REPORT
OF THE INTERNAL INVESTIGATION
OF INDEPENDENCE ISSUES
AT PRICEWATERHOUSECOOPERS LLP

IN THE MATTER OF
PRICEWATERHOUSECOOPERS LLP
U.S. SECURITIES AND EXCHANGE COMMISSION
AP FILE NO. 3-9809

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I. INTRODUCTION

In March 1999, Jess Fardella of Lankler Siffert & Wohl LLP ("LSW") was appointed by the U.S. Securities and Exchange Commission ("SEC") as the "independent, outside person or firm" under Section V.B.1. of the January 14, 1999 Order Instituting Proceedings and Opinion and Order (the "Order") in the above-captioned matter to supervise the undertaking of PricewaterhouseCoopers LLP ("PwC") to conduct the Internal Investigation referred to in that Section. Pursuant to the Order, we respectfully submit the following report of the results of the Internal Investigation.

PwC's Internal Investigation included three principal phases: (1) a firm-wide confirmation process beginning in March 1999 whereby PwC professionals were required to report violations of the rules governing independence for accountants (the "March 1999 Confirmation Process"); (2) a random sample study of the accuracy of the self-reporting in the March 1999 Confirmation Process (the "Random Sample Study"); and (3) an examination of the independence confirmation process in fiscal year 1997 in twelve offices of each of PwC's "legacy" firms, Price Waterhouse LLP ("PW") and Coopers & Lybrand L.L.P. ("C&L"), whose July 1, 1998 merger (the "Merger") formed PwC (the "Internal Controls Study").

The Internal Investigation revealed that substantial numbers of PwC professionals, particularly partners, had violations of the independence rules, and that many had multiple violations. While many PwC professionals reported violations in the firmwide March 1999 Confirmation Process, the full numerical magnitude of independence non-compliance was evident only from the Random Sample Study, which

demonstrated that the overwhelming majority of partners selected for audit failed to report at least one violation in the March 1999 Confirmation Process.

Violations and the failure to report violations appear to have resulted, for the most part, from a range of reasons that included excusable mistake, various forms of laxity, and an insensitivity to the importance of independence compliance, rather than from a deliberate circumvention of the independence rules or reporting requirements, although at least one individual acknowledged intentional non-compliance.

We have not undertaken an assessment of the impact, if any, of the violations revealed during the Internal Investigation on any audit services performed by PwC, and no such impact has come to our attention during the Internal Investigation. The SEC has reviewed certain violations in which individuals performed services for SEC-reporting clients and in all of the cases that were reported in connection with the March 1999 Confirmation Process, the SEC has determined to process the public filings of the clients in the ordinary course of business.

It should be noted that the databases from which the statistical tabulations in this report were drawn do not classify violations by dollar value and do not identify situations in which the circumstances underlying multiple violations might be viewed as related, such as where multiple members of a professional's family hold the same prohibited interest. Nonetheless, the numbers alone, as PwC acknowledges, disclose that there was widespread independence non-compliance at PwC that reflected serious structural and cultural problems rooted in both its "legacy" predecessors. New independence controls being implemented pursuant to the Order are designed to make significant improvements in PwC's independence compliance by reducing the dependence on individual initiative

and facilitating the resolution of past Independence violations. However, the success of PwC's new independence system ultimately will depend not only on its design and implementation but also on the success of efforts to educate PwC professionals concerning the importance of complying with independence rules and procedures.

II. BACKGROUND

A. Brief Overview of the Independence Rules

PwC, a Delaware limited liability partnership, is a certified public accounting firm that employs approximately 39,000 professionals in offices throughout the United States. It provides assurance/business advisory services (i.e., audit-related services), tax-related services, financial advisory services, management consulting services and human resources services, among other services.

Accounting firms like PwC, and their partners, shareholders and principals, as well as certain professional employees, must maintain independence from their audit clients and from their audit clients' parents, subsidiaries, and affiliates ("Independence").[1] Both the SEC and the American Institute of Certified Public Accountants (the "AICPA") have promulgated rules and guidelines governing the Independence of accountants (the "Independence Rules").[2] The following is a broad outline of some of the most basic Independence Rules, with emphasis given to the Rules that are most pertinent to the Internal Investigation: those that relate to financial interests

[1] Hereafter in this report, "audit clients" will also be referred to as "clients" unless otherwise noted.

[2] The SEC's requirements and interpretations governing Independence are set out in Reg. § 210.2-01(b) of Regulation S-X, 17 C.F.R. 210.2-01(b) and Sections 601-602 of the SEC's Codification of Financial Reporting Policies (hereafter, "Sec. 601" or "Sec. 602"). The AICPA's standards are set out in the AICPA Professional Standards ET Section 101 (hereafter, "ET § 101"). The SEC has directed registrants and auditors to the AICPA rules where they do not conflict with those of the SEC. See Sec. 601.04 at 38,583-3 and n. 7.

in an audit client.[3] Non-compliance with these Rules will be referred to hereafter as "Independence violations" or "violations."[4]

Those who must maintain Independence, called "members" under the SEC and AICPA rules and in this report, include all partners, shareholders, and other principals of accounting firms, all professional employees performing professional services for an audit client, and all professional employees with managerial positions in offices participating in a significant portion of the audit engagement.[5] Members also include spouses and cohabitants of members, and any dependents of members.[6]

1. Prohibited Investments

Professionals of an accounting firm are not permitted to hold "direct" financial interests of any amount in any client (or certain of those clients' affiliates) as to which they are "members." "Direct" interests include a wide variety of investments, such as

[3] The Internal Investigation also has examined prohibited relationships between the family of a professional and audit clients. However, issues such as the propriety of certain business relationships between the accounting firm or its members and clients is beyond the scope of the Internal Investigation.

[4] The AICPA rules apply to privately held clients as well as to SEC-registered or regulated entities. In certain areas, the AICPA rules are somewhat less restrictive than the SEC rules. PwC and its legacy firms have or had Independence policies during the period relevant to the Internal Investigation that in some respects go beyond the requirements of the SEC and AICPA. For example, before the Merger, the legacy PW Independence policy prohibited any professional from purchasing an interest in an audit client after joining the firm, except for certain mutual funds, even if the person was not a "member" with respect to this client and the interest would not violate the SEC or AICPA rules. See AGS - U.S. National Guidance AAR 7960 Independence .12(1) at 2.

[5] See ET § 101.11 at 4420.

