July 13, 1999, Mr. Fridley asked PeopleSoft to endorse EY to Standard Register, a PeopleSoft customer, in connection with EY's sales efforts.³² (April 2, 2003, Tr. 56, 62; Div. Ex. 181.) EY's sales efforts were successful and Standard Register selected EY as an implementation consultant and paid EY \$11.6 million to install and implement PeopleSoft's financial modules. (Div. Ex. 428.)

³² PeopleSoft salespeople rated EY a four on a five-point scale on a sale to Standard Register. (Div. Ex. 319.)

Ms. Anderson learned at the user conference that an EY audit client, Arkansas Best Freight Co. (“ABF”), had not yet selected a software vendor. On September 9, 1999, Ms. Anderson gave Mr. Kavanagh, who succeeded Mr. Horne as PeopleSoft’s Global Alliance Manager for EY in July 1999, this information and requested that he supply her with a list of freight companies who have PeopleSoft modules. (Div. Ex. 210.) At the hearing, Ms. Anderson denied she was trying to help PeopleSoft make a sale and claimed EY was obtaining information for ABF at its request. (April 2, 2003, Tr. 221-22.)

On September 13, 1999, in an e-mail titled “Need Info,” Ms. Anderson stated, “We are trying to ‘sell’ PeopleSoft as the solution for [a potential client].” (Div. Ex. 365.) In the same e-mail, Ms. Anderson requested customer information and Mr. Kavanagh responded. (April 2, 2003, Tr. 257-58; Div. Ex. 365 at 035679.)

On January 4, 2000, Ms. Anderson requested PeopleSoft give EY the names of cruise companies that have PeopleSoft modules because “[w]e are heavily involved in the entertainment area (i.e. hospitality, gaming and cruise lines) and [the Hospitality Group] would like to have any info you have on that and what you are doing to help sell [PeopleSoft] as the package of choice for that segment.” (Div. Ex. 361.) Ms. Anderson testified that she made the request because EY clients wanted the information. (April 2, 2003, Tr. 252-54.)

Joint Marketing

EY’s direct and indirect activities with PeopleSoft amounted to joint marketing in an effort to increase implementation sales. EY marketed its implementation services by emphasizing a close working relationship with PeopleSoft. On its Web site, EY stated that its commitment to PeopleSoft includes “joint development between E&Y and PeopleSoft in several areas, continuous feedback directly to PeopleSoft development and product strategists for functional enhancements, and even significant involvement in the testing of PeopleSoft’s latest releases.” (Div. Ex. 185.) EY presented Adventist Health Systems with a work solicitation document dated January 19 and 20, 1999, that shows the PeopleSoft logo and the words, “Implementation Partner,” describes EY/GEMS for Human Resources as a joint product with PeopleSoft, and lists EY as a PeopleSoft Global Implementation Provider and alliance member. (Div. Ex. 583 at 043378, 043399, 043402.) A work proposal that EY submitted to Federal Express sets out the “[s]trengths of EY according to PeopleSoft taken directly from [PeopleSoft’s] ‘1997 Global Alliance Program.’” (Div. Ex. 256 at 033467.) In a work proposal submitted to Primerica Financial Services, EY stated, “As a PeopleSoft Global Solutions Provider, we have been placed in a class above the rest based on our depth and breadth of knowledge in the PeopleSoft arena. PeopleSoft has positioned us in this role due to our functional and technical capabilities, as well as our proven ability to support large scale PeopleSoft implementations.” (Div. Ex. 225 at 032565.)

Sprint Communications Company (“Sprint”) was EY’s largest implementation client and a major client of PeopleSoft. Mr. Fridley informed PeopleSoft on May 17, 1999, that Sprint had asked him to facilitate a meeting with PeopleSoft’s senior management to discuss their difficulties and concerns regarding PeopleSoft. Mr. Fridley proposed a dinner meeting for executives of Sprint and PeopleSoft, which he and EY’s account partner and engagement

director would also attend. (Div. Ex. 315.) Mr. Fridley saw this as an opportunity to sell additional software, and a “win/win opportunity for Sprint, PeopleSoft, and E&Y.” (Id.)

On June 10, 1999, EY’s Alex Zmoira informed PeopleSoft that Sprint was interested in PeopleSoft’s Treasury module. Mr. Zmoira requested that PeopleSoft suggest a date when PeopleSoft could conduct a demonstration for Sprint. Also, EY’s project manager at Sprint would inform PeopleSoft’s account manager of the sales opportunity with Sprint. (Div. Ex. 281 at 34536.)

In June 1999, Mr. Fridley wrote to PeopleSoft:

At our last session of those E&Y Partners that routinely interact in service/working with PeopleSoft, we discussed the desirability of a regular interchange/checkpoint on how we are working together. . . . putting together a balanced scorecard that captures how we are doing together on the many dimensions that E&Y and PeopleSoft operate across. The idea we discussed was a quarterly meeting of 1 hour duration where we would review the status (and hopefully accomplishments) across the three dimensions in which we operate:

1. PeopleSoft as a full service customer of E&Y – where we provide audit, tax and consulting services to your company;
2. E&Y as a major customer of PeopleSoft (probably your largest customer in the Services industry by quite a margin); and
3. The serving of mutual customers of PeopleSoft and E&Y in the marketplace – how can we both grow our sales there – which is really important to you and me.

. . . Overall, I believe that we are working better together in the “field” and on several initiatives (i.e., Healthcare, Treasury Management, EPM, etc.). The information in the PeopleSoft closed business report seems to support that also.

(Div. Ex. 180.)

On July 22, 1999, EY’s project manager for Standard Register, James R. Mittenzwei, asked PeopleSoft to contact Standard Register on behalf of EY. “I would sure like to close this deal and make this a successful project for SRC, PeopleSoft and EY. . . . as soon as we are selected I would like to make the introductions between you and the Sr. VP’s at SRC in regards to Ecommerce and EPM.” (Div. Ex. 287 at 034601.) On July 26, 1999, Tim Schinke, PeopleSoft’s Vice President for the Midwest Region, sent Standard Register a letter that Mittenzwei had drafted endorsing EY.³³ (April 2, 2003, Tr. 57-60.)

Given the complexity, importance and value that will be achieved in your project, we continue to endorse Ernst & Young as your implementation Partner.

³³ Mr. Mittenzwei later became a principal at EY. (April 2, 2003, Tr. 57.)

EY has been a highly successful global alliance implementation provider of PeopleSoft since the early 1990's. Their proven success in running large PeopleSoft projects, streamlining business processes, understanding our products and focusing on business value are strengths of EY as an implementation service provider for large scale projects.

(Div. Ex. 500B.)

In a November 21, 1999, letter, Ms. Anderson suggested to PeopleSoft integrating two EY services into PeopleSoft to get a dynamic combination.

I think it would be [a] great idea to draft a distinct letter to communicate EY's new direction . . . and what we are investing in . . . and how [PeopleSoft] can benefit and our clients can benefit. I'd like to target specifics and send [it] to right folks as well as put together a plan to really make it happen. I believe we can [despite] the current inquiry - (I'd like a letter both aimed at [PeopleSoft] executives as well as EY account/leaders as well.)

(Div. Ex. 355.)

EY submitted a request for proposal for implementation of PeopleSoft HRMS software on February 28, 2000, which stated that EY enjoyed a lengthy, close working relationship with PeopleSoft, including joint development in several areas "including redesigning their HRMS application." (Div. Ex. 513 at 039944.) "We have developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system integrated with PeopleSoft Payroll." (Id.) The request for proposal states that EY provided more resources to test PeopleSoft's version 7.5 release than the combination of other Big Five firms, and that it developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system integrated with PeopleSoft payroll. (Id.)

From at least 1994 through 1999, EY regularly sent representatives from the PeopleSoft Service Line, expatriate services, and other units to user conferences attended by over 10,000 people, and held to generate sales of PeopleSoft's products and services. (April 1, 2003, Tr. 28-29; Div. Ex. 511 at 039897.) PeopleSoft only invited its "certified PeopleSoft business partners" to have display booths featuring their products and sales representatives in what it called the "Products and Partners Fair." (Div. Ex. 495, Tab A at 038679, Tab B at 038736, Tab C at 038846, Tab D at 038975.) EY and some four or five hundred companies paid from \$5,000 to \$40,000 to have a booth at the user conference. (April 1, 2003, Tr. 28-29.) EY considered its participation in the conference to be a marketing effort, and it advised its attendees to promote EY in all activities, network with PeopleSoft personnel and other key strategic alliance partners, and interact with current or potential clients. (Div. Ex. 511.)

PeopleSoft enlarged the focus of the 1999 Users Conference and ran an Executive Symposium for prospective customers. The new event was to help PeopleSoft's implementation partners "close hot prospects." (Div. Ex. 205 at 032443.) Each PeopleSoft partner among the "Big Six" accounting firms could bring eight people with a minimum of four prospects. EY supplied four names for the prospect dinner. (Div. Ex. 205 at 032449-50.)

On December 12, 1999, after she was aware that EY was under investigation for independence violations, Ms. Anderson informed Mr. Kavanagh that EY “would DEFINITELY be interested” in working with PeopleSoft HR marketing to develop a white paper and presentation on key human relations issues for high-level business executives. (April 2, 2003, Tr. 243-46; Div. Ex. 360 at 035358) (emphasis in original.) Based on the Guidelines and advice from EY people working on PeopleSoft audits and the legal department, Ms. Anderson believed that EY could participate in joint marketing with PeopleSoft as long as others participated. (April 2, 2003, Tr. 245-46.) However, PeopleSoft’s inquiry about EY’s participation does not mention any other firm. (Div. Ex. 360.)

On February 11, 2000, Ms. Anderson informed others at EY that PeopleSoft had asked EY to work closely with PeopleSoft in the rollout of a new PeopleSoft Professional Services Automation offering, and questioning whether the situation posed opportunities for EY inasmuch as it had experience with a similar product. (Div. Ex. 398.) A related PeopleSoft press release identified EY as a satisfied PeopleSoft customer. Ms. Anderson claims EY’s audit and legal groups approved EY’s participation in the press release, which Ms. Anderson does not consider an endorsement of an audit client’s product. (April 2, 2003, Tr. 264-66.)

Confidential Information

The evidence is that EY shared considerable proprietary, confidential business information with PeopleSoft so that PeopleSoft would reciprocate and work with EY to achieve sales. Specifically, EY provided Mr. Horne with a copy of Mr. Fridley’s PeopleSoft Business Plan Summary, dated December 1998, that described EY’s efforts to:

Continue to build strong “field” [PeopleSoft’s technical and salespeople] relationships with PeopleSoft.³⁴

Develop and execute an account plan that focuses on PeopleSoft’s growth opportunities and which ones EY can tie into and achieve market dominance.

Identify and work with PeopleSoft on new solutions that are industry specific.

(Div. Ex. 179B at 032219-20, 486 at 038547.) Mr. Fridley intended to focus on health care, services industry, PeopleSoft Select, and Treasury Management Initiative. (April 1, 2003, Tr. 205.)

In December 1998, Mr. Horne of PeopleSoft was the only outsider to participate in a two-day EY brainstorming session that focused on enhancing and defining EY’s PeopleSoft Service Line’s business plan for 1999. (April 1, 2003, Tr. 177-78, 189; Div. Ex. 363 at 035498.) The meeting dealt with confidential material. (April 1, 2003, Tr. 191.) The meeting materials

³⁴ Significant strengthening of PeopleSoft “field” relationships was a major EY achievement in fiscal year 1998. (April 1, 2003, Tr. 204; Div. Ex. 179B at 32218.)

contained the statement, “We really need to join fully with PeopleSoft because we are joined at the hip.” (Div. Ex. 363 at 035453.)

In 1999, EY sent PeopleSoft internal EY privileged and confidential sales reports for the EY’s PeopleSoft Service Line biweekly. The reports showed sales, the names of businesses that were active leads and pursuits, and information about EY’s employees. (April 1, 2003, Tr. 166-70, 172; Div. Ex. 338A.) Other internal confidential documents sent to PeopleSoft included a newsletter with information supplied by EY’s global representatives, and a list of EY’s global clients. (April 1, 2003, Tr. 171-72; Div. Exs. 338C, 338E.)

On January 1, 1999, Mr. Fridley directed others at EY:

[t]o get information on our mutual HRMS customers (PeopleSoft and EY) by industry segment as well as our target accounts; and make this information available to [PeopleSoft’s Global Alliance Manager and his boss] for internal marketing only. Stuart [Horne] and Bill [Parsons] for internal marketing only. Stuart and Bill - you will have to use the info very judiciously.

(Div. Ex. 227 at 32658.) Mr. Horne recognized that Mr. Fridley did not want other companies working with PeopleSoft to have the information. (March 31, 2003, Tr. 101.)

On May 25, 1999, Mr. Fridley gave notice to Howard Gwin at PeopleSoft that he would soon be requesting a meeting to discuss a number of “potential areas of synergy with E&Y and PeopleSoft.” (Div. Ex. 166.) In the same message, Mr. Fridley responded to a request Mr. Gwin made in October 1998, and transmitted to Mr. Gwin and Mr. Horne “a very confidential list of [EY’s] major global clients” that EY considered proprietary. (Id.) Mr. Fridley shared this highly sensitive information so that PeopleSoft could “use it as an early warning mechanism on when [PeopleSoft and EY] should align.” (Id.)

On June 9, 1999, Ms. Anderson requested that PeopleSoft give her “a list of all [its] Hospitality clients and which modules they have.” (Div. Ex. 321 at 035091.) Ms. Anderson claims she requested the information for an EY client, and that it was public information. (April 2, 2003, Tr. 211.) “This might help a client go with PeopleSoft solution[s] rather than do a packaged selection . . . I am trying to work that out.” (Div. Ex. 321 at 035091.)

EY furnished PeopleSoft with EY’s biweekly reports on sales, active customer leads, and employee utilization. (Div. Exs. 338A, 338B.) This material was marked “for internal use only,” and Mr. Fridley considered it information EY wanted to keep to itself. (April 1, 2003, Tr. 167; Div. Ex. 338C at 035170.)

EY and PeopleSoft met on December 1 and 2, 1999, to identify and line up EY salespeople with PeopleSoft’s salespeople in terms of products and industries. (April 2, 2003, Tr. 227-28; Div. Ex. 206B at 032452.) Ms. Anderson testified that the agenda item, “Align opportunities for EY via streams/industries” referred to updating the responsibilities of PeopleSoft employees. (April 2, 2003, Tr. 228-29; Div. Ex. 206B at 032452.) Ms. Anderson

claimed EY held similar meetings with all its vendors as it needed this information to plan the services it would offer and for training purposes.

I discount Dr. Hitt's testimony minimizing the significance of this sharing of information because there were few secrets in the software industry. The witness testimony and the markings on many of the documents indicate that they were considered confidential and proprietary.

Testimonials for PeopleSoft Products

From April 1998 to August 1999, PeopleSoft highlighted EY as a satisfied PeopleSoft customer in a marketing program to sell software. (April 2, 2003, Tr. 130-33, 150-60, 169; Div. Exs. 258 at 033620, 300A.) PeopleSoft chose EY because it had company name recognition, and PeopleSoft's new services industry software was suited for EY's operations. (April 2, 2003, Tr. 132, 141-42.) At PeopleSoft's invitation, Mr. Richardson participated at a major PeopleSoft sales event attended by chief financial officers and chief information officers in March 1999, as a satisfied PeopleSoft customer. (April 2, 2003, Tr. 150-01; Div. Exs. 258 at 033620, 300B.) EY expected its presentation and distribution of material would assist its sales of its consultation services. (April 2, 2003, Tr. 7-9, 11, 19; Div. Ex. 199 at 032382.)