[6] See Sec. 602.02.h. at 38,599-38,601; see also ET § 101.11 at 4422.

debt or equity securities, puts, calls, straddles, options, and warrants.[7] Members may not hold investments in mutual fund clients or in mutual funds whose investment advisors[8] are clients.[9] A member's interest in an individual retirement account ("IRA") or 401(k) plan[10] that invests in client securities is also an Independence violation.[11]

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[7] Direct investments are prohibited regardless of how the ownership arises. For example, ownership of securities through an investment club, payment for services through stock, and interests held through an ownership in a partnership are all Independence violations. Additionally, ownership of shares in a unit investment trust ("UIT") that is sponsored by a client, or that invests in a client, is considered a direct financial interest in a client, and is therefore prohibited. Furthermore, members may not hold prohibited investments through "blind trusts."

[8] A member may maintain a self-directed individual retirement account that has an investment in a non-client mutual fund with a client investment advisor. See 1998/1999 PwC Independence and Related Matters .48 at 15.

[9] Holdings in non-client mutual funds that own shares in a client are considered an indirect investment, and are permissible so long as a member's interest in a particular client through the mutual fund is no more than five percent of the member's net worth. See 1998/1999 PwC Independence and Related Matters .34 at 12.

[10] Where a spouse, cohabitant, or dependent's 401(k) holdings are part of a client-sponsored plan or consist in any part of client securities, the Internal Investigation has applied AICPA Ethics Ruling No. 108, and PwC rules (1998/1999 PwC Independence and Related Matters .38 at 13), which treat an interest in such a plan as "indirect" and therefore subject to a materiality threshold, as long as certain other conditions are met (e.g., the spouse, cohabitant, or dependent receives the securities as part of a normal compensation package, is offered no other options, does not have access to the securities, promptly disposes of the securities upon access to them, and holds a position with an audit client employer that does not impair independence; and the member does not work on the engagement). However, the SEC's Office of Chief Accountant has indicated to PwC that it regards such a situation as constituting a direct interest where the member is a partner.

[11] Additionally, a member's direct interest in a non-client when the non-client is a material investee of a client is an Independence violation. See ET § 101.10 at 4418.

The Independence Rules also prohibit material indirect interests in clients or client affiliates.[12] The determination of materiality is made by examining the net worth of the member, the firm, and the client;[13] generally, if the holding is under five percent of the member's net worth, it is deemed immaterial.[14]

2. Prohibited Loans, Extensions of Credit, Bank Deposits, and Brokerage Accounts

Members are also prohibited from taking out loans from clients, except for "grandfathered" loans and "permitted" loans. A grandfathered loan is one where the lender is a client requiring Independence, but the following conditions are met: the loan is either a home mortgage, or another secured loan for which collateral must equal or exceed the balance as of January 1, 1992 and thereafter, or is not material to the member's net worth, and the loan was either in existence at January 1, 1992 or was obtained prior to the date that the lender became a client requiring Independence with respect to the member. Grandfathered loans must be kept current as to terms, and cannot be renegotiated past the latest of the above dates.[15] Permitted loans are loans obtained under normal lending procedures, from a client requiring Independence, that are either auto loans and leases collateralized by the auto, loans of the surrender value under the

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[12] For example, a member's material interest in a non-client, when the non-client is an immaterial investee of the client investor, constitutes an Independence violation. See ET § 101.10 at 4418.

[13] See Sec. 602.02.b.i. at 38,586.

[14] See, e.g., Sec. 602.02.b.iii. at 38,587.

[15] See ET § 101.07 at 4413-4414.

terms of an insurance policy, or loans fully collateralized by cash deposits at the same financial institution.[16]

Additionally, members may not hold credit cards with client institutions that carry balances over $5,000.[17] Also, if members have balances in client institutions above the FDIC insured limit of $100,000, any balance over $100,000 that is material to the member's net worth is an Independence violation.[18] Furthermore, members may not leave cash or securities with a broker-dealer client longer than the normal settlement period, allow funds to be swept into a temporary investment in a client, or hold a margin account with a broker-dealer client.[19]

3. Prohibitions Regarding Trusts and Estates

A member may not serve as a trustee of any trust if the trust has or is committed to acquire any direct or material indirect financial interest in a client.[20] A member may not be a beneficiary of a trust that holds a financial interest in a client that is material to the member.[21] Members may not be executors or administrators of any estate if the estate has or is committed to acquire any direct or material indirect financial interest in a client.[22]

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[16] See ET § 101.07 at 4414.

[17] See id.

[18] See AICPA Ethics Ruling No. 70.

[19] See Sec. 602.02.g., Example 17 at 38,598; 1998/1999 PwC Independence and Related Matters .45-.47 at 15.

[20] See Sec. 602.02.g., Example 18 at 38,598; ET § 101.02(A)(2) at 4411.

[21] See 1998/1999 PwC Independence and Related Matters .51 at 16.

[22] See Sec. 602.02.g., Example 18 at 38,598; ET § 101.02(A)(2) at 4411.

4. Prohibitions Regarding Family-Client Relationships

Independence violations may exist when members' spouses, cohabitants, or dependents are employed by a client. Violations exist when the member's spouse, cohabitant, or dependent has a position that allows significant influence over the client's operating, financial, or accounting policies, and the member either participates in the engagement, or is a proprietor, partner, or shareholder who is (1) located in an office participating in a significant portion of the engagement, (2) has the ability to exercise influence over the engagement, or (3) has any involvement with the engagement.[23] There may also be an Independence violation when a spouse, cohabitant, or dependent of an individual participating in the engagement has a position with the client involving activities that are audit-sensitive, even when the position does not allow "significant influence."[24]

5. Prohibited Interests or Relationships of Non-Dependent Relatives

Violations also exist when non-dependent close relatives of members[25] have material financial interests,[26] business relationships, or important positions with a client,[27]

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[23] See ET § 101.11 at 4422.

[24] See ET § 101.11 at 4422.

[25] See Sec. 602.02.h. at 38,599; see also ET § 101.11 at 4423.

[26] Generally, a material holding is one that is over five percent of the holder of the interest's net worth. See supra n. 14.

[27] See Sec. 602.02.h. at 38,599. The AICPA rules note that a non-dependent close relative's employment by a client is a violation when, during a period covered by financial statements, during a period of professional engagement, or at the time of expressing an opinion, (a) an individual participating in an engagement has a close relative who could exercise significant influence over the operating, financial, or accounting policies of the client, or who is otherwise employed in a position in which the person's activities are audit-sensitive, or (b) a member who is located in an office

of which the member is aware.[28] Under SEC rules, impairment due to a non-dependent close relative's material financial interest may be mitigated where there is sufficient geographical distance between the member and (1) his or her relative; and (2) the audit engagement.[29]

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participating in a significant portion of the engagement has a close relative who could exercise significant influence over the operating, financial, or accounting policies of the enterprise. See ET § 101.11 at 4423.

[28] See ET § 101.11 at 4423.

[29] See Sec. 602.02.h. at 38,599.

B. Background of the Internal Investigation

As a result of the investigation of Independence problems in the legacy C&L firm, as well as in connection with the Merger, the subject of Independence became increasingly prominent within PwC beginning approximately two years ago.

1. The Investigation of C&L's Tampa Office

The SEC's Order on January 14, 1999 was the culmination of an investigation into Independence issues centering around the Tampa office of C&L that began in late 1997. The Order made findings that PwC neither admitted nor denied. The Order found that several C&L professionals had violated Independence Rules and that three individuals in the Tampa office had owned securities of a total of four publicly-held audit clients for which they provided professional services. The Order also made the finding that C&L's retirement plan owned securities of 45 publicly-held C&L audit clients. See Ex. 1.[30]

2. PwC's Internal Communications Concerning Independence Issues Raised By the Merger and the SEC Investigation

During 1998, PwC's legacy firms were preparing for the consummation of the Merger, in part by promulgating policies to address Independence issues that would arise when the Merger became effective on July 1, 1998. After the date of the Merger, PwC members were required to adhere to Independence rules not only with respect to the clients of their respective legacy firms, but also with respect to clients of their non-legacy firms.

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[30] "Ex." refers to the accompanying Exhibits to the Report of the Internal Investigation of Independence Issues at PricewaterhouseCoopers LLP, In the Matter of PricewaterhouseCoopers LLP, U.S. Securities and Exchange Commission AP File No. 3-9809.

In May 1998, PwC promulgated a Transition Independence Policy that required the disposal of interests that became prohibited as a result of the Merger.[31] See Ex. 2. On July 28, 1998, PwC officials sent a memo to all partners advising them that in August 1998 they would be asked to confirm their compliance with PwC's Transition Independence Policy. See Ex. 3. Then, on August 18, 1998, PwC sent all partners of the merged firm a confirmation (the "Merger Confirmation") requiring them to state whether they were in compliance with the Transition Independence Policy. See Ex. 4.

On November 5, 1998, PwC's chief executive and its chairman sent a memo to all PwC professionals explaining that Independence problems had been discovered in a recent internal review, that the firm took such issues seriously, that two partners and one manager were no longer with the firm as a result of these problems, and that PwC was instituting a new Independence system that would include an audit of brokerage statements and tax returns to ascertain the accuracy of confirmation responses. See Exs. 5, 6. This letter was followed the next day by an e-mail sent to all audit partners requiring them to report ownership of the securities of any of their audit clients (the "Audit Partner Confirmation"). See Ex. 6. In late December 1998, PwC circulated a new Independence policy for the combined firm, noting differences between it and the policies of the respective legacy firms. See Ex. 7.

On January 14, 1999, as noted supra, the SEC investigation of the Tampa Office and the C&L pension plan culminated in the entry of the Order. The Order provided that PwC, among other things, would conduct the Internal Investigation under the supervision

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[31] The Policy required, inter alia, that any liquid investment that became prohibited as a result of the Merger be disposed of immediately after, but no later than 30 days from, the effective date of the Merger unless the investment was brought to the attention of the

of an "independent, outside person or firm appointed by the Commission." See Ex. 1 (Section V.B.1.). The Order also required PwC to implement a new Independence system with mechanisms and procedures designed to improve compliance with Independence Rules. See id.

On January 14, 1999, PwC officials sent a letter to all PwC partners advising them of the SEC settlement in this case. See Ex. 8. In that letter, PwC officials described the Tampa violations as "aberrant." Id. As set forth more fully in this report, that assessment proved to be incorrect.

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national Independence office.

III. THE INTERNAL INVESTIGATION

A. The March 1999 Confirmation Process

1. Mechanics of the March 1999 Confirmation Process

In connection with the Order, PwC undertook a firmwide Independence confirmation process. On or about March 3, 1999, PwC electronically mailed an Independence confirmation (the "March 1999 Confirmation") to approximately 39,424 persons. See Ex. 9.

The March 1999 Confirmation required respondents to confirm their Independence or report Independence violations that existed during the period from the last firm-wide confirmation (fiscal year 1997) to the date of response. It stated that the Confirmation process was "being conducted under the oversight of the SEC staff," and contained the following warning, in large type, bold-face, all capital letters:

> **IMPORTANT NOTE: YOUR ANSWERS MAY BE SUBJECT TO EXAMINATION BY THE SECURITIES AND EXCHANGE COMMISSION, AND ANY FALSE STATEMENT TO THE SEC MAY BE SUBJECT TO CHARGES OF MAKING A FALSE STATEMENT UNDER 18 U.S.C. § 1001. YOU MAY BE REQUIRED TO PROVIDE BROKERAGE STATEMENTS, OTHER DOCUMENTS AND SWORN TESTIMONY TO CONFIRM THE ACCURACY OF YOUR RESPONSES.**

See id.

About half of the responses were received by March 17, 1999, the deadline for response. Approximately 70% of the responses were received by March 23, 1999, and a follow-up e-mail was sent to non-respondents. Beginning in early April 1999, a third notice was sent threatening disciplinary action, including possible termination, to the

small percentage who still had not responded.[32] By April 21, 1999, all partners had responded; virtually all non-partners had responded by mid-May 1999.

The process of obtaining and accounting for responses was complicated by several factors,[33] including the fact that, as set forth infra, a large number of matters and violations were reported in the process, and many Confirmation responses did not include clear or sufficient information concerning each of them.[34] PwC utilized its Regional Independence Partners ("RIPs"),[35] along with other PwC Independence personnel, to assist in the labor-intensive process of pursuing non-respondents, gathering necessary additional information, determining whether reported matters were violations, ensuring

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[32] One person was terminated after failing to respond to the Confirmation, although his failure to respond was one among several reasons for his termination.

[33] Certain PwC professionals gave insufficient priority to the task of submitting and collecting responses. However, logistical difficulties played a significant role as well. Some persons, including certain persons on job assignments overseas, were unable to receive the firm's e-mail or to receive it in timely fashion. Accounting for responses was complicated by the fact that, although most individuals replied electronically, many individuals responded manually, by faxing or mailing a completed response to PwC Independence personnel. The Confirmation responses were tracked through a Lotus Notes database (the "Confirmation Database") which was designed by PwC, and to which LSW has had access. It was more difficult and time-consuming to keep track of the manual responses than the electronic responses, and many individuals had to be asked to resubmit their responses.

[34] The forms required responses regarding Independence for three distinct periods of time: from the end of fiscal 1997 to June 30, 1998; from July 1, 1998 (the date of the Merger) to the date of the Confirmation response; and as of the date of the Confirmation response. In addition, the forms sought extensive information concerning any reported matters, in some cases beyond what was required to determine whether the matter constituted an Independence violation, to enhance the usefulness of the Confirmation process and the chances of learning about any issues that were time-sensitive. The form also contained one inquiry not pertinent to the subject of the Internal Investigation.