Also, in June 1999, Mr. Richardson appeared as a customer at a PeopleSoft interactive audio conference and described how EY successfully created for itself one of the largest PeopleSoft Financials-based Service Implementations in the world. (April 2, 2003, Tr. 162-63; Div. Exs. 300A, 320 at 35080, 35082.) The PeopleSoft User Conference featured a similar session with an EY representative.³⁵ (April 2, 2003, Tr. 149.) In each instance, PeopleSoft and EY coordinated their presentations.

Based on her endeavors with Mr. Richardson, Ms. Jeffries assumed there were no auditor independence problems if PeopleSoft treated EY just like it treated any customer making a testimonial on its behalf. (April 2, 2003, Tr. 165.) Ms. Jeffries took Mr. Richardson's recommendation that EY be PeopleSoft's preferred partner for service industries to mean that Mr. Richardson wanted PeopleSoft to recommend that EY implement the software. (April 2, 2003, Tr. 165-66.) Ms. Jeffries considered that Mr. Richardson simply paid lip service to the restrictions imposed by the audit relationship. (April 2, 2003, Tr. 184.)

Health Care Initiative

EY and PeopleSoft saw the health care industry as a lucrative market for their products and services and they embarked on a Health Care Initiative to make sales.³⁶ Major health care providers, mainly hospitals, are large users of computer software programs. Beginning in

³⁵ Pursuant to their agreement, Pamela Jeffries, PeopleSoft's manager of marketing communications for service industries, communicated sales leads developed at the audio conference to Mr. Richardson on July 1, 1999. (April 2, 2003, Tr. 172-73; Div. Ex. 283.)

³⁶ PeopleSoft considered EY to be the strongest health care implementer, and it wanted to convince EY that PeopleSoft software was a good solution for EY clients. (April 7, 2003, Tr. 15-16.)

November 1998, EY began meeting with PeopleSoft's senior management on what could be done to improve each company's share of the health care portion of the services industry market. (Div. Ex. 199 at 032385.) At EY's request, PeopleSoft arranged for EY consultants to meet with PeopleSoft sales representatives in late 1998. (March 31, 2003, Tr. 59; Div. Ex. 313.) In one sales initiative, EY met with PeopleSoft health care salespeople and made specific assignments in terms of "geography and accounts to directly target/prioritize opportunities." (Div. Ex. 199 at 032385.)

In 1998 and 1999, PeopleSoft's health care unit alliance manager organized meetings of PeopleSoft's salespeople trying to sell software to an account with salespeople from EY or another service firm partner who interacted with that account. (April 7, 2003, Tr. 6-12.) The goal was to share information and to establish a working relationship that would result in sales for PeopleSoft and EY. (April 7, 2003, Tr. 12.) PeopleSoft also arranged many meetings in regions, states, and cities where its sales force and product experts would meet with EY partners to share information about accounts. (April 7, 2003, Tr. 12-14.)

PeopleSoft prepared a "1999 Master Account Plan PeopleSoft, Inc., Ernst & Young LLP," which described the mission of its relationship with EY as growing the list of joint clients by, among other things, developing strong local relationships between the two firms. (Div. Ex. 165 at 032029-30). The plan refers to the "E&Y PeopleSoft practice," to EY as a "Software partner," and that "because of [its audit] relationship E&Y is committed to helping PeopleSoft grow and become a successful company." (Div. Ex. 165 at 032030.) The reference to "grow" is to increase PeopleSoft sales. (March 31, 2003, Tr. 130-31.) Under "Strategic Market Initiatives – Health Care," the plan describes an effort headed by the Health Service Line leaders at both PeopleSoft and EY to "educate E&Y Target Account leaders on the benefits that PeopleSoft products can bring to their clients." (Div. Ex. 165 at 032034.) Under "Other Markets - Secondary Initiatives," PeopleSoft envisioned working with EY "opportunistically in the larger market retail sector," and setting up a planning meeting with EY Revenue team leaders and others "to discuss opportunities in insurance and banking." (Div. Ex. 165 at 032036.)

To assist PeopleSoft meet its revenue targets for implementations, Ms. Duginski, notified thirteen PeopleSoft salespeople on January 18, 1999, that EY had identified contact people for PeopleSoft to work with to help EY close business deals. (Div. Ex. 173, 190 at 032342; April 7, 2003, Tr. 54-58.) Ms. Duginski wrote:

E and Y must help PeopleSoft close 7 to 10 healthcare deals in the next 45 days in order for them to reach their numbers. They know they have more success in that endeavor when [they] help us in the sales cycle. (According to the closed business report from the last 12 months, all six deals in which they were involved in the sales cycle resulted in their winning the implementation.) **They realize they will have more success in their sales cycle if they help us with ours.** Let them help in your sales cycle.

(Div. Ex. 173) (emphasis in original.) These EY contacts would identify EY's experience in the account, devise a joint strategy for EY and PeopleSoft "to win," and when necessary, sell the partner responsible for the account why PeopleSoft is the right solution. (Id.) Mr. Horne

believed Ms. Duginski's message indicated that "cooperation in the sales cycle is mutually beneficial." (March 31, 2003, Tr. 105.)

In January 1999, a PeopleSoft salesperson in Texas informed an EY partner of the health care accounts in Texas where he was focusing his sales efforts. (April 7, 2003, Tr. 50-51; Div. Ex. 297S.) In late January 1999, EY made a joint sales presentation with PeopleSoft to Adventist Hospital. PeopleSoft, the vendor, was present to support EY's two-day presentation. (March 31, 2003, Tr. 210-12.) Mr. Flury believed that PeopleSoft won the SI contract, which would have been for two to eight times the \$1.5 million software cost. (March 31, 2003, Tr. 213-14.)

On May 27, 1999, Mr. Horne asked EY for the names of EY personnel with contacts at eight health care providers that PeopleSoft intended to target. PeopleSoft sought the information to see "if we can leverage the relationships the large [systems implementers] have with these [Health Plan providers]." (March 31, 2003, Tr. 138-39; Div. Ex. 316.)

On July 21, 1999, Mr. Fridley forwarded to several people at EY an e-mail from Zan Calhoun, an EY partner in health care, suggesting, among other things, joint sales visits by EY and that EY "swarm the accounts with PeopleSoft, under the assumption that there is plenty of money there for all of us and if we help them, they'll help us. I think we can do that without any audit relationship issues." (April 2, 2003, Tr. 214-18; Div. Ex. 450A.) Mr. Fridley forwarded Mr. Calhoun's ideas, noting that some of Mr. Calhoun's ideas for the 2000 business plan were "very good." Mr. Fridley did not state that the independence rules prohibited joint sales by an auditor and its client. (April 2, 2003, Tr. 216-17.) According to Ms. Anderson, EY did not follow through on Mr. Calhoun's recommendations. (April 2, 2003, Tr. 216-18.)

PeopleSoft Express Initiative

EY's PeopleSoft 1999 Business Plan included a strategy to enable EY to become dominant in PeopleSoft Express. (Div. Ex. 199 at 032370, 032375, 032386-87.) An undated EY document titled, "PeopleSoft Select/Express Information Guide," refers to two meetings that discussed an operating agreement for "Partnering" with PeopleSoft and an agreement in principle to work together for PeopleSoft Express implementations. (Div. Ex. 231 at 032687, 032706.) PeopleSoft Express involved a bundling of software to sell to small companies where the software installation did not require customization. (April 2, 2003, Tr. 26.) According to Mr. Fridley, PeopleSoft was making sales based on leads furnished by EY, and then PeopleSoft was doing the implementation. The "operating agreement really referred to . . . rules for the road in terms of the exchanging leads. Because if all [EY] were doing was giving them leads and they were selling, then that wasn't going to last very long." (April 2, 2003, Tr. 29.) Mr. Fridley testified that EY and PeopleSoft were to share leads and then make independent selling efforts; however, the document specifies "an agreement with PeopleSoft Inc.'s national leadership to go to market together" and aggressive market efforts "independently" and "[w]ith PeopleSoft." (April 2, 2003, Tr. 36; Div. Ex. 231 at 032708-9.) In March 1999, EY and PeopleSoft met to evaluate EY's "PeopleSoft Express" project. (March 31, 2003, Tr. 121-29; Div. Ex. 176 at 032166.) PeopleSoft used the term "express" "to describe [PeopleSoft's] rapid implementation methodology that leverages 'Partners' as integrators." (Div. Ex. 176 at 032177.) The materials

prepared for the meeting indicate that with respect to the procedure for agreement on EY's changes to the Statement of Services ("SOS"):

PeopleSoft Inc. (Joe Mangano) will want to review all changes to an SOS that will be used for a client that PeopleSoft has discussed implementation scope and pricing with, and subsequently forwarded to E&Y. This is to ensure that we are not sending mixed messages to the potential clients.

PeopleSoft Inc. will also consider incorporating changes that E&Y suggests to assist in the efforts of going to market with similar offerings.

No review is necessary for an SOS that E&Y will be using for clients that they are contracting with independent of PeopleSoft Inc.

(Div. Ex. 176 at 32190.) Mr. Fridley claimed that to the best of his knowledge no leads were shared because new management at PeopleSoft abandoned the effort. (April 2, 2003, Tr. 35.) However, the fact that EY was dissatisfied with the arrangement indicates that some activities had occurred. Also, if nothing had happened, there would be no need for an evaluation session.

Services Industry Initiative/BERT

The services industry consists of companies that offer services instead of products, such as law firms, accounting firms, software firms, and manpower type agencies. (April 2, 2003, Tr. 6-7.) EY considered itself a services company. (March 31, 2003, Tr. 155.) During the relevant period, EY wanted to package the knowledge it had gained implementing PeopleSoft's products in-house and offer those services to customers it had in the services industry. (*Id.*) EY called its internal system BERT. EY and PeopleSoft engaged in serious discussions and planning, but BERT never went into effect.

In 1999, EY embarked on a Services Industry Initiative, which included elevating "the PeopleSoft/E&Y relationship to premier status," aligning "with PeopleSoft's sales force in the field to drive sales and utilize best practices to dominate/close service industry opportunities," and working with PeopleSoft on product enhancement. (Div. Ex 228 at 032662.) Mr. Fridley asked to meet with Mr. Gwin at PeopleSoft in July 1999, "for a quarterly update and to review EY's plans to invest in the Services Industry with PeopleSoft." (Div. Ex. 328.) Mark Richardson at EY sent PeopleSoft a discussion draft of a "Business Services Industry Initiative, June 1999." (Div. Ex. 258.) The twenty-one-page slide presentation was the subject of a phone call with PeopleSoft's Director of Product Development. (March 31, 2003, Tr. 156; Div. Ex. 258.) The presentation noted that: (1) "EY has significant intellectual capital and many experienced resources focused on the services industry that can help PeopleSoft enhance its products and increase sales;" (2) EY can help accelerate PeopleSoft's sales; (3) PeopleSoft and EY should work together on a Business Services Industry Initiative; (4) PeopleSoft and EY can generate significant new revenue from growth in the services industry and access to new accounts; (5) working together will lead to cross-selling other EY services and PeopleSoft software; and (6) PeopleSoft and EY should work together to build and deliver a PeopleSoft and EY Services Industry solution. (Div. Ex. 258 at 033616-17, 033623, 033625.)

In April 1999, Mr. Fridley passed on to others at EY, including Mr. Frick, notes from a meeting with PeopleSoft that considered what EY would like to see develop with PeopleSoft “as partnering organizations” around opportunities for both companies in the Services Industry. (Div. Ex. 236.) Mr. Richardson believed the following actions were desirable in the “PeopleSoft/EY marketing and sales partnership:”

- a. E&Y to be the preferred partner for Services Industries
- b. An ongoing dialogue regarding products, tools, etc.
- c. PeopleSoft to deliver presentations regarding [PeopleSoft] solutions within the E&Y organization
- d. PeopleSoft to assist with E&Y presentations

(Div. Ex. 236 at 032749.) Mr. Richardson committed EY to be the featured customer at a PeopleSoft “Service Supply Chain” audio conference. (*Id.*) Mr. Frick does not consider that meetings of PeopleSoft and EY sales forces to identify common realistic sales prospects would raise concerns about joint sales and independence problems. (March 25, 2003, Tr. 109.)

Treasury Initiative

PeopleSoft had an initiative to interest software implementers in its Treasury Management Module. Mr. Fridley believed that this PeopleSoft initiative presented an opportunity for EY. In November 1998, Mr. Fridley requested and received from PeopleSoft a confidential list of companies that had purchased PeopleSoft’s Treasury Management module. (Div. Ex. 171.) Mr. Fridley intended to use the confidential customer list to “get started on a target list of prospects for EY.” (*Id.* at 032121.) In December 1998, Mr. Fridley directed the EY consultants that:

We need to smartly go to each of the industry segments where we have gaps and have someone from the PeopleSoft service line help us grow that particular market. . . . we need to look at treasury and decide whether or not this is an area where we would like to dominate so we can put forth plans and really get there. Mark Richards will be doing some co-development with PeopleSoft.

(Div. Ex. 364 at 035533.)

On March 3-4, 1999, Mr. Fridley, Mr. Frick, and Phillippe Paradis attended a meeting of representatives from the EY practice groups that had PeopleSoft as a client to consider the EY PeopleSoft 1999 Business Plan.³⁷ (Div. Ex. 199 at 032369, 032408.) The 1999 Business Plan projected refocusing the PeopleSoft Service Line on, among other things, achieving dominance in implementing PeopleSoft’s Treasury Management Module. (Div. Ex. 199 at 032375.) The Treasury Management Module proposed having EY “[w]ork with PeopleSoft’s senior

³⁷ Mr. Paradis worked with Mr. Frick on the PeopleSoft audits. Mr. Paradis became an EY partner in 1998 or 1999. (March 25, 2003, Tr. 18.)

management to drive rapid sales (probably through SWAT force and/or ‘one to many’ center selling approach).” (Div. Ex. 199 at 032380.)

In approximately May 1999, EY named a senior partner to EY’s effort to make sure EY was doing all the right things and PeopleSoft Treasury Management Module was successful. EY and PeopleSoft representatives met in June 1999. (Div. Ex. 286 at 034588-89.) The goal was “to develop joint [EY-PeopleSoft] treasury strategy and plans.” (*Id.*) EY was “looking forward to continuing a successful E&Y-PeopleSoft relationship in the [PeopleSoft Treasury] arena.” (*Id.*) EY’s Mr. Zmoira urged that the “to do” list that came out of the June meeting on how EY and PeopleSoft planned to work together on sales be treated with extreme confidentiality. (Div. Ex. 172 at 032129.)

There is no evidence that EY carried through on its proposed joint marketing program with PeopleSoft. EY argues that the testimony of Mr. Horne is that the Treasury Management Initiative did not occur. (EY Brief at 90-91.)

IV. CONCLUSIONS OF LAW

Applicable Legal Standards

The Division alleges that EY violated Rule 2-02 of Commission Regulation S-X, caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act and Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1 and 14a-3, and violated Section 4C of the Exchange Act and Rule 102(e) of the Commission’s Rules of Practice.