[35] Legacy C&L conducted Independence oversight at least in part through a system of partners at the regional and line of service levels who reported to a national partner responsible for Independence. Since the Merger, PwC has used a similar Independence structure.

that violations were properly resolved, and verifying that all necessary information, including resolution, had been documented.

In fixing the universe of professionals for further analysis and eventual audit in the Random Sample Study, PwC, with LSW's consultation, eliminated certain categories of people from the list of 39,424 persons to whom a March 1999 Confirmation was sent. Most of those eliminated did not submit a March 1999 Confirmation response and fell into one of the following categories: approximately 2,818 persons who had left the firm before March 3, 1999; approximately 116 persons not subject to Independence requirements who were sent a March 1999 Confirmation erroneously; 63 seasonal workers who were not currently working at PwC; 170 individuals who were on leave during the March 1999 Confirmation Process; and 22 retired partners.

After accounting for the foregoing adjustments, the March 1999 Confirmation responses of approximately 36,170 professionals (2,698 partners, or 7% of the total respondents, and 33,472 non-partners, or 93% of the total respondents) were the subject of tabulation and analysis.[36]

2. Development of a Database for the Results of the March 1999 Confirmation Process

It was important both to LSW and PwC to collect enough information to permit a useful study of the March 1999 Confirmation Process, rather than merely to ensure the discovery and resolution of Independence issues. Accordingly, we worked with PwC to

[36] See App. A. "App." refers to the accompanying Appendices to the Report of the Internal Investigation of Independence Issues at PriceWaterhouseCoopers LLP, In the Matter of PricewaterhouseCoopers LLP, U.S. Securities and Exchange Commission AP File No. 3-9809.

develop a Lotus Notes database (the "Reported Matters Database")[37] that could track and summarize important information from matters reported in the Confirmation responses, such as whether a reported matter was a violation, the nature of the violation, the dates of its occurrence and resolution, and whether the person reporting the violation worked on the engagement of the client as to which the violation existed (including whether such work was performed on the audit). We helped PwC develop a Reported Matter Form ("RMF") to collect such information for each reported matter in an electronic format that could later be analyzed.[38] See Ex. 10. The RIPs supervised the completion of RMFs based on data supplied in the Confirmation responses and gathered subsequently, and were responsible for final approval of each confirmation response and RMF.[39] LSW also worked with PwC to design "views" in the Reported Matters Database in which pertinent information was tabulated for analysis, such as a breakdown of reported violations by professional status, legacy firm, line of service, type and source.

In light of the number of reported matters and reported violations, the number of different ways in which we have attempted to tabulate the results, and the number of RIPs and other individuals involved in the collection, classification and input of information

[37] LSW has had access to this database.

[38] Each reported financial interest or relationship was deemed a separate reported matter requiring preparation of a separate RMF.

[39] To maximize the accuracy of data tabulated from the Confirmation Database and the Reported Matters Database, all Confirmation responses and corresponding documentation were required to be "approved" by an RIP. During the period of heavy activity by the RIPs in collecting information, filling out RMFs, and approving RMFs, we held weekly and sometimes twice-weekly conference calls with the RIPs and PwC National Independence partners and the PwC personnel assisting them to monitor the progress of the March 1999 Confirmation Process, including logistical and other difficulties that were encountered. Modifications to the Databases were engineered in response to certain of these difficulties to make the process more manageable.

into the Reported Matters Database, errors and inconsistencies are inevitable.[40] However, we believe that the tabulations from the Reported Matters Database, while to some extent imprecise, are useful in describing the broad contours of reported violations. Of course, errors will more substantially affect categories with small numbers of reported violations.[41] Moreover, there is no guarantee that the Reported Matters Database does not contain errors or omissions that in individual cases are of a more significant nature, as the result either of typographical errors or erroneous "judgment calls" by those classifying violations.

It is also important to note certain ground rules that were used in tabulating reported violations in the Reported Matters Database.[42] Each entity that was the subject of a violation, even if it was part of the same corporate or mutual fund family, was counted separately. For example, if an individual had holdings in five separate funds

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[40] For example, a slight error is introduced into certain tabulations because a small number of respondents appear more than once in the Reported Matters Database as the result of double name entries, transposition of last and first names, or typographical errors in staff identifier numbers. Uncertainties also may occur in certain classifications of violations, such as type of investment or source of violation, because of the way in which different RIPs might have interpreted the available categories. See, e.g., Table 15, infra, which provides for categorization of an interest either as a "direct investment" or "sweep account." Additionally, as set forth in Part III, Sections A.3(b) and A.3(d)(iii), infra, we noted possible errors in the classification of reported matters.

[41] For example, a total of 14 reported violations were identified in the Reported Matters Database as having arisen from impermissible employment relationships between a family member and a client. We examined the files for these violations and found that at least two of them, based on the face of the reported information, appear to be erroneously classified as "family relationship" violations.

[42] The same methodology was used for recording unreported violations in the Random Sample Study.

belonging to the same mutual fund family, five separate violations were recorded.[43] Moreover, the same prohibited investment was deemed a separate violation for each family member who held it, and generally for each type of account (regular, IRA, 401(k), trust or estate) in which it was held. Furthermore, a single interest in one non-client entity could result in multiple violations where that non-client entity was affiliated with or invested in multiple restricted entities.[44] Additionally, no attempt was made to aggregate violations based on their provenance or cause. Thus, where an individual had many prohibited holdings all stemming from the same stated reason, such as a lack of awareness that the Independence Rules applied to a particular kind of interest, each holding was tabulated as a separate violation. Moreover, the Reported Matters Database did not record the dollar value of investments or interests. Violations therefore include interests that range from nominal amounts to much larger sums.

Finally, the figures from the Reported Matter Database presented in the following sections include not only violations of SEC or AICPA rules, but also matters that violate only more restrictive firm policies. See supra n. 4. However, PwC believes that reported matters that do not violate SEC rules comprise an immaterial portion of violations in the Reported Matters Database.

[43] Many individuals had multiple violations arising from various holdings in funds belonging to the same mutual fund family.

[44] For example, an individual who was a trustee of a trust or an executor of an estate had a separate violation for each of the restricted entities in which the trust or estate held an investment. An individual who purchased an interest in a non-client UIT would have a separate violation for each restricted entity in which the UIT invested.