Various provisions of the federal securities statutes mandate that financial statements incorporated in Commission filings be certified by an independent public or certified accountant. Sections 7(a) and 10(a) of the Securities Act and Items 25, 26, and 27 of Schedule A to the Securities Act; Sections 12(b), 13(a), 14(a), and 17(e) of the Exchange Act; Section 30(i) of the Investment Company Act of 1940; and Section 203(c) of the Investment Advisers Act of 1940. The Commission has used its authority to define “accounting, technical, and trade terms” under Section 19(a) of the Securities Act and Section 3(b) of the Exchange Act to define the term “independent.”

Congress granted the independent auditor an important public trust in the framework it enacted for the federal regulation of securities.³⁸ Auditors have been characterized as “gatekeepers” to the public securities markets that are crucial for capital formation.

³⁸ See Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 2d Sess., Federal Regulation and Regulatory Reform 35 (Subcomm. Print 1976) (Moss Report); “Relationships Between Registrants and Independent Accountants,” Accounting Series Release (“ASR”) No. 296 (Aug. 20, 1981); Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 1, § 220.03 (American Inst. of Certified Pub. Accountants 1999).

The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

As we have stated, the federal securities laws make "independent auditors the 'gatekeepers' to the public securities markets. This statutory framework gives auditors both a valuable economic franchise and an important public trust. Within this statutory framework, the independence requirement is vital to our securities markets."

KPMG Peat Marwick LLP, 74 SEC Docket 384, 406 & n.54 (Jan. 19, 2001) (citation omitted), reconsideration denied, 74 SEC Docket 1351 (Mar. 8, 2001), petition for review denied, 289 F.3d 109 (D.C. Cir. 2002).

Throughout its history, the Commission has stressed that auditor independence is essential to the notion that an auditor's opinion on financial statements provides investors with critical assurance that the financial statements have been subject to a rigorous examination by an impartial and skilled professional.

The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management. Because it is the issuer's responsibility to file independently audited financial statements, if the auditor is not independent, the issuer's filings are deficient under the securities laws.

Proposed Revision of Commission's Auditor Independence Requirements, 65 Fed. Reg. 43,148, 43,150 (July 12, 2000) in evidence as EY Ex. 1309. The courts have supported the Commission's consistent public assertion that auditor independence is crucial to the statutory scheme which aims to protect the vitality of the capital markets. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984); Cornucopia Gold Mines, 1 S.E.C. 364, 366-67 (1936).

EY acted through its partners, officers, and employees and their actions are imputed to the firm. Mallis v. Bankers Trust Co., 717 F.2d 683, 689 n.9 (2d Cir. 1983) ("It is a basic tenant of the law of agency that the knowledge of an agent, or for that matter a partner or joint venturer, is imputed to the principal."); see also C.E. Carlson, Inc. 859 F.2d 1429, 1435 (10th Cir. 1988); A.J. White & Co., 556 F.2d 619, 624 (1st Cir. 1977); SEC v. Manor Nursing Center Inc., 458 F.2d 1082, 1096-97 (2d Cir. 1972).

Rule 2-02(b) of Commission Regulation S-X and GAAS

Rules 2-01 and 2-02 of Regulation S-X are the Commission's two key rules on auditor independence. 17 C.F.R. §§ 210.2-01, .2-02. Rule 2-01(b) specifies that an accountant must be independent to be recognized by the Commission. In this proceeding, the Division seeks to

apply Rule 2-01 before it was amended in 2000.³⁹ (Div. Initial Brief at 8 n.2 (citing KPMG, 74 SEC Docket at 407 n.56).)

Rule 2-01 stated:

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person . . . (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he [sic], his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest . . .

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationship existing in connection with the filing of reports with the Commission.⁴⁰

17 C.F.R. § 210.2-01(b), (c) (Apr. 1, 2000). In circumstances where the relationship at issue is not otherwise delineated, the basic test for auditor independence that has emerged from Commission pronouncements is:

[W]hether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having neither mutual nor conflicting interests with its audit client and as exercising objective and impartial judgment on all issues brought to the auditor's attention.

KPMG, 74 SEC Docket at 411 n.74 (Jan. 19, 2001) (citing FRR 50, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,450 at 62,307-08, and Office of the Chief Accountant, Securities and Exchange Commission, Staff Report on Auditor Independence, 2 (1994)).

Independence in fact refers to a state of mind, a subjective condition not easily demonstrated. The Commission has held that independence in fact and appearance are equally important under the securities laws because audits must not only produce more reliable financial information, but investors must believe that they do, so that auditors must appear to be free of biases and prejudices that may impair their objectivity. KPMG, 74 SEC Docket at 409-10. For this reason, a showing of the auditor's mental state and the fact that the audit was properly performed do not establish that the auditor was independent. Id. at 415-16.

³⁹ All references are to Rule 2-01 before it was amended in 2000.

⁴⁰ The preliminary note to the current Rule 2-01 states that the Rule "is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance." It seems reasonable that the purpose was the same prior to 2000.

The Commission has applied an appearance of independence standard since the enactment of Rule 2-01(b). KPMG, 74 SEC Docket at 407 n.58 (citing 2 John L. Carey, The Rise of the Accounting Profession to Responsibility and Authority: 1937-1969, 176-77, 180 (AICPA 1970) (“Thus, as commentators have recognized, this Commission has, from its beginning, refused to accept ‘certificates’ from auditors whose relations with clients would appear to the public to create conflicts of interest.”)); see also Codification of Accounting Standards and Procedures, Code of Professional Conduct No. 2, ET § 55.01 (American Inst. of Certified Pub. Accountants 1999) (“Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.”).

Rule 2-02(b)(1) of Regulation S-X requires that the accountant’s report state whether the audit was made in accordance with GAAS. The American Institute of Certified Public Accountants (“AICPA”), the professional organization representing accountants, issues pronouncements on GAAS in Statements on Auditing Standards issued by the AICPA’s senior technical body, the Auditing Standards Board. The AICPA has stated: “[i]ndependent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.” Codification of Accounting Standards and Procedures, Statement of Auditing Standards No. 1, § 220.03 (American Inst. of Certified Public Accountants 1999). Financial statements filed with the Commission must satisfy the Commission’s requirements where those rules are stricter than AICPA standards. KPMG, 74 SEC Docket at 409 & n.66.

Codification of Financial Reporting Policies - Section 602.02.g

The Commission’s Codification of Financial Reporting Policies (“Codification”), Section 600, Matters Relating to Independent Accountants, is an authoritative discussion of auditor independence and contains the Commission’s responses to various scenarios on the subject. Codification, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,251 et seq. The accounting industry has long relied on the Codification for guidance. Section 602.02.g of the Codification discusses examples of business relationships between an auditor and its audit clients that impact the auditor’s independence.⁴¹

Section 602.02.g of the Codification specifies that:

Direct and material indirect business relationships, other than as a consumer in the normal course of business, with a client . . . will adversely affect the accountant’s independence with respect to that client. Such a mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interest would, to some extent, be dependent upon the client. In addition to the relationships specifically prohibited by Rule 2-01(b), joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests, (except for immaterial landlord-tenant relationships) and sales by the accountant of items other than professional services are examples of other connections which are also included within this classification.

⁴¹ Section 602.02.g on business relationships has been renumbered as Section 602.02.e.

Commission's 1989 Response to Petition of Several Accounting Firms

The parties both rely on a February 14, 1989, Commission response to a petition filed by Arthur Andersen & Co., Peat Marwick Main & Co., and Price Waterhouse to modify Section 602.02.g of the Codification to incorporate a materiality standard when evaluating auditor independence in a prime or subcontract relationship (or similar cooperative service arrangement) ("Commission's 1989 Response"). Arthur Andersen & Co., SEC No-Action Letter (Feb. 14, 1989), *available at* <http://www.sec.gov/info/accountants/noaction/aaartan1.htm>, in the record as Div. Ex. 129. In denying the petition, the Commission stated that:

The Commission has recognized that certain situations, including those in which accountants and their audit clients have joined together in a profit-seeking venture, create a unity of interest between the accountant and client. In such cases, both the revenue accruing to each party in the prime/subcontractor relationship and the existence of the relationship itself create a situation in which to some degree the auditor's interest is wedded to that of its client. That interdependence impairs the auditor's independence, irrespective of whether the audit was in fact performed in an objective, critical fashion. Where such a unity of interests exists, there is an appearance that the auditor has lost the objectivity and skepticism necessary to take a critical second look at management's representations in the financial statements. The consequence is a loss of confidence in the integrity of the financial statements. Application of the type of materiality standard proposed in the petition would fail to protect adequately against the loss of independence and the appearance of auditor partiality that result from this type of relationship.

. . . In addition, the Commission would not raise an independence question if the party receiving the combined services contracted separately with the auditor and the audit client for their respective portions of the service engagement, thereby separating the accountant's liability and contractual obligations from those of its audit client (unless the arrangement is considered to be a material indirect business relationship).

. . . In summary, the closeness and unity of interest inherent in joint business ventures . . . between an auditor and its audit client, rather than just the amount of revenues derived from such a relationship, creates a mutuality of interest between auditor and client and may cause financial statement users to question the auditor's objectivity.

Id.

EY's Broad Legal Challenges

EY argues that there is no legal or factual basis for a finding that EY violated any statute or Commission rule or for the imposition of any sanctions against EY. Two of EY's legal arguments are that: (1) the Commission cannot sanction EY under Section 4C or Rule 102(e) for

any conduct that occurred prior to May 20, 1997, five years prior to issuance of the OIP in an earlier proceeding;⁴² and (2) it would violate due process and fundamental fairness to sanction EY in view of its “good-faith attempts to comply with vague, open-ended rules that defy interpretation.” EY cites Section 602.02.g of the Codification, the Commission’s 1989 Response, two records of oral independence advice given by the Office of the Chief Accountant, and materials on the Commission’s Web site titled “Independence Reference Materials.” (EY Brief at 96-101, 111-23.)

The Division argues that Johnson does not apply to any of the remedies it recommends. It notes that in a consent filed in connection with registration statements that PeopleSoft filed on January 31, 1997, EY affirmed that it conducted independent audits in 1994, 1995, and 1996, and that audit engagements continue until they are terminated. (Div. Reply Brief at 20 n.14.) It notes further that there is not one case that supports EY’s position on disgorgement. (Id. at 21.) The Division considers Johnson inapplicable because in that case the court: (1) applied the limitations of 28 U.S.C. § 2462 to a proceeding brought under Section 15(b) of the Exchange Act, while this proceeding involves Rule 102(e) of the Commission’s Rules of Practice and Section 4C of the Exchange Act; (2) found no showing of a current need for relief while here the recommended sanctions are remedial measures needed because of the risk to the public; and (3) stated that 28 U.S.C. § 2462 does not apply to disgorgement or restitution. (Id. at 23.)

Ruling – Statute of Limitations

EY’s interpretation of the holding in Johnson has no impact on this proceeding because EY’s conduct with PeopleSoft in connection with EY/GEMS for PeopleSoft and in connection with implementing PeopleSoft software continued well after May 20, 1997. The Licensing Agreement between EY and PeopleSoft was effective on October 1, 1994, but EY granted its last license for EY/GEMS for PeopleSoft under its Licensing Agreement with PeopleSoft in September/October 1999. EY Consulting continued activities with PeopleSoft in connection with implementing PeopleSoft software until EY sold its Consulting practice to Cap Gemini on or about May 25, 2000.

Ruling - Vagueness

I reject EY’s defense that the Commission’s rules on auditor independence are so vague as to defy interpretation, and that EY made a good faith attempt to comply with them. Rules 2-01 and 2-02 of Regulation S-X and Section 602.02.g of the Codification are clear and unambiguous. EY understood the independence rules in 1995, because it agreed to abide by them. On March 13, 1995, the United States District Court for the Northern District of Texas

⁴² The parties entered into a tolling agreement, which covered the period between the dismissal of an earlier OIP issued May 20, 2002, and this one. (EY Brief at 96 n.34.) Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996), held that the Commission could not impose a censure and six-month suspension because 28 U.S.C. § 2462, which imposed a five-year statute of limitations on “an action, suit, or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise,” was applicable in a Commission administrative proceeding.

entered a Final Order that contained the terms of a settlement where EY agreed with respect to its future activities to:

comply with standards and guidelines issued by the Commission and the accounting profession regarding the independence of public accountants that audit the financial statements of any issuer whose securities are registered with the Commission pursuant to Section 12 of the [Exchange Act] relating to loans, leases, and other business relationships with audit clients as specified in the Codification of Financial Reporting Policies Section 602.02.g.

SEC v. Ernst & Young, Civil Action No. 3-91-2267-X (N.D. Tx. 1995) (cited in the record as Div. Ex. 246). Based on the settlement, it seems reasonable to assume that EY understood the Commission's rules on auditor independence between 1995 and 2000.

EY's claim does not meet the established standard for showing that it did not have fair notice of what was prohibited by the Commission's independence rules. "Due process requires only that laws give a 'person of ordinary intelligence a reasonable opportunity to know what is prohibited.'" Michael J. Marrie, 80 SEC Docket 2694, 2720-21 (July 29, 2003) (citing Grayned v. City of Rockford, 408 U.S. 104, 108 (1972)). The Division has met the general requirement that a person must have received reasonable notice of what the government regulation required of the regulated public. Gen. Elec. V. EPA, 53 F.3d 1324, 1328-34 (D.C. Cir. 1995); Satellite Broad. Co. v. FCC, 824 F.2d 1, 3-4 (D.C. Cir. 1987); see also KPMG, LLP v. SEC, 289 F.3d 109 (D.C. Cir. 2002); United States v. Chrysler Corp., 158 F.3d 1350, 1354-57 (D.C. Cir. 1998); Upton v. SEC, 75 F.3d 92 (2d Cir. 1996); Timpinaro v. SEC, 2 F.3d 453 (D.C. Cir. 1993); Gates & Fox v. OSHRC, 790 F.2d 154 (D.C. Cir. 1986).

The Commission has stated that:

[d]isciplinary rules, like Rule 102(e), long have withstood vagueness challenges because professionals are deemed to know the standards that govern their conduct. The standards we enforce in this matter, basic concepts of GAAS such as the duties to exercise due care, to evaluate whether audit conclusions are supported by sufficient competent evidential matter, and to bring to the work an appropriate level of professional skepticism, are standards to which all accountant must adhere and which any accountant can be expected to understand.

Michael J. Marrie, 80 SEC Docket 2694, 2721 (July 29, 2003) (citing United States v. Hearst, 638 F.2d 1190, 1197 (9th Cir. 1980), cert. denied, 451 U.S. 938 (1981) and Crimmins v. American Stock Exchange, Inc., 368 F. Supp. 270, 277 (S.D.N.Y. 1973), aff'd, 503 F.2d 560 (2d Cir. 1974)).

Did EY/GEMS for PeopleSoft Violate the Independence Rules?

Direct or Material Indirect Business Relationship

Section 602.02.g of the Codification prohibits a direct and material indirect business relationship between an auditor and a client, unless the auditor is a consumer in the normal course of business. I will consider first whether EY and PeopleSoft had a direct or material indirect business relationship and, if that is true, whether EY was a consumer in the normal course of business.

The Division believes that the evidence establishes that EY and PeopleSoft engaged in a joint venture to create EY/GEMS for PeopleSoft and that EY and PeopleSoft openly promoted the product and touted their joint relationship with respect to it. (Div. Brief at 17-21.) The Division cites the expert testimony of Dr. Carmichael and Walter Rush, III in support of its position.⁴³ Dr. Carmichael views the Licensing Agreement as a direct business relationship, and that the joint involvement of EY and PeopleSoft in revenue generating activities was known to potential users of PeopleSoft financial statements by, among other things, EY's press release announcing the Licensing Agreement and other press reports. (Div. Exs. 242, 741 at 10-12.) Dr. Carmichael concluded that "[t]he joint business activity of development and marketing of EY/GEMS for PeopleSoft impaired EY's audit independence, and as a result, EY's audits of PeopleSoft's financial statements were not made in accordance with GAAS." (Div. Ex. 741 at 10.)

Mr. Rush believes that the Licensing Agreement violated the independence rules because it: (1) constituted a direct business relationship between EY and PeopleSoft; (2) created a mutuality of interest; (3) created a close identity in fact and appearance; (4) had important elements of partnering; and (5) did not involve a consumer in the normal course of business. (Div. Ex. 748 at 7-14.)

EY strenuously denies that EY/GEMS for PeopleSoft was a joint product. (EY Brief at 11-27.) EY contends that it developed and marketed EY/GEMS for PeopleSoft, and provided technical support. EY contends that it was allowed to use "a PeopleSoft development tool" to modify its existing GEMS product under Section 602.02.g of the Codification, which allows an

⁴³ When he testified, Dr. Carmichael was the Director of the Center for Integrity in Financial Reporting at Baruch College, City University of New York, where he was the Wollman Distinguished Professor of Accountancy. Dr. Carmichael has a PhD in Accountancy, and is a CPA and a Certified Fraud Examiner. He is the author and co-author of numerous textbooks and scholarly articles. (Div. Ex. 741, Ex. 1.) Dr. Carmichael is now the Chief Auditor and Director of Professional Standards at the Public Company Accounting Oversight Board.

Mr. Rush has been a CPA for thirty-five years and is presently licensed in California and Colorado. Mr. Rush was a senior staff member of the Commission for two years and a partner with Coopers & Lybrand, the predecessor of PricewaterhouseCoopers for twenty years. Mr. Rush was the Northwest Regional Director of Accounting, Auditing, and SEC Reporting at Coopers & Lybrand. (Div. Ex. 748.)

auditor to purchase or license products from an audit client “as a consumer in the normal course of business.” (EY Brief at 3.) EY maintains that EY/GEMS for PeopleSoft is not a combination or packaging of EY and PeopleSoft products; rather, EY simply used PeopleTools. EY argues that even if EY/GEMS for PeopleSoft were a combination, the rules do not prohibit a bundling of fragments of EY and PeopleSoft products. Finally, EY argues that the Licensing Agreement specifies that it does not create a joint venture or joint ownership, and the royalty provisions do not change the intent of the parties. (EY Brief at 11-27.)

EY’s experts, Dr. Hitt and Mr. Mooney, represent that licensing PeopleTools was a normal business practice for PeopleSoft and cite technology practices in “today’s world,” but they do not cite any situation where an auditor licensed development software from its audit client. (EY Exs. 1310 at 11-12, 1311 at 11-12.) In addition, Dr. Hitt stressed that the Licensing Agreement provisions were standard in the software industry, and that persons familiar with the industry knew that EY/GEMS for PeopleSoft was not a joint product, and the persons “with a modest understanding of the software industry” would not conclude that partnering and alliance endeavors indicated a legal partnership or joint development or marketing effort. (EY Ex. 1310 at 12-20.)

However, the standard in assessing independence is not the perception of a specialized group of people. Rather, the standard is whether EY and PeopleSoft shared a mutual interest in the success of EY/GEMS for PeopleSoft and acted together to promote the product so that a reasonable investor with knowledge of all the facts would conclude that EY was closely identified in fact and appearance with its audit client. (Div. Ex. 748 at 9-10 (citing Codification Section 602.02.g).) Moreover, at least two people at PeopleSoft with industry experience were concerned due to EY’s status as PeopleSoft’s auditor. Ms. Gonzalez voiced concerns to her supervisor and Mr. Horne believed that the revenue sharing arrangement violated EY’s Guidelines on auditor independence. (March 24, 2003, Tr. 18-19, March 31, 2003, Tr. 158-59.)

Finding

The Licensing Agreement between EY and PeopleSoft created a direct business relationship. The following provisions of the Licensing Agreement created an identity or mutuality of interest between EY and PeopleSoft: (1) EY’s payment of royalties of the greater of a base of \$300,000 or actual royalties on product sales or renewals; (2) PeopleSoft’s agreement to provide EY with technical support to assist product development; (3) PeopleSoft’s right of final approval over release of EY/GEMS for PeopleSoft and how it was priced; (4) PeopleSoft’s right to approve marketing materials prepared by EY; (5) the right of EY to use PeopleSoft’s trademark to market materials; and (6) the requirement that EY obtain signed sublicense agreements from each end-user of EY/GEMS for PeopleSoft prior to delivery of the product. (Div. Exs. 121.) The terms of the Licensing Agreement created a situation where the success of EY/GEMS for PeopleSoft was in the best interests of both EY and PeopleSoft. The greater the sales of EY/GEMS for PeopleSoft, the higher the royalties that EY paid to PeopleSoft.⁴⁴ Certain

⁴⁴ There is no indication that the computer processing situation described in the Codification, which EY claims is analogous, involved an agreement for royalties or any of the other features

provisions of the Licensing Agreement considered separately, such as the royalty provisions, EY's use of the PeopleSoft logo and trademark for marketing purposes, and PeopleSoft's right to approve the final product and give input on the product price individually, support a joint business venture finding. Considering the totality of the Licensing Agreement, the evidence is overwhelming that EY/GEMS was a joint product. (Div. Ex. 121.)

The evidence is persuasive that EY/GEMS for PeopleSoft was much more than a bundling of fragments and that EY did more than use PeopleTools for development purposes. Standing alone, EY/GEMS for PeopleSoft provides significant indicia that cause it to be considered a joint business venture. (March 24, 2003, Tr. 108.) “[W]e approached PeopleSoft with the idea of developing a version of EY/GEMS in their development tool which would be completely integrated with their HRMS. The solution was beneficial for both sides as mutual clients would have the integrated system with the same look and feel for data entry and processing, as well as real-time data access.” (Div. Ex. 126 at 031933.) EY/GEMS for PeopleSoft is the result of putting together EY's proprietary EY/GEMS software and PeopleSoft's proprietary product, HRMS using PeopleTools into a single integrated system. (March 21, 2003, Tr. 245; Div. Ex. 127 at 031943-44.) Persons acquiring EY/GEMS for PeopleSoft received material that listed the program's functions and identified those that were part of PeopleSoft. (Div. Exs. 412 at 036201-2, 531 at 040778-79.) The use of PeopleTools to create screens always involves the use of PeopleSoft's proprietary language PeopleCode. (March 24, 2003, Tr. 120-21, 144-46.) Pursuant to the Licensing Agreement, PeopleTools was incorporated into EY/GEMS for PeopleSoft and distributed to end-users. (Div. Ex. 121 at ¶ 2-b.) EY already had access to PeopleTools as part of its PeopleSoft HRMS license and as an implementation consultant, but it needed an additional license to distribute PeopleTools as part of EY/GEMS for PeopleSoft. (March 28, 2003, Tr. 82.)

The EY/GEMS for PeopleSoft developers succeeded in producing a product that would “share common functionality and databases and adhere to the standards of the PeopleSoft application.” (Div. Ex. 591.) In application, “the user would only have to log on to one application to be able to access both the PeopleSoft delivered screens and the EY/GEMS screens.” (March 24, 2003, Tr. 171.) The log-on was accomplished through PeopleSoft HRMS. (EY Brief at 14.) The screen would show the standard PeopleSoft tool bars, menu items, and functionality. A double-click on the PeopleSoft icon would bring up EY/GEMS for PeopleSoft as a menu option.⁴⁵ (March 24, 2003, Tr. 143-62, 168-71; Div. Ex. 618 at 043632.)

The intellectual assets of EY and PeopleSoft are the integral components of the product EY/GEMS for PeopleSoft. Knowledgeable people described EY/GEMS for PeopleSoft in terms that reasonable people would interpret as indicating a joint business venture or joint product. An EY partner characterized EY/GEMS for PeopleSoft as an effort “to port the EY/GEMS product to the PeopleSoft platform.” (Div. Ex. 198 at 032364.) The result was that EY's GEMS

contained in the Licensing Agreement. The factual situation set out in the Codification does not describe the agreement for services. Codification, Section 602.02.g, Example 1.

⁴⁵ A user also has to click “OK” to verify data base type and sign-on. Once in PeopleSoft, the user would click “Start” and see the menu options, one of which is “EY/GEMS for PeopleSoft.” (Div. Ex. 618 at 043632.)

application interfaced seamlessly with PeopleSoft's HRMS/Payroll product. (March 21, 2003, Tr. 126; Div. Ex. 652 at 043792.) Dr. Hitt described EY/GEMS for PeopleSoft as "a software application that complemented the capability of the PeopleSoft Human Resources Management System (HRMS) to enable end users, typically corporate human resource professionals, to perform a variety of tax calculations, compensations calculations, and recordkeeping activities relating to expatriate employees." (EY Ex. 1310 at 2.) Ms. Gonzalez considered that "it was made with PeopleTools so that made it kind of [a] joint product." (March 24, 2003, Tr. 108.)

EY and PeopleSoft viewed EY/GEMS as mutually beneficial. (March 24, 2003, Tr. 15, 22-29, 64-65.) EY projected that "[a]s PeopleSoft expands its sales both in the U.S. and globally, the demand for EY/GEMS functionality to be integrated into its HRMS product will only increase." (Div. Ex. 641 at 043755.) PeopleSoft explained in a 1999 publication that:

[f]or clients using PeopleSoft HRMS/Payroll, the integration of [EY/GEMS] functionality provides a total solution for international companies. . . .

The database consists of four core administrative and planning modules and several supplemental modules, which all interface to minimize data entry and create a system that addresses pertinent expatriate management needs. Because the system is integrated into PeopleSoft HRMS, clients also receive the benefits of:

A single integrated system, thus eliminating duplicate processes and procedures.

The same flexibility as PeopleSoft for customization of panels and code.

EY/GEMS upgrades simultaneous with PeopleSoft upgrades.

The full spectrum of EY/GEMS tools needed to get the job done.

(Div. Ex. 304 at 034917.)

EY argues that the terms of the Licensing Agreement do not create a joint business venture because, among other things, the payment of royalty fees was standard in the software industry. (EY Brief at 22-27.) EY's argument is unpersuasive. As PeopleSoft's auditor, EY had to abide by the independence rules regardless of what others in the industry were doing. In addition, EY's defense that EY/GEMS for PeopleSoft was a software product developed and marketed by EY alone is not true. EY paid \$75,000 to PeopleSoft for technical assistance and admits that PeopleSoft provided technical assistance on "rare occasions." (EY Ex. 1311 at 14.) The evidence is that EY marketed EY/GEMS for PeopleSoft as a joint product, and that it did so at PeopleSoft User Conferences. At PeopleSoft's 1999 User Conference, Michael Fischer from EY's Tax practice insisted that PeopleSoft announce that EY/GEMS for PeopleSoft was PeopleSoft's preferred solution for computing expatriate payroll and tax data. (March 24, 2003, Tr. 91-92.)

In its promotional literature, EY described EY/GEMS for PeopleSoft as a joint product. "We have developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system

integrated with PeopleSoft Payroll.” (Div. Ex. 243 at 33119.) In a 1999 sales presentation, EY described “JOINT PRODUCTS – EY/GEMS for Human Resources.” (Div. Ex. 299H at 034807.) In another sales presentation, EY in discussing its “Lengthy, Close Working Relationship” with PeopleSoft repeated, “We have developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system integrated with PeopleSoft Payroll.” (Div. Ex. 513 at 039944.) An EY brochure bearing the logos of both EY and PeopleSoft titled “EY/GEMSTM + PeopleSoft tm = EY/GEMS for PeopleSoft” explained that:

PeopleSoft is the worldwide leader in relational client/server HRMS/payroll packaged software. For more than twenty-five years [EY] has been the worldwide leader in providing expatriate services. EY/GEMS for PeopleSoft brings together the experience of these two leaders

EY/GEMS for PeopleSoft is a single integrated system

(Div. Ex. 127 at 031943-44; March 21, 2003, Tr. 241-45.) EY’s advertising materials for EY/GEMS for PeopleSoft featured the PeopleSoft logo. (March 21, 2003, Tr. 241-47; Div. Exs. 127, 625.) Mr. Bishko did not seek advice from either Mr. Coulson or anyone at EY on whether EY marketing materials bearing the EY and PeopleSoft logos violated the independence rules.⁴⁶ (March 21, 2003, Tr. 245.)

The major accounting firms, including EY’s predecessor, acknowledged in a petition, which resulted in the Commission’s 1989 Response, that “while an accountant may provide non-attest services for an audit client’s own use, the provision of such services is forbidden if the client intends to combine the services with its own and sell the entire package to a third party.” (Div. Ex. 127 at 031946.) This prohibition, which EY recognized in 1988, applies to EY/GEMS for PeopleSoft, a combination of auditor and client products in a single package.

EY activities in marketing EY/GEMS for PeopleSoft provide additional indicia that EY promoted the product based on its mutuality or identity of interests with PeopleSoft. A January 24, 1995, EY press release announced that:

EY/GEMS for PeopleSoft delivers a seamless interface that provides the same functionality for information systems (IS) professionals maintaining the system and HR professionals utilizing the reporting and recordkeeping functionalities, regardless of their location. PeopleSoft provides the development toolset that enables Ernst & Young to build a client/server Windows-based application of EY/GEMS. . . . EY/GEMS will seamlessly interface with PeopleSoft’s current international assignment module, expanding on the tracking of employee home and host data, defining assignment details, tracking employee residence, visa and work permit requirements, and adding the compensation and tax functionality needed by HR professionals.

⁴⁶ Mr. Bishko supplied PeopleSoft with a hard copy of the EY logo in 1995. (Div. Ex. 600 at 043581.)

“We’re excited about EY/GEMS adding this important global dimension to PeopleSoft’s premier line of human resources applications,” said Michael J. Bishko, National Director of Expatriate Services for Ernst & Young.

(Div. Ex. 122 at 031905.) A news report in January 1995 stated that EY had “teamed up” with PeopleSoft “to develop a new software package it [hoped would] dominate the market for global work force management systems.” The same press report quoted Jay Levine, an EY partner and director of Expatriate Technology, Technology Services Group, as stating that EY viewed expatriate services as an emerging market since 600 of the top 1,000 United States companies had large international work forces. (Div. Exs. 123, 242.) A similar article appeared in Software Magazine in March 1995. (Div. Ex. 242.)

When EY released EY/GEMS for PeopleSoft in January 1996, it announced that it combined PeopleSoft’s human relations software with EY’s tax expertise for tracking and calculating expatriate employees’ costs and taxes.⁴⁷ The software was completely integrated into an installed PeopleSoft HRMS Payroll product and provided a seamless interface with other PeopleSoft panels and menu applications. (Div. Ex. 238A at 032768.) EY marketing materials declared:

PeopleSoft is the worldwide leader in relational client/server HRMS/payroll packaged software. For more than twenty-five years [EY] has been the worldwide leader in providing expatriate services. EY/GEMS for PeopleSoft brings together the experience of these two leaders to enhance your ability to support your company’s international agenda, your management and your expatriate employees. It creates a win-win equation for you and your organization.