3. Results of the March 1999 Confirmation Process

(a) Reported Matters

The Reported Matters Database revealed that 2,276 (or 6%) of the 36,170 PwC respondents reported a total of 9,889 potential Independence matters.[45] However, as illustrated by Table 1, approximately half of all partners reported matters, while under 3% of all non-partners did so.[46]

TABLE 1
(Percentage of Population With Reported Matters)

	Partner	Non-Partner	Total
Individuals with Reported Matters	1365	911	2276
Individuals in Population as a Whole	2698	33472	36170
Percent of Population with Reported Matters	50.6%	2.7%	6.3%

Tables 2 and 3 show the breakdown of these reported matters, respectively, by legacy firm and professional classification.[47]

TABLE 2
(Reported Matters by Legacy Firm)

	C&L	PW	PwC	Total
Reported Matters	5408	4164	317	9889
Percent of Total Reported Matters	54.7%	42.1%	3.2%	100%

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[45] In the subsequent Tables, and in the accompanying Appendices, "PwC" refers only to professionals who joined PwC after the Merger. "PTR," "MGR" and "EMP" in the Tables and Appendices refer, respectively, to partners, managers, and non-managerial professional employees. The figures in the Reported Matters Database reflect RIP approval of 99.6% of the RMFs.

[46] See also Apps. B, C, and D.

[47] See also Apps. E and F, respectively.

TABLE 3
(Reported Matters by Professional Classification)

	PTR	MGR	EMP	Total
Reported Matters	7365	2080	444	9889
Percent of Total Reported Matters	74.5%	21.0%	4.5%	100%

(b) Reported Violations

Through its RIPs, PwC determined that 1,825 (or 18%) of the 9,889 reported matters did not constitute Independence violations, leaving a total of approximately 8,064 violations (or 82% of the total reported matters). Tables 4 and 5 indicate the breakdown of reported matters and reported violations,[48] and the ratio of the latter to the former, by legacy firm and professional classification, respectively.[49]

TABLE 4
(Reported Matters to Reported Violations by Legacy Firm)

	C&L	PW	PwC	Total
Reported Matters	5408	4164	317	9889
Reported Violations	4384	3470	210	8064
Percent of Reported Matters that are Violations	81.1%	83.3%	66.2%	81.5%

TABLE 5
(Reported Matters to Reported Violations by Professional Classification)

	PTR	MGR	EMP	Total
Reported Matters	7365	2080	444	9889
Reported Violations	6558	1405	101	8064
Percent of Reported Matters that are Violations	89.0%	67.5%	22.7%	81.5%

[48] We will subsequently refer to "reported matters" and "reported violations" using the distinction explained above.

[49] See also App. G.

As these numbers indicate, employees' reported matters more often turned out to be non-violations than those of managers and partners. However, the percentage of reported violations to reported matters was about the same for PwC's two legacy firms.

To assess the accuracy of PwC's determination that certain reported matters did not constitute violations, LSW examined all of the reported matters that RIPs had determined were not violations in a randomly-selected group of 81 partners and 51 non-partners for whom one or more reported matters had been classified as non-violations. With respect to the partners, of 180 reported matters that had been marked as "no violation," it appeared that roughly 5% were erroneously marked, and were actually violations. With respect to the non-partners, of 164 reported matters that had been marked as "no violation," it appeared that roughly 1% were erroneously marked, and were actually violations.[50] In the course of this review, LSW also found that some reported matters classified as violations were in fact not violations, but LSW did not attempt to audit a sample of violations for this purpose.

(c) Breakdown of Reported Violations By Professional Classification, Legacy Firm and Line of Service

(i) Breakdown of Individuals with Reported Violations

The 8,064 reported violations were distributed among approximately 1,885 different individuals, or 5% of the total 36,170 March 1999 Confirmation respondents. Almost half of all PwC partners – 1,301 partners out of a total of 2,698 – reported at least one violation in the March 1999 Confirmation Process. A much smaller portion of the non-partner population (less than 2%) reported at least one violation. Table 6 shows the

[50] A small number of RMFs and Confirmation responses did not contain sufficient information for LSW to draw a conclusion about whether the RIPs' determinations were correct.

breakdown of individuals with reported violations as a percentage of the total population by partners and non-partners.[51]

TABLE 6
(Percentage of Population With Reported Violations)

	Partner	Non-Partner	Total
Individuals with Reported Violations	1301	584	1885
Individuals in Population as a Whole	2698	33472	36170
Percent of Population with Reported Violations	48.2%	1.7%	5.2%

The 1,301 partners who reported a violation reported an average of approximately five violations per person; 153 partners had more than ten violations each. Tables 7 and 8 break down the number of violations per individual by professional classification and by legacy firm, respectively. Table 9 illustrates the distribution of violations among individuals by professional classification.

TABLE 7
(Average Reported Violations per Individual by Professional Classification)

	PTR	MGR	EMP	Total
Reported Violations	6558	1405	101	8064
Individuals with Reported Violations	1301	547	37	1885
Average Reported Violations per Individual	5.0	2.6	2.7	4.3

TABLE 8
(Average Reported Violations per Individual by Legacy Firm)

	PW	C&L	PwC	Total
Reported Violations	3470	4384	210	8064
Individuals with Reported Violations	852	979	56	1887
Average Reported Violations per Individual	4.1	4.5	3.8	4.3

[51] See also Apps. H, I and J.

TABLE 9
(Distribution of Individuals with Reported Violations by Professional Classification)

	PTR	MGR	EMP	Total
Individuals with 1-5 Reported Violations	933	487	32	1452
Individuals with 6-10 Reported Violations	215	47	4	266
Individuals with 11-15 Reported Violations	84	12	1	97
Individuals with 16-20 Reported Violations	32	0	0	32
Individuals with 21-30 Reported Violations	28	0	0	28
Individuals with 31-50 Reported Violations	7	1	0	8
Individuals with 51-70 Reported Violations	2	0	0	2
Total Individuals with Reported Violations	1301	547	37	1885

(ii) Breakdown of Numbers of Reported Violations

The total of 8,064 reported violations involved 2,159 clients or other entities as to whom Independence was required. Many of these clients are members of the same corporate or mutual fund family. PwC estimates that, if related entities among this group of 2,159 are aggregated, the number of entity groupings that are the subject of reported violations would be approximately 600.

As set forth in Table 10, approximately 81% (or 6,558) of the 8,064 reported violations were by partners; 18% (or 1,405) of the reported violations were by managers and 1% (or 101) were by employees.[52] The percentage of reported violations attributable to partners (81%) was significantly higher than the percentage of partners (7%) in the firm's professional population.[53] This difference likely reflects, at least in part, both the broader Independence prohibitions to which partners are subject and partners' greater financial resources.

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[52] See also App. K.

[53] See also App. A.

Tables 10 and 11 show the percentage of total reported violations by professional classification and legacy firm, respectively:

TABLE 10
(Reported Violations by Professional Classification)

	PTR	MGR	EMP	Total
Reported Violations	6558	1405	101	8064
Percent of Total Reported Violations	81.3%	17.4%	1.3%	100%

As set forth in Table 11, legacy C&L professionals had 54% of the reported violations, which at first glance appears to be disproportionate to their share of the total professional population (roughly 40%).[54] However, this difference is at least partly explained when one looks only at partners, whose reported violations as set forth in Table 10 above comprise the vast majority (81%) of the total reported violations. Legacy C&L partners make up approximately 55% of the total partner population. As illustrated by Table 12, this 55% figure is not disproportionate to the percentage of total reported partner violations by legacy C&L partners (57%).[55]

TABLE 11
(Reported Violations by Legacy Firm)

	C&L	PW	PwC	Total
Reported Violations	4384	3470	210	8064
Percent of Total Reported Violations	54.4%	43.0%	2.6%	100%

[54] See also App. L.