(Div. Ex. 127 at 031944.) EY demonstrated the 6.0 version release of EY/GEMS for PeopleSoft at the 1997 PeopleSoft User Conference attended by over 10,000 people. (Div. Ex. 641.) EY projected increased demand for “EY/GEMS functionality to be integrated into [PeopleSoft] HRMS product” as PeopleSoft sales expanded domestically and globally. (Id.) EY noted in a 1998 product description that it had created this version of GEMS as an “Application Development Partner with PeopleSoft.” (Div. Ex. 238C at 032793.)

The EY-PeopleSoft direct business relationship continued into 1999, when PeopleSoft considered how to address customer concerns regarding expatriate processing, and decided to continue its partnership with EY. (March 24, 2003, Tr. 15-25.) EY’s Mr. Fischer tried unsuccessfully to convince PeopleSoft to sell and service a more integrated form of EY/GEMS for PeopleSoft. PeopleSoft rejected that proposal, but agreed to declare that EY/GEMS for PeopleSoft was its “preferred solution” for computing expatriate payroll and tax data. (March 24, 2003, Tr. 57, 60-61.)

⁴⁷ An EY document, dated June 1999, represented that version 7.0 was in production in the U.S. since December 1997. (Div. Ex. 182 at 032248, 032252.)

I find that a reasonable investor who knew of EY and PeopleSoft's mutual interest in the business success of EY/GEMS for PeopleSoft would make an objective and pragmatic assessment that EY would not be objective in its audit of PeopleSoft. My ruling has considered Mr. Mooney's concerns that the appearance of lack of independence is an arbitrary and capricious type of standard, and his warning that if it is used, it must be applied pragmatically and sensibly. (April 8, 2003, Tr. 60-61, 67-70.)

I reject: (1) EY's characterization of its status as a PeopleSoft application partner and alliance member, and its teaming up with PeopleSoft as involving "inconsequential matters"; and (2) its reliance on a Gartner Group Report that stated, "[b]ecause PeopleSoft is an audit client of E&Y, that precludes close partnering opportunities available to other [implementation consultants]." (EY Ex. 1311 at 15.) The use of the terms "partner" and "alliance member" are not per se determinative, but based on the evidence, they do connote a significant relationship and status in the technological industry. (March 24, 2004, Tr. 19-20; Div. Ex. 454 at 037140.) The record establishes that EY and PeopleSoft acted as partners in the sense that they shared a business interest and they acted together in a variety of ways for their mutual benefit. Finally, nothing suggests that the Gartner Group Report was anything more than a statement of what the author believed to be the standard for auditor-client business relationships. Even if the Gartner Group knew all the facts and made a conclusion, the standard is a reasonable investor standard not the conclusion of an information technology market research firm.

For all these reasons, I find that EY's actions in connection with EY/GEMS established a direct business relationship in the form of a joint product. EY's direct business relationship with PeopleSoft relative to EY/GEMS for PeopleSoft violated the auditor independence requirements unless EY was acting as a consumer in the normal course of business. See Codification, Section 602.02.g.

Consumer in the Normal Course of Business

EY believes that the record supports its judgment that the consumer in the normal course of business exception covers EY/GEMS for PeopleSoft. (EY Brief at 27-28.) The Division asserts that EY bears the burden of proof as to the applicability of the exception to its situation because a party asserting an affirmative defense has the burden of establishing it by the necessary proof. In re Johnson Bros. Truckers Inc., 9 Fed. App. 156, 161-62 (4th Cir. 2001) (assertion of "ordinary course of business exception" under 11 U.S.C. § 547(c)(2) operates as an affirmative defense). The Division likens the "consumer in the ordinary course of business" exception to an issuer claiming a statutory exemption to the Section 5 registration requirements of the Securities Act. SEC v. Ralston Purina, 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under Section 4 of the Securities Act carries the burden of showing that the exemption is met) (Div. Brief at 101-04, Reply Brief at 59 n.36.) EY disputes the Division's position, citing Steadman v. SEC, 450 U.S. 91, 102 (1981), and characterizes the Division's case law as distinguishable and "specious." (EY Brief at 28.)

Inasmuch as the purpose of the securities statutes and regulations is to protect investors, the burden of persuasion is with the person claiming an exemption from a Commission rule. Steadman places the burden on the Division to prove the allegations in the OIP; however,

Ralston Purina places the burden on a respondent if it claims that a rule of general applicability does not apply to its particular situation. 346 U.S. at 126. In any event, the evidence here is compelling, and the Division carried any burden that it may have had. (Div. Findings of Fact at 60-61; EY Brief at 28-29; Div. Reply Brief at 59 n.36.)

Dr. Carmichael and Mr. Rush reject EY's position that its relationship with PeopleSoft relative to EY/GEMS for PeopleSoft was as a consumer in the normal course of business because EY was not a consumer and the transaction was not in the normal course of business. (Div. Exs. 741 at 12, 748 at 12.) Dr. Carmichael cites Black's Law Dictionary to support his contention that EY is not a consumer because it did not use the PeopleSoft's product internally.⁴⁸ In support of their positions, Dr. Carmichael and Mr. Rush cite the Commission's 1989 Response where it rejected the accounting firms' position that prime or subcontractor relationships or other cooperative service arrangements between auditors and clients fell within the consumer in the normal course of business exception. (Div. Exs. 741 at 15, 748 at 12.) In his forty years of accounting experience, Mr. Rush has never known an accounting firm to pay royalties to an audit client. (Div. Ex. 748 at 13-14.) Mr. Rush concluded that the relationship was not in the normal course of business because, among other things: it was unusual for PeopleSoft to provide its proprietary language; it is not normal for an accounting firm to pay its suppliers royalties; an accounting firm does not normally give a supplier a third-party-beneficiary interest in its revenues; a CPA firm does not normally allow a supplier to give input on how it should price its services and products; and a CPA firm does not normally receive a large competitive advantage from an audit client. (Div. 748 at 13-14.)

Mr. Mooney believes that EY did not violate the independence rules because, in substance, the transaction was nothing more than an effort by EY to rewrite an existing software program. (EY Ex. 1311 at 9-10.) Mr. Mooney believes that EY entered into the Licensing Agreement as a consumer in the normal course of business. (EY Ex. 1311 at 11-14.) Dr. Hitt concluded that EY was a consumer of software development tools in the normal course of its business as a software developer, and that EY/GEMS for PeopleSoft was an EY product marketed by EY. (EY Ex. 1310 at 3.) Dr. Hitt opined that:

1. The Licensing Agreement's grant of the use of PeopleTools, the payment of royalties, EY's limited consultation with PeopleSoft technical support personnel, use of the terms "partner" or "alliance" member, and use of PeopleSoft in the product's name does not show that EY/GEMS for PeopleSoft was a joint product.
2. PeopleSoft did not directly distribute or install or provide technical support for EY/GEMS for PeopleSoft. It did not issue press releases, and it did not develop or test the final product. The absence of these activities indicates that EY/GEMS for PeopleSoft was not a joint product or joint business venture.

(EY Ex. 1310 at 19-20.)

⁴⁸ Consumer is "one who consumes. Individuals who purchase, use, maintain, and dispose of products and services." Black's Law Dictionary 219 (6th ed. 1991).

I disagree with EY and its experts that “in entering into the licensing agreement, E&Y was acting as a ‘consumer in the ordinary course of business’ and thus squarely covered by the exception provided in Rule 602.02.g.” (EY Ex. 1311 at 11.) Several facts cause me to conclude that EY was not a consumer and did not enter agreements similar to the Licensing Agreement in the normal course of business. A consumer is one who consumes and the definition of the verb “consume” is to do away with completely, to use up, to eat or drink, to engage fully. Merriam-Webster’s Collegiate Dictionary 248 (10th ed. 2001). EY did not consume PeopleCode or PeopleTools; rather, it used these intellectual properties and passed them on in the form of new software. For this reason, I find that EY was not a consumer in the generally accepted meaning of the term.

EY cites the fact that EY had earlier versions of EY/GEMS and to Dr. Hitt’s opinion to support its assertion that during the relevant period EY licensed software development tools to produce GEMS related software in the normal course of its business. (EY Brief at 29.) I reject this reasoning. Dr. Hitt’s citations do not support his assertion, and there is no evidence that whatever licensing was required to produce GEMS in a DOS version, a Windows version, and a client/server application involved agreements similar to the Licensing Agreement. EY’s businesses were auditing, tax, and consulting. The “bread and butter” services of EY’s tax group were tax return preparation and tax consulting. (March 21, 2003, Tr. 120-21, 139-40.)

EY licensed PeopleTools, a developmental tool, and a PeopleSoft application, PeopleSoft’s HRMS, to produce EY/GEMS for PeopleSoft. (Div. Ex. 121.) EY initiated GEMS and had developed upgrades of the program not as a major piece of its practice but as a defense measure to protect against competition and to show that EY was on the cutting edge of technology. (March 21, 2003, Tr. 139-40.) Mr. Coulson acknowledged that EY had never entered an agreement similar to the Licensing Agreement in the ordinary course of its business. This was the first time that Mr. Coulson had ever encountered a situation where the issue was whether an auditor could pay a royalty to its audit client without violating independence standards. Mr. Coulson knew of no other situation where EY made a royalty payment to an audit client. (March 26, 2003, Tr. 162.) Mr. Coulson was unaware of any other agreement: (1) making an audit client the beneficiary of an agreement the auditor entered with a third party; (2) giving an audit client veto power over what the auditor could sell; and (3) where an auditor paid a client a quarterly technical support fee during product development. (March 26, 2003, Tr. 198-01.)

The fact that some PeopleSoft employees found EY’s license of PeopleTools to EY unusual supports a finding that PeopleSoft licensed its software for product development infrequently in 1994. (March 24, 2003, Tr. 24, 167, March 28, 2003, Tr. 77, 83.) Ms. Gonzalez knew of only one other company that PeopleSoft allowed to use PeopleTools to write an application that interfaced with its HRMS/payroll. (March 24, 2003, Tr. 24.) Marsha Ann Matthews, a PeopleSoft product manager employee, was surprised when she first saw EY/GEMS for PeopleSoft in 1999 because at the time she was unaware of any products that had been built on PeopleTools. (March 24, 2003, Tr. 121, 167.) EY states that Dr. Hitt cited “numerous” examples to support his conclusion that licensing PeopleTools was a normal practice for PeopleSoft during the relevant period. (EY Brief at 30.) Dr. Hitt found three instances that PeopleSoft licensed PeopleTools to software developers who used it to produce “bolt-on”

applications that added functionality to an existing PeopleSoft application by 1993. (EY Ex. 1310 at 8.) Dr. Hitt notes that PeopleSoft licensed PeopleTools to two accounting firms by 1994, and he cited newspaper reports of two others licenses in the late 1990s. (*Id.*) It is questionable whether six licenses in a period of about ten years can be characterized as numerous. Dr. Hitt found one product that had “for PeopleSoft” in its name prior to EY/GEMS for PeopleSoft. (EY Ex. 1310 at 17-18.)

The “consumer in the normal course of business” exception originated as a narrow exception for goods or services acquired for internal use or consumption added because under the original rule “if you’re the auditor of the A&P, you couldn’t buy a loaf of bread” from an A&P grocery store. (March 27, 2003, Tr. 135-38.) In a notice of a proposed rule amendments regarding auditor independence issued in 2000, the Commission stated:

In general, an accountant acts as a “consumer in the ordinary course of business” when the accountant buys “routine” products or services on the same terms and conditions that are available to the seller’s other customers or clients. An accountant is not acting as a “consumer” if it resells the client’s products or services. Likewise, a purchase is not “in the ordinary course of business,” nor is the product “routine,” if it is significant to the firm or its employees.

Proposed Revision of the Commission’s Auditor Independence Requirements; 65 Fed. Reg. 43,148, 43,167 (July 12, 2000) in evidence as EY Ex. 1309.

EY maintains that the “consumer in the normal course of business” exception has evolved substantially since it was added to the rule in 1972. EY considers this situation similar to where the Commission found an accounting firm’s use of a client’s computer income tax data processing services for performing tax work for its clients within the “consumer in the normal course of business” exception.⁴⁹ (EY Ex. 1311 at 11, 14.) EY also cites as support the fact that the Commission has not challenged the fact that an auditor bills clients “for the costs of using another audit client’s products – such as telephone, or delivery services – so long as the terms are consistent with those available to others.” (EY Ex. 1311 at 11.)

The examples of data processing services and telephone or delivery services do not support EY’s position that EY was a consumer in the normal course of business in the arrangement between EY and PeopleSoft relative to EY/GEMS for PeopleSoft. In the computer company example, the accounting firm was one of several accounting firms using a company whose business was to run a computer program based on data supplied by the accounting firm. The accounting firm needed to have the data processed to perform the tax service it offered its clients. Using a computer processing company client to run math calculations that the auditor used in providing tax services is different in character and significance from licensing a proprietary software code and adapting it with an in-house program to produce a one-of-a-kind software containing applications of both the auditor and its client. In 1999, EY/GEMS for

⁴⁹ The Commission found that the business relationship would adversely affect the auditor’s independence if billings for the service were significant to the accounting firm, its local office that performed the audit, or to the computer firm. Codification, Section 602.02.g, Example 1.

PeopleSoft was the only expatriate management system available written using PeopleTools. (March 21, 2003, Tr. 218-19, March 24, 2003, Tr. 72.)

Another indicia that EY's relationship with PeopleSoft concerning EY/GEMS for PeopleSoft was not in the normal course of business is the level of importance each company assigned to it. The Licensing Agreement was signed by Mr. Bishko, an EY partner, national director Expatriate Services, Tax, and by PeopleSoft's general counsel. It is reasonable to assume that arrangements for computer processing services, telephone, and delivery services are not negotiated, agreed to, and signed by persons at similar high corporate levels.

I accept the reasoning of Dr. Carmichael and Mr. Rush as to why EY was not acting as a consumer in the normal course of business when it entered the Licensing Agreement. I reject Dr. Hitt's opinions because his analysis ignored the auditor-client relationship, which has implications or nuances that are not present in the technological arena. I disagree with the implications Mr. Mooney drew from the facts.

For all these reasons, I find that EY was not a consumer in the normal course of business in the direct business relationship it had with PeopleSoft relative to EY/GEMS for PeopleSoft. EY, therefore, violated Rule 2-02 of Regulation S-X because EY was not independent when it audited PeopleSoft's financial statements for fiscal years 1994 through 1999.

Did EY's Implementation Activities Violate Auditor Independence?

The second basis for the allegations in the OIP concerns EY's activities as a consultant implementing PeopleSoft software. The Division claims the implementation relationship was "fraught with potential" independence violations, and that EY's interactions with PeopleSoft in marketing and sales created a direct business relationship in violation of auditor independence. (Div. Proposed Findings at 28-32.) The Division contends that provisions of the Implementation Agreement are directly inconsistent with "actual independence and an appearance of independence between E&Y and PeopleSoft." (Div. Initial Brief at 38.) The Division cites specifically the provisions that required PeopleSoft to:

- (i) designate E&Y "as a participant in PeopleSoft's Implementation **Partner Program**";
- (ii) market E&Y's implementation services by agreeing to distribute a one-page profile of E&Y – containing information provided by E&Y – to PeopleSoft end-users; and
- (iii) permit E&Y "to attend PeopleSoft's annual user conference and to participate in its product fair."

(Div. Initial Brief at 38, Div. Reply Brief at 89) (emphasis in original.) The Division contends that additional provisions in the succeeding Implementation Agreement, which Ms. Anderson signed on behalf of EY knowing of the Commission investigation that led to this proceeding, are inconsistent with the appearance of independence. These provisions:

(i) allowed E&Y to demonstrate PeopleSoft's software products to prospective PeopleSoft customers; (ii) permitted E&Y to use PeopleSoft's Global Alliance Program logo on E&Y's marketing materials; (iii) required E&Y to maintain a minimum customer satisfaction rating and to share such ratings with PeopleSoft; (iv) obligated both parties to try to meet prior to working for a "joint Customer"; (v) obligated both parties to create a "Steering Committee" comprised of E&Y and PeopleSoft key executives to meet at least twice a year to review the status of the agreement; and (vi) required E&Y to indemnify PeopleSoft against any legal claims or judgments arising from E&Y's services to PeopleSoft's customers.

(Div. Initial Brief at 39-40, Div. Reply Brief at 90.)

The Division argues that the EY and PeopleSoft relationship as software implementer and seller, respectively, "involved extensive and intricately interwoven joint activities that created a direct business relationship," that violated auditor independence. (Div. Initial Brief at 42.) The Division maintains that, viewed in its totality, the preponderance of the evidence is that EY and PeopleSoft had a direct business relationship in which EY was not a consumer in the normal course of business, and that a mutuality or identity of interests existed that caused EY to lose the appearance of objectivity and impartiality in the performance of its audits. (Div. Reply Brief at 77.) The Division cites the following examples of behavior that created a direct business relationship between EY and PeopleSoft: (i) extensive joint coordination, including sharing confidential business information on at least three major marketing initiatives; (ii) joint targeting of specific potential clients and sharing confidential and sensitive information; (iii) mutual assistance on sales and closing deals; (iv) mutual endorsements; and (v) promoting the joint relationship for the purpose of generating mutual revenues. (Div. Initial Brief at 42; Div. Findings at 32.)

Dr. Carmichael considers that "the joint business activity of providing software implementation services to" third parties "combined with the extensive mutuality of interests in marketing and sales efforts related to these services impaired EY's audit independence." (Div. Ex. 741 at 10.) Dr. Carmichael argues that the Implementation Agreement comes within the definition, "contractual agreements to perform interdependent services for the profit of the parties to the agreement," as prohibited "joint business ventures" or "limited partnership agreements." (Div. Exs. 741 at 19-20, 129 at 031951.) Dr. Carmichael points out that the Commission's 1989 Response allowed an auditor to enter relationships, other than a direct business relationship, with a client through the use of separate contracts, but that arrangement is subject to the test of whether it created a mutuality or identity of interests which would have the auditor lose the appearance of objectivity and impartiality. (Div. Ex. 741 at 20.) Dr. Carmichael is troubled more by the "degree of connectedness" in selling than the basic implementation allowed by the Implementation Agreement. (March 28, 2003, Tr. 38, 40-41.) Dr. Carmichael concludes that considered in the aggregate, EY's implementation activities created an appearance of a mutuality and identity of interests with PeopleSoft that Section 602.02.g indicates impairs audit independence. (Div. Ex. 741 at 23.) Finally, Dr. Carmichael believes that an auditor and a client can have separate contracts with third parties; however, their interconnected activities can

create a direct business relationship between the auditor and the audit client, and that is what happened here. (March 28, 2003, Tr. 174-76.)

In forty years of accounting experience, Mr. Rush had never encountered any other audit firm or client with such a close business relationship as EY Consulting and PeopleSoft. (Div. Ex. 748 at 18.) Mr. Rush rejects EY's position that the Commission has allowed cooperative arrangements between auditors and clients, and finds that EY's implementation activities with PeopleSoft, in particular the marketing related activities created a direct business relationship that compromised EY's independence. Mr. Rush concludes that by working closely together to increase their respective revenues, EY violated the prohibition on an auditor and client "join[ing] together in a profit-seeking venture." (Div. Ex. 748 at 17.) Mr. Rush faults EY for proposals it submitted to prospective clients that boasted that PeopleSoft had positioned EY above the rest of the implementers, and Mr. Rush disagrees that reasonable investors would conclude that EY's "partner" status was as innocuous as EY claims. (Div. Ex. 748 at 10-11, 16 n.34.)

EY claims its business relationship with PeopleSoft did not cause it to lose its independence or the appearance of independence because the Commission's 1989 Response allowed auditors to provide software implementation to third parties who acquired software from an audit client, provided the implementation and acquisition were by separate contract. (EY Brief at 4.) EY cites the Commission's 1989 Response:

[T]he Commission would not raise an independence question if the party receiving the combined services contracted separately with the auditor and the audit client for their respective portions of the service engagement, thereby separating the accountant's liability and contractual obligations from those of its audit client (unless the arrangement is considered to be a material indirect business relationship).

(Div. Ex. 129 at 031949.)

EY's expert Mr. Mooney opined that, in substance, the Implementation Agreement was nothing more than an arrangement that permitted EY to hold itself out as a qualified PeopleSoft software implementer, and that "most major accounting firms were providing implementation services involving their audit clients' software and used similar arrangements." (EY Ex. 1311 at 16.) Mr. Mooney relies on language in the Commission's 1989 Response that it "would not raise an independence question if the party receiving the **combined services** contracted separately with the auditor and the audit client for their respective portions of the service engagement thereby separating the accountant's liability and contractual obligations from those of its audit client." (Id. at 16-17) (emphasis in original.) Mr. Mooney would not imply a prohibited business relationship from use of the term "partner" in the agreement, noting that neither party accepted responsibility for the actions of the other and that the Implementation Agreement states that EY is an independent contractor. (Id. at 16, 19-20.) Mr. Mooney states that the applicable test is whether or not the activities create a mutuality or identity of interest between the auditor and its client. (Id. at 18.) Mr. Mooney considers the Division's position on implementation as based largely on arguments that EY's implementation activities created an appearance that EY lacked independence. He notes there is no evidence that any informed investor, investment

analyst, reporter, or other person held this view, and he cites a report of the Gartner Group as evidence that the public understood EY's activities vis-à-vis PeopleSoft were limited because of independence considerations. (Id. at 15, 23.) Mr. Mooney understands that EY and PeopleSoft did not co-sell or jointly sell products or services, and he views the evidence as showing “nothing more than instances of mutual cooperation, or isolated occurrences.” (Id. at 23.)

Dr. Hitt asserts that “a reasonable person with a modest understanding of business practices of the software industry would not conclude that there was a ‘partnership’ in the legal sense or a ‘mutuality of interests’ between EY and PeopleSoft.” (EY Ex. 1310 at 3-4.) Dr. Hitt opines that the amount of interaction and extent of cooperative business relationships are substantially less than would be expected given EY's size and presence among software implementers. (Id. at 3) Dr. Hitt characterizes the business interactions between EY and PeopleSoft as normal. (Id. at 29.) Dr. Hitt asserts that EY was less aggressive and had more restrictive service offerings than its peer consulting firms, and that the peer consulting firms had significantly closer relationships with PeopleSoft than did EY. (Id. at 3, 27.) Dr. Hitt concluded that EY was foregoing potentially lucrative business opportunities, in part because of independence concerns.⁵⁰ (Id. at 3.) According to Dr. Hitt, there are few secrets regarding sales opportunities in the software implementing community, and it is common to share sales leads or client lists and this information provides no special advantage. (Id. at 22.)

Applying the same logic used to decide whether EY violated the independence rules in connection with EY/GEMS for PeopleSoft, the first question is whether EY engaged in a direct or a material indirect business relationship with PeopleSoft in connection with implementing PeopleSoft software, and, if so, whether in those business relationships, EY was a consumer in the normal course of business. And finally, if EY engaged in any direct or material indirect business relationships with PeopleSoft as a consumer in the normal course of business, whether its conduct created such an identity or mutuality of interests that a reasonable investor would conclude that EY would not be impartial or objective in auditing PeopleSoft's financial statements. See Codification, Section 602.02.g; Commission's 1989 Response.

The 1993 and 2000 Implementation Agreements created a direct business relationship between EY and PeopleSoft, and EY's implementation activities on behalf of third parties created a material indirect business relationship between EY and PeopleSoft.⁵¹ Unlike the EY/GEMS for PeopleSoft situation, these relationships did not per se cause EY to violate the independence rules because EY was acting as a consumer in the normal course of business. Unlike EY/GEMS for PeopleSoft, to conduct its normal business activity, EY Consulting had to enter an Implementation Agreement and deal with PeopleSoft to be able to implement PeopleSoft software. (March 27, 2003, Tr. 203-04.)

⁵⁰ Dr. Hitt appears to rely on a statement by the Gartner Group that “[b]ecause PeopleSoft is an audit client of E&Y, that precludes close partnering opportunities available to other SIs.” (EY Ex. 1310 at 28.)

⁵¹ Dr. Carmichael considered the Implementation Agreement evidence of a continuing relationship for the mutual benefit of EY and PeopleSoft, but not standing alone an independence violation. (March 27, 2003, Tr. 197-98.)

Mr. Coulson stated that the Commission's staff allowed a certain level of cooperation between a vendor and a consultant so long as the cooperation "did not go too far" such that a material indirect business relationship developed that would raise independence questions. (EY Ex. 1311 at 18.) I find that EY violated the rules on auditor independence because EY's activities went "too far" and established "a continuing relationship for the mutual benefit of [the] two parties" and created such an identity or mutuality of interests between EY and PeopleSoft that a reasonable investor would believe that EY would not be objective in auditing PeopleSoft's financial statements. See Codification, Section 602.02.g.

I reject EY's defense that any violations were occasional and occurred by chance. Almost all of EY's actions detailed in the Findings of Fact regarding the implementation of PeopleSoft software were suspect and most were inappropriate for an auditor because of independence considerations. The unrefuted evidence is that Mr. Fridley and Ms. Anderson implemented a broad strategy to use the PeopleSoft sales force to the greatest degree possible to maximize sales by EY's PeopleSoft Service Line, and that EY and PeopleSoft acted together to accomplish this end, which benefited both parties. The following statement by PeopleSoft's director of corporate advertising is in sync with voluminous evidence that shows what amounted to joint sales by EY and an audit client. "Because [EY is] also a business partner of [PeopleSoft], we shared the leads that were relevant to their business and had our respective sales teams work together to contact leads generated from this marketing event." (Div. Ex. 283 at 034554.)

EY's defense that its conduct was no different than the conduct of other software implementers is also unpersuasive. Dr. Hitt's opinions and evidence that software implementers had similar business relationships with software vendors are largely irrelevant because EY was held to a different standard as PeopleSoft's auditor.

PeopleSoft's Partner Profile for EY, which was based on information EY supplied, stated that as an auditor EY must maintain an "air of independence when dealing with PeopleSoft in the marketplace," and that EY and PeopleSoft could not do joint marketing, have the PeopleSoft and EY logos appear together, refer to each other as a partner, or be in an exclusive, preferred or alliance relationship.⁵² (Div. Ex. 169.) As detailed in the Findings of Fact, EY and PeopleSoft engaged in all these actions that are inimical to an independent relationship because they cause the auditor to lose the appearance of objectivity and impartiality. Considering the types of activities and the level of activities, EY's conduct was blatant. The most outrageous were the joint marketing and joint sales activities that occurred across the board. EY agrees that the physical presence of PeopleSoft representatives at EY's sales presentation to Adventist Hospital in January 1999 was improper. I find equally improper the fact that EY and PeopleSoft salespeople held meetings in the field with respect to the Health Care Initiative and other subjects and targeted customers based on shared information; that EY and PeopleSoft regularly shared confidential, proprietary information as to customers, business plans, and sales; that EY salespersons called on and received assistance from PeopleSoft in making sales; that EY assisted

⁵² The profile explained, "E&Y is a Global Implementation Service Provider. They are not part of [PeopleSoft's] Global Consulting Alliance program, but have equal capabilities to deliver services globally to [PeopleSoft] customers." (Div. Ex. 169 at 032052.)

PeopleSoft in achieving its sales expectations; that EY used PeopleSoft logos in touting its services; and that EY asked for and received business information from PeopleSoft that was unavailable from any other source.

A software vendor and a software implementer have to interact. Where the implementer is the vendor's auditor, the auditor must be sensitive to the auditor's status and the appearance of independence. This record has no evidence that EY was sensitive or concerned about EY's appearance of independence. There is no evidence that EY's PeopleSoft Service Line ever consulted with Mr. Coulson or anyone in EY's national office on independence issues. There is no evidence that Mr. Fridley or anyone else at EY complied with the provisions of EY's PPS on Engagements in Association with Clients.

Mr. Mooney argues that investors, analysts, reporters, and publications, such as those of the Gartner Group, did not question EY's relationship with PeopleSoft and this is "compelling evidence that there was no impairment of E&Y's appearance of independence because of these matters." (EY Ex. 1311 at 23.) I disagree with Mr. Mooney for several reasons.⁵³ Most of the information in this record was not in the public domain. A great deal of evidence consists of e-mails between and among EY and PeopleSoft personnel, and internal documents of both companies. Also, even if public investors, analysts, reporters, and publications had some of this information, they did not have the total picture revealed by the evidence in this record. Also, prior to 2000, public investors and, perhaps to a lesser extent, analysts and reporters presumed that accounting firms observed applicable legal standards regarding auditor independence.

EY and PeopleSoft's activities concerning software implementations for third parties, viewed collectively, violated Rules 2-01 and 2-02 because no reasonable investor who knew all the facts - including that in both 1998 and 1999 EY earned approximately \$500,000 from auditing PeopleSoft and \$150 million from implementing PeopleSoft software - would consider EY as independent and objective when it audited PeopleSoft's financials. "[A]s the size of management advisory services fees from a particular client rises in proportion to audit fees there is a greater likelihood that independence may be impaired either in fact or in appearance." 2 Louis Loss & Joel Seligman, Securities Regulation 738 (3rd ed. 1989) (citing Scope of Services by Independent Accountants, 17 SEC Docket 877, 881 (1979)).

⁵³ On March 22, 2002, Mr. Mooney testified under oath: "I have never thought that independence rules ought to be based on appearances because that in turn always raises the question of what is perceived to be a compromise in independence by whom and the 'by whom' could reflect all kinds of different views, experiences, levels of knowledge. And I think it is an arbitrary and capricious type of standard." (April 8, 2003, Tr. 61, 67.) In the same testimony, Mr. Mooney admitted he was not aware of a general requirement with respect to the appearance of independence. (April 8, 2003, Tr. 71-72.) After reflecting on the subject, Mr. Mooney testified in this proceeding that he agreed "completely that independence in appearance is an important consideration in maintaining investor confidence in the audit process and the related financial statements." (April 8, 2003, Tr. 67-70, 78-79; EY Ex. 1311 at 14-15.)

Causation

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize sanctions by the Commission where there is a finding that a person was the cause of a violation of the Securities Act, Exchange Act, or any rule or regulation thereunder. The OIP alleges that EY caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Exchange Act Rules 13a-1 and 14a-3.⁵⁴ Case law has established that causation requires findings that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his/her conduct would contribute to the violation. Erik W. Chan, 77 SEC Docket 851, 859-60 (Apr. 4, 2002); Valicenti Advisory Servs., Inc., 68 SEC Docket 1805, 1812 n.11 (Nov. 18, 1998), aff'd, 198 F.3d 62 (2d Cir. 1999).