[55] See also App. M.

TABLE 12
(Reported Partner Violations by Legacy Firm)

	C&L	PW	PwC	Total
Number of Violations Reported by Partners	3712	2821	25	6558
Percent of Violations Reported by Partners	56.6%	43.0%	0.4%	100%

We also tabulated the reported violations by line of service. Table 13[56] shows the relationship between percentage of reported violations and percentage of the professional population by line of service.[57]

TABLE 13
(Reported Violations by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Number of Reported Violations	3647	567	520	1259	222	1849	8064
Percent of Reported Violations	45.2%	7.0%	6.5%	15.6%	2.8%	22.9%	100%
Percent of Firm Line of Service Comprises	34.5%	3.4%	4.7%	35.3%	3.6%	18.5%	100%

As indicated above by Table 13, audit professionals taken as a whole appear to have had a disproportionate share of the reported violations; they comprise 34% of the firm's professional population, but had 45% of the reported violations. However, as

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[56] In this and other Tables and Appendices, "ABAS" (Assurance and Business Advisory Services) refers to professionals who perform services related to the audit of financial statements, as well as internal audit outsourcing and certain advisory services related to mergers and acquisitions; "FAS" (Financial Advisory Services) refers to professionals who perform services related to asset and business valuations, capital sourcing, underwriting, asset transactions and litigation support; "GHRS" (Global Human Resources Solutions) refers to professionals who perform human resources services; "MCS" refers to professionals who perform management consulting services, including management change, business process design and computer system design and installation; "NATL" refers to national-level administrative personnel; and "TLS" (Tax and Legal Services) refers to professionals who perform tax planning and compliance and financial planning services.

[57] See also App. N.

illustrated below by Table 14, this discrepancy appears to be at least partly attributable to the fact that, while audit professionals as a whole comprise 34% of the professional population, (1) audit partners comprise 47% of all PwC partners and account for a share of total partner violations roughly proportionate to that percentage; and (2) partners as a group have the overwhelming majority of reported violations (81%). See supra Table 10.

TABLE 14
(Audit and Non-Audit Partner Reported Violations)

	ABAS Partners	Non-ABAS Partners	Total
Percent of Partner Population	46.8%	53.2%	100%
Number of Violations	2792	3766	6558
Percent of Total Partner Violations	42.6%	57.4%	100%

(d) Breakdown of Reported Violations By Source and Type

(i) Sources of Violations

As shown in Table 15, approximately 48% of the reported violations (or 3,911 violations) resulted from investments or interests, including IRAs and 401(k)s, held by the reporting professional himself or herself, either solely or jointly.[58] Prohibited spousal investments or interests, including IRAs and 401(k)s, accounted for another 22% (1,802 violations) of the reported violations.[59]

[58] See also App. O (categories A, C and F). Categories A and B in Table 15 include holdings in securities, mutual funds, bank accounts or insurance products. These categories do not include securities acquired through gift or inheritance, or held by a trust or estate, which are separately tabulated.

[59] See also App. O (categories B, D, E and G).

TABLE 15
(Reported Violations By Source of Violation)

	Number of Reported Violations	Percent of Total Reported Violations
A. Direct Investment by the Reporter	2960	36.7%
B. Spouse/Cohabitant Direct Investment	904	11.2%
C. 401(k) – Former Employer (Reporter)	224	2.8%
D. Spouse/Cohabitant 401(k) – Current Employer	214	2.7%
E. Spouse/Cohabitant 401(k) – Former Employer	128	1.6%
F. IRA (Reporter)	727	9.0%
G. Spouse/Cohabitant IRA	556	6.9%
H. Dependent Investment	658	8.2%
I. Non-Dependent Close Relative Investment	76	0.9%
J. Family Member's Employment	19	0.2%
K. Gift/Inheritance	147	1.8%
L. Executor/Trustee	331	4.1%
M. Beneficiary	22	0.3%
N. Broker/Dealer Cash/Securities Account	423	5.2%
O. Margin Account	17	0.2%
P. Sweep Account	290	3.6%
Q. Loan/Bank Deposits	129	1.6%
R. Other	239	3.0%
TOTAL	8064	100%

(ii) Types of Investment or Interest

As shown in Table 16, the overwhelming majority of reported violations was made up of investments in mutual funds (53%), and stocks (31%).[60]

TABLE 16
(Reported Violations by Type of Interest)

	Number of Reported Violations	Percent of Total Reported Violations
Bank Deposit	94	1.2%
Brokerage Account	522	6.5%
Debt Instrument	101	1.2%
Insurance Product	49	0.6%
Loan	65	0.8%
Mutual Fund	4248	52.7%
Stock Option	26	0.3%
Stock	2539	31.5%
Sweep Account	341	4.2%
Other	79	1.0%
TOTAL	8064	100%

[60] See also App. P.

(iii) Merger Violations

Violations also were classified on the basis of whether they were attributable solely to the Merger, i.e., where a member of one of the legacy firms held an interest in or had a relationship with a client of the other legacy firm prior to the Merger, and such an interest or relationship became prohibited under the Independence Rules solely as a consequence of the Merger.[61] As set forth in Table 17, PwC RIPs determined that 46% of the reported violations were "merger" violations.[62] As set forth in Table 18, most of the merger violations (89%) were by partners.[63]

TABLE 17
(Reported Violations Caused by Merger)

	Merger	Non-Merger	Total
Number of Violations	3697	4367	8064
Percent of Total Violations	45.8%	54.2%	100%

TABLE 18
(Reported Merger Violations by Professional Classification)

	PTR	MGR	EMP	Total
Number of Merger Violations	3290	403	4	3697
Percent of Total Merger Violations	89.0%	10.9%	0.1%	100%

[61] Only unresolved violations or violations resolved more than 30 days after the Merger qualified as merger violations for the purposes of the Internal Investigation.

[62] See also App. Q.

[63] See also App. R.

As illustrated by Tables 19, 20 and 21, approximately half of all reported partner violations were merger violations, while managers and employees reported much lower rates of merger violations.