PeopleSoft violated Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3, because it filed financial statements with the Commission for fiscal years 1994 through 1999 that were not audited by an independent accountant. EY's lack of independence, within the meaning of Rule 2-01 and GAAS, caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3. EY knew or should have known that its conduct would cause PeopleSoft to violate the reporting requirements of the securities statutes and the Commission's rules thereunder.

Did EY Engage In Improper Professional Conduct?

In 1998, the Commission amended Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 210.102(e), and provided that amended Rule 102(e) would automatically apply in all cases considered after the amendment's effective date, except for trials underway, regardless of when the conduct in question occurred. Amendment to Rule 102(e) of the Commission's Rules of Practice, 68 SEC Docket 707-08 (Oct. 19, 1998); see also Carroll A. Wallace, CPA, 80 SEC Docket 3370, 3372-73 (Aug. 20, 2003), appeal pending, No. 03-1350 (D.C. Circuit). As the result of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), 107 P.L. No. 204, 116 Stat. 745 (2002), Rule 102(e) was codified in Section 4C of the Exchange Act.

Rule 102(e) as it applies to this situation reads as follows:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: . .

⁵⁴ Sections 7(a) and 10(a) of the Securities Act set forth the information to be disclosed in a registration statement and prospectus, respectively. Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1 and 14a-3 set forth the information to be provided by issuers of securities registered pursuant to Section 12 of the Exchange Act in periodic and other reports and in proxy solicitations.

(ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; . . .

(iv) With respect to persons licensed to practice as accountants, ‘improper professional conduct’ under Rule 102(e)(1)(ii) means:

(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

(B) Either of the following two types of negligent conduct:

(1) 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 have known, that heightened scrutiny is warranted.

(2) 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.

The Division claims EY is subject to a sanction pursuant to Rule 102(e) because its conduct was “at least reckless” in: (1) entering the Licensing Agreement; (2) failing to recognize that its conduct pursuant to the Implementation Agreement exceeded independence limits; and (3) failing “to adopt, implement, and maintain a thorough system of quality control policies and procedures designed to provide it with reasonable assurances” that the firm conformed with independence standards under GAAS in its audit engagements. (Div. Initial Brief at 120-21.)

The Division also asserts that: (1) a negligence standard is appropriate to assess whether EY’s actions are considered improper professional conduct; and (2) to be free from improper professional conduct as to independence, accounting firms practicing before the Commission “must adopt, implement, and maintain a thorough system of quality control policies and procedures to provide it with reasonable assurance that it is conforming to GAAS, ‘including its independence standards in its audit engagements.’” (Div. Initial Brief at 118 (citing KPMG, 74 SEC Docket at 438 n.152).) The Division claims that EY’s highly unreasonable conduct merits a sanction because EY was under an outstanding court order to comply with the same independence standards it violated. The Division alleges that EY engaged in repeated instances of unreasonable conduct by issuing audit reports for several years when it was not independent, by entering the Licensing Agreement with an audit client, and by not informing the engagement partner of the Licensing Agreement for several years. Finally, the Division claims that EY acted unreasonably by not being proactive to ensure that EY consultants were independent. (Div. Initial Brief at 121-23.)

EY maintains that it committed no violations, but even if it is found to have committed some technical independence violation, the record is devoid of evidence showing its actions, with respect to auditor independence, were knowing, reckless, or negligent within the meaning of Rule 102(e) and Section 4C of the Exchange Act. (EY Brief at 103-04.)

I find that EY engaged in improper professional conduct because it violated applicable professional standards for auditors by conduct that was both reckless and negligent.

Reckless Conduct

Recklessness has the same meaning in Rule 102(e) and Section 4C of the Exchange Act as it does under the Exchange Act's antifraud provisions. Amendment to Rule 102(e), 68 SEC Docket at 710, & nn.36, 37 (citing SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992) (quoting Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1976)). Recklessness is defined as an "extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it." Sundstrand, 553 F.2d at 1045 (internal quotations omitted). In Wallace, the Commission held under Rule 102(e) that, "the definition of reckless conduct establishes the mental state that must be shown with respect to conduct that results in a violation of applicable professional standards . . . [t]he question is whether the accountant recklessly violated applicable professional standards." 80 SEC Docket at 3373.

The record shows that EY acted recklessly in several distinct ways. EY recklessly violated applicable professional standards by entering the Licensing Agreement with PeopleSoft and in conducting activities that violated the standards for auditor independence in connection with business relationships with an audit client. The subject of allowable business relationships between an auditor and its audit clients was a subject of much debate from the late 1980s. In 1994, EY had never entered an agreement that was similar to the Licensing Agreement. This was Mr. Coulson's first encounter with the issue of whether an auditor could pay a royalty to its audit client without violating independence standards, and he knew of no other situation where EY made a royalty payment to an audit client. (March 26, 2003, Tr. 162.) Mr. Coulson was unaware of any other agreement: (1) making an audit client the beneficiary of an agreement the auditor entered with a third party; (2) giving an audit client control over product quality; (3) where an audit client helped set the fees that its auditor charged third parties; and (4) where an auditor paid an audit client a quarterly technical support fee during product development.

Mr. Coulson conducted no independent research on the subject. Mr. Coulson did not read the proposed licensing agreement. Mr. Coulson did not consult with others at EY or at the Commission on the royalty or other issues, which were not normal in arrangements between auditors and their clients, because he considered these features standard to licensing arrangements. (March 26, 2003, Tr. 164, 195-96, 198, 200.) Mr. Coulson approved the Licensing Agreement based on two or three phone conversations of approximately twenty minutes each with Mr. Bishko. Mr. Coulson relied on an unknown person who assured him that the proposed agreement contained standard licensing provisions, and his belief that Mr. Bishko would inform him of any unusual provisions in the proposed agreement. (March 26, 2003, Tr. 157-58, 163-64.) Mr. Bishko, however, initiated the project so he had an interest in getting the Licensing Agreement approved. Mr. Coulson kept no record or notes of his conversations with Mr. Bishko and did not tell anyone at EY of the advice that he had given. (March 26, 2003, Tr. 197.)

EY's expert Mr. Mooney opined:

Considering the nature of the matter, and its size in relationship to both E&Y and PeopleSoft, Mr. Coulson made a supportable judgment based on a reasonable investigation and I believe that Mr. Coulson's decision not to look at the contract was reasonable in the circumstances. . . . I have now examined that contract and there is nothing in it that would have caused me to give advice different from that given by Mr. Coulson to Mr. Bishko.

(EY Ex. 1311 at 14.) Mr. Mooney's position is unpersuasive. The Commission has never found that an auditor, who develops a product that contains a proprietary asset of its client and markets the product bearing the client's name to persons using the client's product, is a consumer in the normal course of business. Mr. Mooney justifies EY's actions because of the "matter, and its size" in respect to the size of EY and PeopleSoft. The Commission's 1989 Response rejected the use of a materiality standard when determining auditor independence. Also, this logic would hold larger companies to a lower legal standard than smaller companies. Mr. Mooney does not define what he means by "reasonable investigation," but there is no evidence that Mr. Coulson did any investigation. Finally, Mr. Mooney is inconsistent. He finds that Mr. Coulson behaved reasonably in not reading the agreement before approving it, but Mr. Mooney found it necessary to read the Licensing Agreement before he opined on Mr. Coulson's conduct. I disagree with Mr. Coulson and Mr. Mooney. The facts support Dr. Carmichael's conclusion that "EY's conduct in entering into the agreement with PeopleSoft to develop and market EY/GEMS for PeopleSoft was an extreme and unreasonable departure from what a reasonable independent auditor would have done in these circumstances to avoid an impairment of independence." (Div. Ex. 741 at 10.)

EY also recklessly violated applicable professional standards because Mr. Frick certified that PeopleSoft's financials for fiscal years 1994 through 1999 were the subject of independent audits. Mr. Frick first saw the EY independence Guidelines when he received an e-mail from Mr. Fridley in January 1999. Mr. Frick was not an expert on independence, and he considered independence rules "somewhat vague guidelines." (March 25, 2003, Tr. 15-16, 109-10; Div. Ex. 201.) Despite these facts, Mr. Frick was the lead audit partner and his judgment was required on whether EY was independent and whether the audit was conducted in accordance with GAAS. Mr. Frick either did not know or ignored evidence that showed EY had improper business relationships with EY about EY/GEMS for PeopleSoft and software implementations. Mr. Coulson testified that a coordinating partner would know about any kind of relationship that EY had involving a Commission audit client. However, Mr. Frick did not learn that EY had a Licensing Agreement with PeopleSoft that included royalty payments until April 1999. (March 25, 2003, Tr. 91-92, March 26, 2003, Tr. 96, 113.) Mr. Frick could not exercise judgment on the Licensing Agreement or EY's various actions taken pursuant to the Licensing Agreement from October 1994 until April 1999, because he did not know about them. Mr. Coulson found it hard to imagine that a coordinating partner on an EY audit would not know of EY's interaction with the audit client. (March 26, 2003, Tr. 114.)

When he learned of the Licensing Agreement, Mr. Frick concluded that others in EY had decided that the Licensing Agreement and EY/GEMS for PeopleSoft posed no independence

issues. (March 25, 2003, Tr. 92-93, 96-97.) Mr. Frick was satisfied when Mr. Paradis learned in April 1999 that people in EY's national office had approved the Licensing Agreement, and he accepted Mr. Bishko's representation that EY Legal would review any new agreements and marketing materials even though Mr. Frick did not know what Mr. Bishko meant by new marketing materials. (March 25, 2003, Tr. 93, 138-39; Div. Ex. 234 at 032729.) Mr. Frick did not call and address any inquiries to Mr. Bishko because he considered EY/GEMS to be within Mr. Bishko's area of responsibility, and he considered Mr. Bishko knowledgeable on independence. (March 25, 2003, Tr. 139-40.) Mr. Frick did not make basic inquiries about EY/GEMS for PeopleSoft that would have revealed facts that required consideration; rather, he relied on Mr. Bishko to bring independence concerns to his attention.

Mr. Frick also knew that EY had an Implementation Agreement with PeopleSoft but he relied completely on the consulting partners, non-accountants who headed EY's PeopleSoft service line – Mr. Lindeman, Mr. Fridley, and Ms. Anderson - to bring independence issues to his attention. (March 25, 2003, Tr. 42-43, April 2, 2003, Tr. 192.) Mr. Frick's practice was to ask questions and, if he was unsatisfied, to consult with EY's experts. (March 25, 2003, Tr. 15.) Mr. Frick remembers Mr. Lindeman, and later Mr. Fridley, raising a handful of issues annually, and he recalls discussions with Mr. Coulson. (March 25, 2003, Tr. 46-47, 177.) When questioned about documents and e-mails that pertained to EY's implementation activities, Mr. Frick stated that he would have questioned many of the statements and representations concerning EY's consulting activities from an independence perspective, if he had known about them. (March 25, 2003, Tr. 59-65, 128-37; Div. Ex. 387 at 035882, 035893, 035894.) The record does not show that Mr. Frick consulted much, if at all, with Mr. Coulson or anyone in EY's national office on any of the independence issues that are the subject of this proceeding. There is also no evidence that Mr. Frick determined whether EY followed its internal procedures, PPS AA 7505, Engagements in Association with Clients, as to any of the implementation activities detailed in the Findings of Fact.

Highly Unreasonable Conduct

Rule 102(e) of the Commission's Rules of Practice and Section 4C of the Exchange Act define improper professional conduct 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." According to the Commission, the "highly unreasonable" standard is

an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness used in cases brought under Section 10(b) of the Exchange Act and Rule 10b-5. The highly unreasonable standard is an objective standard. The conduct at issue is measured by the degree of the departure from professional standards and not the intent of the accountant. . . . conduct that poses a threat of future harm to the Commission's processes and conclusively demonstrates that the accountant lacks competence to practice before it.

Amendment to Rule 102(e), 68 SEC Docket at 710.

I found that Mr. Frick acted recklessly and violated applicable professional standards by certifying that PeopleSoft's financial statements for fiscal years 1994 through 1999 were the subject of independent audits for the reasons stated previously. If a reviewing authority should determine that this conduct does not satisfy the definition of reckless conduct, it meets the standard of highly unreasonable conduct.

Negligent Conduct

I find that EY committed repeated instances of unreasonable conduct, each of which resulted in violations of applicable professional standards, that indicate a lack of competence to practice before the Commission. See Rule 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and Section 4C of the Exchange Act. The Commission has defined the term "unreasonable" under Rule 102(e)(1)(iv)(B)(2) as "an ordinary or simply negligence standard." Amendment to Rule 102(e), 68 SEC Docket at 712. The term "repeated instances" means "more than once" and can be satisfied by "as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits." Id. Mr. Frick was reckless in certifying that PeopleSoft's audits from fiscal years 1994 through 1999 were done in accordance with GAAS and that EY was independent. If a reviewing authority should determine that the conduct described above does not satisfy the definition of reckless or highly unreasonable conduct, at a minimum, it comes within the definition of negligent conduct.

The overwhelming evidence is that during the relevant period, EY's day-to-day operations were profit-driven and ignored considerations of auditor independence in business relationships with PeopleSoft. EY's partners shared in the pooled revenues of the firm's three practice areas, and each EY partner was evaluated annually on his or her achievement toward five preset goals, one of which was sales. EY did not give its employees any formal training on a regular basis concerning the independence rules on business dealings with an audit client. Most of the EY employees who testified relied on the Guidelines and EY used them in the information it provided to PeopleSoft for its Partner Profile; however, EY never formally endorsed these directives. The evidence demonstrates that not everyone received the Guidelines. Those who received copies interpreted them differently. Further, EY made no firm-wide attempt at educating its employees about them to assure a consistent interpretation.

EY had no procedures in place that could reasonably be expected to deter violations and assure compliance with the rules on auditor independence with respect to business dealings with audit clients. Mr. Coulson expected EY employees to seek his advice; however, there is no evidence that Mr. Fridley and the other Consulting partners ever sought his advice. EY's national office that addressed independence issues is not mentioned in the voluminous communications in this record that pertain to EY's implementation efforts. The only oversight mechanism to enforce the "culture of consultation" that allegedly existed was a self-reporting form on which EY partners and employees were required to report whether they abided by the firm's independence policies. The evidence is persuasive that it is not effective to rely on members of an accounting firm to self-report on the issue of independence without the threat of random verification. (April 8, 2003, Tr. 37-40.) As an expert in audits, EY knew or should have

known that a worldwide firm with thousands of employees could not rely on voluntary compliance. The fact that EY relied on self-interested people to voluntarily raise independence issues and to file forms where positive responses would cause a loss of income are strong indications that EY was negligent.

V. SANCTIONS

Based on the findings in this Initial Decision, I find the following sanctions necessary in the public interest.

Cease and Desist

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission, after it has found a violation of the respective statute or any rule or regulation thereunder, to require a person who has violated or caused a violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation. The Division requests that EY be ordered to cease and desist from committing any future violations of Rule 2-02 of Regulation S-X, and from causing any future violations of Sections 7(a) and 10(a) of the Securities Act, and Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3.

The Court of Appeals for the District of Columbia Circuit recently vacated a Commission order to cease and desist based on a finding that the Commission's action was arbitrary and capricious. WHX Corp. v. SEC, 2004 U.S. App. LEXIS 6942 (Apr. 9, 2004). The court found that the Commission failed to meet the evidentiary standard it had set for itself as to when to impose a cease-and-desist order, which included a finding of some risk of future violation, and that the Commission had failed to explain how a reasonable application of the KPMG factors could support imposition of an order to cease and desist. Id. at *13-20.

In KPMG, the Commission found the accounting firm had acted negligently in violating Rule 2-02 and in causing its audit client's violation of Section 13(a) of the Exchange Act and Rule 13a-1 and ordered the firm to cease and desist upon consideration of the following factors:

Along with the risk of future violations, we will continue to consider our traditional factors in determining whether a cease-and-desist order is an appropriate sanction based on the entire record. Many of these factors are akin to those used by courts in determining whether injunctions are appropriate, including the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings.

The evidence demonstrates that it is necessary to order EY to cease and desist in order to protect public investors and the capital markets. Based on my observation of the witnesses and my review of record, I conclude that EY will likely commit future violations absent an explicit directive to cease and desist. Although EY has sold its consulting practice and certain partners have retired, many EY partners, who either committed the violations or knew about them and did nothing to stop them, are still at EY: Mr. Fisher in tax, Mr. Frick and Mr. Paradis in audit, Mr. Coulson, and unnamed persons in both the national office on independence and legal department. In addition, the evidence shows that EY has an utter disdain for the Commission's rules and regulations on auditor independence. In their testimony, Mr. Bishko, a retired partner, Mr. Coulson, and Mr. Frick, present partners, were at times argumentative, sarcastic, and not forthcoming.⁵⁵

A second compelling reason why a cease-and-desist order is required is that the Commission has tried and failed to bring EY into compliance through litigation. As noted previously, in 1995, the United States District Court for the Northern District of Texas entered a Final Order that contained the terms of a settlement where EY agreed with respect to its future activities that:

Ernst & Young undertakes to, and shall, comply with standards and guidelines issued by the Commission and the accounting profession regarding the independence of public accountants that audit the financial statements of any issuer whose securities are registered with the Commission pursuant to Section 12 of the [Exchange Act] relating to loans, leases, and other business relationships with audit clients as specified in the Codification of Financial Reporting Policies Section 602.02.g.

SEC v. Ernst & Young, Civil Action No. 3-91-2267-X (N.D. Tx. 1995) in evidence as Div. Ex. 246. In June 2002, the Commission censured a Dutch accounting firm that was a member of EY International because the firm lacked independence due to its joint business relationships with an audit client that was a software company. Moret Ernst & Young Accountants, 77 SEC Docket 3416 (June 27, 2002) in evidence as Div. Ex. 453.

In addition, the persuasive evidence in this record is that EY is neither implementing, nor does it have in place, policies and procedures that can reasonably be expected to ensure compliance with independence rules in business dealings with audit clients. The TOS Report, which found that EY's systems and controls designed to achieve compliance with independence rules were effectively designed and implemented as of June 30, 2001, and that they operated effectively from June 30, 2001, to December 31, 2001, is a consideration. However, the TOS authors did not view the evidence in this record, and the TOS Report is not dispositive on the issue of whether EY will likely violate the independence rules in the future.

⁵⁵ Mr. Bishko refused to comply with a subpoena requiring him to testify on March 18, 2003, and the hearing had to be postponed until he appeared voluntarily on March 21, 2003.

EY's violations occurred over a prolonged time period and concerned matters that are significant to public investors and the capital markets. Congress affirmed that auditor independence is one of the paramount conditions that auditors must observe by enacting the Sarbanes-Oxley Act. A Senate Report on the legislation states:

The statutory independent audit requirement has two sides. It grants a franchise to the nation's public accountants – their services, and only their services, and certification, must be secured before an issuer of securities can go to market, have the securities listed on the nation's stock exchanges, or comply with the reporting requirements of the securities laws. This is a source of significant private benefit to the public accountants.

But the franchise is conditional. It comes in return for the CPA's assumption of a public duty and obligation. As a unanimous Supreme Court noted nearly 20 years ago: "In certifying that public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility. [That auditor] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

S. Rep. No. 107-205, at 14 (2002) (citing United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (emphasis in original)).

EY committed repeated violations of the auditor independence standards by conduct that was reckless, highly unreasonable, and negligent. It has not acknowledged that it has committed any violations, and it has offered no assurance that it will not commit violations in the future.

For all the above reasons, I find the public interest requires a cease-and-desist order to secure compliance.

Disgorgement

Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act authorize the Commission to order disgorgement, including reasonable interest, in any cease-and-desist proceeding where there is a finding that someone is violating, has violated, or is about to violate any provision of any statute, rule, or regulation.

The Division recommends that EY be ordered to disgorge \$1,686,500, the amount of EY's fees for auditing PeopleSoft for fiscal years 1994 through 1999, and prejudgment interest totaling \$729,302.13.⁵⁶ (Stipulations.) According to the Division, equity requires that EY disgorge its audit fees that amount to "but a fraction of the nearly half a Billion dollars of revenues EY obtained through its consulting and other business relationships with PeopleSoft

⁵⁶ The parties stipulated to the amount of EY's audit fees, but the Division did not show how it calculated the amount of prejudgment interest. (Stipulations; Div. Initial Brief at 125.)

that caused” EY to violate the independence regulations. (Div. Initial Brief at 116) (emphasis in original). In support of its position, the Division cites SEC v. Hughes Capital, 124 F.3d 449, 455 (3d Cir. 1997) (quoting SEC v. First City Financial Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (disgorgement “is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws.”) and SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (“The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable.”) (Div. Initial Brief at 115.)

Based on the evidence, disgorgement is warranted to prevent unjust enrichment and to deter EY and others from committing similar violations. “The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits.” Manor Nursing Centers, 458 F.2d at 1104. This was not a situation of an isolated mistake or confusion over a complicated, technical issue. These violations occurred over an extended period. They were committed by professionals throughout the firm who exhibited no caution or concern for the rules of auditor independence in connection with business relationships with an audit client. I therefore will order that EY disgorge \$1,686,500, the amount of its fees for auditing PeopleSoft for fiscal years 1994 through 1999, and prejudgment interest from April 1, 2000, the first day of the month following March 30, 2000, the day PeopleSoft filed its Form 10-K for fiscal year ended December 31, 1999. (Div. Ex. 549 at 041936.)

Requiring An Independent Consultant

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to supplement a cease-and-desist order with a requirement that such person:

comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

The Division recommends that the Commission use this authority to require EY to hire an independent consultant acceptable to the Division. The independent consultant would: (1) review EY’s auditor independence policies, procedures, and practices regarding its business relationships with audit clients, including the business relationships set out in this Initial Decision; (2) review all of EY’s business relationships with audit clients from which EY and/or its audit client received revenues over \$100,000 (exclusive of audit fees) during any calendar year since January 1, 2000, or such other threshold set by the independent consultant after consultation with the Division and EY; and (3) determine whether any such relationship violated the auditor independence requirements established by the Commission and GAAS.

The Division recommends that within six months of the date of the Initial Decision, the independent consultant shall submit a report documenting its findings and making recommendations (the “Report”) to EY, the Division, and the Chief Administrative Law Judge.

The Report will include recommendations necessary to remedy the failures found in the Initial Decision and any additional failures found in the Report. EY shall adopt all recommendations in the Report; provided however, that EY may suggest an alternative policy or procedure designed to achieve the same result in writing to the independent consultant, the Division, and the Chief Administrative Law Judge. EY and the independent consultant shall negotiate in good faith any recommended policy or practice as to which there is dispute. EY shall adopt the recommendations the independent consultant deems appropriate. Finally, the Division recommends that within forty-five days of receiving the independent consultant's written Report, EY shall file an affidavit with the Division and the Chief Administrative Law Judge certifying that it has implemented the independent consultant's recommendations. (Div. Initial Brief at 125-26, clarified by the Division's Motion To Supplement the Record, December 18, 2003.) The Division points to Peat Marwick Mitchell & Co., 45 S.E.C. 789 (July 2, 1975), as an example of an order entered on consent that imposed various remedial sanctions on a firm. (Div. Initial Brief at 124 n.53 (citing Moret Ernst & Young Accountants, 77 SEC Docket 3416 (June 27, 2002) (settlement order); Syncor International Corp., 79 SEC Docket 378 (Dec. 10, 2002) (settlement order); DeGeorge Financial Corp., 65 SEC Docket 2608 (Nov. 12, 1997) (settlement order)).)

EY considers the requirement that it retain an independent consultant as an "outrageous" attempt to punish EY for alleged transgressions that happened several years ago that is unsupported by any record evidence. (EY Brief at 149-50.) EY cites several cases for the proposition that relief pursuant to Rule 102(e) of the Commission's Rules of Practice and Sections 4C and 21C of the Exchange Act must be remedial in nature, rather than punitive, must be tailored to the challenged conduct at issue, and must be directed toward preventing future harm to the investing public and the Commission's processes. (EY Brief at 126 (citing County of Nevada, 70 SEC Docket 3303, 3334-35 (Oct. 29, 1999); Warren G. Trepp, 65 SEC Docket 614 (Aug. 18, 1997).) According to EY, there has been no harm to the investing public, and EY had reasonable policies and procedures in place to address independence issues and these processes worked. In addition, EY claims that subsequent events such as the end of EY/GEMS for PeopleSoft, the sale of EY's consulting practice, the TOS report, and the provisions of the Sarbanes-Oxley Act, make any sanction unwarranted. (EY Brief at 127, 140-49.)

Section 8A of the Securities Act and Section 21C of the Exchange Act specify that the Commission may take actions in addition to an order to cease and desist to achieve compliance. The record demonstrates that it is in the public interest for the Commission to exercise this authority as a means of obtaining compliance with the Commission's independence rules. Despite EY's strong denials, the evidence shows that the firm paid only perfunctory attention to the rules on auditor independence in business dealings with a client, and that EY reliance on a "culture of consulting" to achieve compliance with the rules on auditor independence was a sham. EY has offered no promises of future compliance. I reject EY's argument that intervening events make sanctions unnecessary. Congress in the Sarbanes-Oxley Act reaffirmed the Commission's responsibility to act vigorously to eliminate improper professional conduct by codifying the provisions of Rule 102(e) in Section 4C of the Exchange Act. I have previously rejected EY's claims that: (1) it had reasonable policies and procedures in place, which it implemented reasonably to assure compliance with auditor independence standards in business

relationships; and (2) the TOS Report provides assurance that EY will comply with the independence rules in the future.

I accept the Division's recommended sanction as appropriate, however, I will order a less detailed requirement for the independent consultant and shift oversight responsibility to the Commission so that it can delegate that responsibility to whomever it deems appropriate.

Six-Month Suspension

The Division recommends that the Commission, pursuant to Section 4C of the Exchange Act and Rule 102(e) of the Rules of Practice, suspend EY:

from accepting audit engagements for new SEC registrant audit clients for a period of six months from the date of this Order, or, if not accomplished before that date, until such date on which it demonstrates, to the satisfaction of the Chief Administrative Law Judge, that it has implemented procedures sufficient to comply with this Order.

(Div. Initial Brief at 126.)

EY opposes the suspension for many of the same reasons it opposed the independent consultant. It characterizes the Division's recommendation as outrageous and unprecedented. It notes that Peat Marwick was a settlement that did not involve audit failures. EY argues that the requested relief is unsupported by the record and is an attempt to punish EY for alleged independence transgressions that happened many years before. EY argues that Commission precedent in cases involving serious audit failure, which were not present here, do not support a six-month, firm-wide suspension. In Ernst & Ernst, 46 S.E.C. 1234 (May 31, 1978), the Commission reversed an administrative law judge's finding that an accounting firm should be barred from Commission practice with respect to new clients for six months. In Ernst & Whinney, 47 SEC Docket 291 (June 28, 1990), the administrative law judge rejected the Division's request for a firm-wide suspension and ordered a forty-five day suspension on the firm's local office that contributed to the audit failure. (EY Brief at 151.)

The Commission has repeatedly stated that the assessment of the proper sanctions to be imposed depends "on [the] particular facts and circumstances, and cannot be determined in comparison with the actions taken in other cases." Stonegate Securities Inc., 76 SEC Docket 111, 118 n.22 (Oct. 15, 2001.) Here considerable evidence shows that EY partners acted recklessly and negligently in committing willful and deliberate violations of well-established rules that govern auditor independence standards in connection with business relationships with an audit client. EY's misconduct was blatant and occurred after the Commission and a court accepted EY's representations that it would observe the very same auditor independence rules, that it now claims are too vague to be followed. There is nothing in this record that shows that EY is willing to accept the auditor independence rules applicable to business relationships with audit clients. EY has not acknowledged any wrongdoing and it has made no commitment to lawful conduct.

Congress gave the Commission authority to suspend EY from accepting audit engagements for new SEC registrant audit clients. I find that the record demonstrates that it is in the public interest for the Commission to exercise its authority as a means of obtaining compliance with the Commission's independence rules. I therefore will suspend EY from accepting audit engagements for new SEC registrant audit clients for a period of six months.

VI. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items described in the record index issued by the Secretary of the Commission on February 4, 2004, and the additional exhibits I admitted into evidence in this Initial Decision.

VII. ORDER

Based on these findings and conclusions:

I ORDER, pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, that:

A. Ernst & Young LLP shall cease and desist from committing any violations and any future violations of Rule 2-02 of Regulation S-X, and from causing any violations and any future violations of Sections 7(a) and 10(a) of the Securities Act of 1933, and Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, and Rules 13a-1 and 14a-3 thereunder.

B. Ernst & Young LLP shall disgorge the sum of \$1,686,500, and prejudgment interest, calculated from April 1, 2000, through the last day of the month preceding the month in which payment is made pursuant to Commission Rule 600.⁵⁷ 17 C.F.R. § 201.600.

Ernst & Young LLP shall pay disgorgement and prejudgment interest on the first day following the day this Initial Decision becomes final by United States postal money order, wire transfer, certified check, bank cashier's check, or bank money order payable to the U.S. Securities and Exchange Commission. Payment with a cover letter should identify Ernst & Young LLP as the Respondent in Administrative Proceeding No. 3-10933, and should be delivered by hand or courier to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312. A copy of the cover letter should be sent to the Commission's Division of Enforcement.

C. Ernst & Young LLP shall retain an independent consultant acceptable to the Commission, to work with Ernst & Young LLP to assure the Commission that Ernst & Young LLP's leadership is committed to, and has implemented policies and procedures that reasonably can be expected to remedy the violations found in this Initial Decision and result in compliance

⁵⁷ Rule 600(b) of the Commission's Rules of Practice prescribes the underpayment rate of interest established under 26 U.S.C. § 6621(a)(2) and that interest on the sum to be disgorged shall be compounded quarterly. 17 C.F.R. § 201.600(b).

with the Commission's rules on auditor independence related to business relationships with clients and with GAAS. Ernst & Young LLP shall cooperate with the independent consultant in all respects, including staff support, and shall compensate the independent consultant, and staff, if one is necessary, at reasonable and customary rates. Once retained, Ernst & Young LLP shall not terminate the relationship with the independent consultant without Commission approval. The independent consultant shall report to the Commission in writing six months from the date work has begun as to the findings of its review and Ernst & Young LLP's efforts at correcting the violations.

I FURTHER ORDER, pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, that Ernst & Young LLP is suspended from accepting audit engagements for new Commission registrant audit clients for a period of six months from the date this Initial Decision becomes effective.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the Initial Decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

Brenda P. Murray
Chief Administrative Law Judge