TABLE 19
(Reported Merger vs. Non-Merger Violations: Partners)

	Merger	Non-Merger	Total
Number of Violations	3290	3268	6558
Percent of Total Violations	50.2%	49.8%	100%

TABLE 20
(Reported Merger vs. Non-Merger Violations: Managers)

	Merger	Non-Merger	Total
Number of Violations	403	1002	1405
Percent of Total Violations	28.7%	71.3%	100%

TABLE 21
(Reported Merger vs. Non-Merger Violations: Employees)

	Merger	Non-Merger	Total
Number of Violations	4	97	101
Percent of Total Violations	4.0%	96.0%	100%

LSW conducted a review of the RIPs' merger violation determinations by examining all of the approximately 670 reported matters in 119 randomly-selected partner files in which the RIP classified at least one violation as a merger violation.[64] Of the 670 reported matters, RIPs determined that approximately 592 were violations, and that 363 of these were merger violations. LSW's review indicated that a significant portion (roughly one-fourth) of the 363 merger violation determinations was erroneous.

[64] We reviewed a smaller group of non-partner files and also found some misclassified merger violations, though at a lower rate than what we found in the partner files.

In many such instances, RIPs classified violations as merger violations where the individuals had acquired an interest in a non-legacy firm client after the effective date of the Merger. This error could be offset at least in part by instances in which reported matters not designated merger violations by RIPs should have been classified as merger violations. LSW came across a number of such instances, but did not attempt to audit a sample of non-merger violation determinations to ascertain what percentage should have been classified as merger violations.

(e) Reasons for Violations

The RMFs attempted to capture explanations that were given by respondents for the reported violations.[65] The most frequent reason cited by respondents (3,545 violations) was a failure to check the lists of entities for which Independence was required. For 1,561 violations, respondents claimed a lack of understanding of the relevant Independence Rules. A lack of knowledge of spousal investment activity was reported as the cause of 671 violations. In addition, 99 violations were attributed to errors in the Independence lists. Finally, for 649 matters, respondents asserted reasons that the RIPs classified as "technical" violations, i.e., the respondent made a good-faith effort to cure an inadvertent violation promptly after becoming aware of it.

(f) Reported Client Service Violations

The overwhelming majority of reported violations were committed by individuals who performed no services for the client as to which the individual had a prohibited interest or relationship. However, in connection with the March 1999 Confirmation

[65] These responses should be considered in light of the fact that there was no reason recorded in the RMFs for 2,187 violations and that some individuals gave more than one reason as the cause of a violation.

Process, PwC learned that certain individuals provided services to clients while they or their family members held financial interests in those clients or affiliates of those clients that were SEC registrants ("client service violations").[66] The client service violations involved 52 clients, aggregating related entities. PwC has notified each of these clients of the nature of the violations and has provided the SEC with detailed information about those situations. We include the following rough summary of these client service violations.

[66] This section describes the audit-related and non-audit-related violations with respect to SEC registrant clients or their affiliates that were either reported in, or whose discovery arose out of, the March 1999 Confirmation Process. The Random Sample Study has uncovered additional instances where individuals provided client services for clients with respect to whom they had Independence violations; those situations are discussed in Part III, Section B.3(b)(viii), infra. Table 22 shows that 45 audit professionals had audit-related client service violations, and 13 audit professionals had non-audit-related client service violations. Nonetheless, the total number of audit professionals with client service violations is 57, because one individual had both an audit-related and a non-audit-related client service violation.

PwC found that approximately 60 individuals had client service violations that were audit-related, i.e., they were committed by individuals who, during the period of the violation, performed services that were related to the attestation of a client or a client affiliate's financial statements. Approximately 79 PwC individuals had client service violations that were not audit-related. Table 22 below summarizes the data concerning the individuals with client service violations by line of service, professional classification and whether their violation was audit-related or not audit-related.[67]

TABLE 22
(Individuals With Reported Client Service Violations: Summary)

	Audit	Non-Audit	Total
ABAS	**45**	**13**	**57**
PTR	12	2	14
MGR	21	8	28
EMP	12	3	15
FAS	**3**	**7**	**10**
PTR	0	3	3
MGR	3	3	6
EMP	0	1	1
GHRS	**0**	**6**	**6**
PTR	0	3	3
MGR	0	3	3
EMP	0	0	0
MCS	**1**	**16**	**17**
PTR	0	3	3
MGR	1	12	13
EMP	0	1	1
TLS	**11**	**37**	**48**
PTR	2	9	11
MGR	6	22	28
EMP	3	6	9
TOTAL	**60**	**79**	**138**

[67] See also Apps. S-W.

Among the 60 individuals with reported audit-related service violations, there were a total of approximately 184 violations; among the 79 individuals with service violations that were not audit-related, there were a total of approximately 201 violations. Table 23 shows the number of reported client service violations by line of service, professional classification and whether the violation was audit-related or was not audit related.[68]

TABLE 23
(Reported Client Service Violations by Line of Service and Professional Classification)
(Audit vs. Non-Audit)

	Audit	Non-Audit	Total
ABAS	**141**	**30**	**171**
PTR	51	2	53
MGR	51	15	66
EMP	39	13	52
FAS	**10**	**39**	**49**
PTR	0	30	30
MGR	10	8	18
EMP	0	1	1
GHRS	**0**	**15**	**15**
PTR	0	11	11
MGR	0	4	4
EMP	0	0	0
MCS	**1**	**19**	**20**
PTR	0	3	3
MGR	1	15	16
EMP	0	1	1
TLS	**32**	**98**	**130**
PTR	2	14	16
MGR	14	60	74
EMP	16	24	40
TOTAL	**184**	**201**	**385**

[68] See also Apps. X-BB.

(i) Reported Audit-Related Service Violations

The 60 individuals with audit-related violations included 45 audit professionals (12 partners, 21 managers, and 12 employees); 11 tax professionals (two partners, six managers, and three employees); three financial advisory professionals (managers); and one management consulting professional (a manager). These violations involved 33 clients (if related entities are aggregated). LSW did not undertake any examination of whether these violations had any impact on the audits of these clients; however, no evidence of any such impact came to LSW's attention during the course of the Internal Investigation. In addition, after reviewing these situations, the SEC determined that the public filings of all 33 clients may be processed in the ordinary course of business.

A significant number of individuals with audit-related service violations had only one service-related violation apiece. Roughly nine individuals had two service-related violations apiece, where each of the two arose from interests in different corporate families. Other individuals incurred multiple audit-related service violations within a single corporate family by holding multiple interests in the same family or by holding a single investment and providing services to multiple entities in the same family. In one case, an audit partner had 35 violations based on a single stock holding in a non-audit client, a brokerage firm investee of a large financial services client, because he was the concurring partner for 35 mutual funds affiliated with the financial services client.

The types of audit-related violations may be broken down into the following general categories.

Approximately 44 violations stemmed from direct ownership of non-mutual fund securities in clients or client affiliates by reporting persons. There were one audit

partner,[69] five audit managers, one audit employee, one tax manager, and one financial advisory services manager in this group. Of these 44 violations, three were related to holdings that reporting persons acquired in connection with prior employment.

Approximately seven violations stemmed from direct ownership of non-mutual fund securities in clients or client affiliates by spouses of reporting persons. There were one audit partner,[70] four audit managers, and one management consulting manager in this group. Of these seven violations, three were related to holdings that spouses had acquired in connection with current or prior employment.

Roughly 59 violations related to the ownership by reporting persons of client mutual funds. There were four audit managers, seven audit employees, three tax managers, and three tax employees in this group. Of these 59 violations, approximately 30 were related to holdings acquired in connection with prior employment.

Approximately 39 violations related to the ownership by spouses of client mutual funds or non-client funds that were administered or advised by a client. There were three audit partners,[71] six audit managers, one tax partner, one tax manager, one tax employee, and two financial advisory services managers in this group. Of these 39 violations, 24 were related to holdings that the spouses had acquired in connection with current or prior employment. At least three additional violations related to the holdings of dependents of an audit partner.

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[69] As noted supra, this concurring audit partner had one holding that resulted in 35 violations.

[70] This partner's situation is described in greater detail at Part III, Section A.3(i)(ii), infra.

[71] One of these individuals was the engagement partner for the audit of a subsidiary of the company that acted as the fund's advisor. One individual's spouse held client funds in a 401(k) and IRA account; another individual's spouse held client funds in a 401(k) plan.

Roughly 18 violations stemmed from brokerage accounts at client broker-dealers holding cash or securities beyond settlement dates. One of these violations was by an audit partner who held a brokerage account with an affiliate of a client for which he was the engagement partner.

Additionally, four audit-related violations stemmed from material direct holdings or employment with a client by a non-dependent close relative. Other types of audit-related violations included five sweep accounts into a client fund; two prohibited trusteeships or executorships for trusts or estates holding securities of clients; a prohibited mortgage with a client bank; investment in a benefit plan sponsored by a former employer that is a client; and an unsecured line of credit at a non-client bank that was subsequently acquired by a client bank.

Well over half of the approximately 183 violations stemmed from interests in affiliates of clients to which the individuals provided services, rather than interests in the clients themselves.

(ii) Reported Non-Audit-Related Service Violations

The 79 individuals with client service violations that were not audit-related included 13 audit professionals (two partners, eight managers, and three employees); 37 tax professionals (nine partners, 22 managers, and six employees); 16 management consulting professionals (three partners, 12 managers, and one employee); seven financial advisory professionals (three partners, three managers, and one employee); and six human resources professionals (three partners and three managers). These violations involved 19 clients for which there were only non-audit service violations, and 13 of the 33 clients, discussed supra, for which there were also audit-related service violations.

The SEC has determined that in the case of the 19 clients for which there were only non-audit service violations, the public filings of those clients may be processed in the ordinary course of business.

The categories of the non-audit service violations include: prohibited securities holdings acquired in connection with prior employment with a client by reporting persons; prohibited securities holdings acquired in connection with current or prior employment with a client by spouses or cohabitants; ownership of securities in clients or client affiliates by reporting persons, spouses, cohabitants, or dependents;[72] ownership by reporting persons, spouses, cohabitants, or dependents of securities funds that were clients or were administered by clients; prohibited brokerage accounts at broker-dealer clients or broker-dealer affiliates of clients; beneficiary or representative relationships with trusts or estates holding securities of clients; credit cards with balances over $5,000 with clients; a mortgage with a client bank; holding a material amount over $100,000 in a client bank account; an unsecured loan with a client bank; and a power of attorney over a parental portfolio with a holding in a client.

Of the approximately 201 non-audit related service violations, at least 27 stemmed from interests in affiliates of clients for whom the individuals provided services, rather than in the clients themselves.

(g) Reported Violations By Individuals Who Oversee Independence Issues

As set forth at n. 35, supra, a group of partners at the national and line of service levels oversee PwC's Independence program, under the supervision of a partner whose

[72] Although most of these situations entailed securities ownership by the reporting person or family members, at least one of them involved ownership through a UIT.

responsibilities include PwC's non-U.S. operations. We examined the March 1999 Confirmation responses of the partners in this group who had Independence responsibilities during the March 1999 Confirmation Process. Six out of eleven reported violations. Several reported only one and no one reported more than five violations. Several of the violations related to bank, brokerage or sweep accounts, and only a few related to stock or mutual fund holdings. For example, a National Independence partner reported that, in view of the Merger, he instructed his broker to sell his holding in a PW legacy client before he left for vacation in July 1998, only to discover after his return that the instruction had not been followed; the stock was sold August 10, 1998.

Additionally, we examined the March 1999 Confirmation responses of the regional partners who help administer PwC's Independence program. Each of the 12 RIPs reported at least one violation; five RIPs reported more than ten; one reported 38 violations and another reported 34 violations.[73] The types of RIP violations include bank, brokerage and sweep accounts as well as individual, spousal and dependent stock or

[73] One of these RIPs attributed some of the violations to a sale of interests shortly after the July 31, 1998 Merger deadline and to a lack of awareness that his 20 year-old child's investments were ascribed to him under the Rules and that his brokerage accounts were prohibited. (He thought that it was impermissible for a client brokerage firm to hold securities for him only if they were held in the broker's "street name," as opposed to safekeeping.) Many of the violations by the other RIP arose from interests in two UITs owned by his children.

mutual fund holdings.[74] Some RIPs reported difficulties in checking the Independence lists or lack of awareness that the Rules applied to certain interests.[75]

(h) Reported Violations by PwC Senior Management

We also examined the March 1999 Confirmations of PwC's senior management, specifically the partners on PwC's Board of Partners and its U.S. Leadership Committee. Thirty-one of the 43 partners who comprise these bodies had at least one reported violation.[76] A number of these individuals had numerous violations. Ten individuals had between five and ten violations; two others had between 10 and 20 and four others had more than 20; one of these partners had 41 violations and another had 40 violations.[77]

(i) Implications of the March 1999 Confirmation Process for the Accuracy of Reporting in Prior Independence Confirmations

(i) August 1998 Merger Confirmation Process for the Transition Independence Policy

As set forth in Part II, Section B.2, supra, PwC created a Transition Independence Policy to govern Independence issues at the time of the Merger between PW and C&L.

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[74] Two RIPs were chosen in the Random Sample Study, see infra Part III, Section B. One of them had no unreported violations and the other RIP, who was in the process of replacing an existing RIP this past spring, had one, a non-client fund whose investment advisor was a PwC audit client.

[75] In addition, one RIP asserted that he did not understand that Independence Rules prohibited his wife's on-line brokerage account at a client affiliate from holding securities for her in the client affiliate's street name.

[76] Some of the violations reported by senior management appear to have been inadvertent. For example, one partner and his son both owned stock of a client that became prohibited by the Merger. The partner sold his son's stock on time, but certain shares of his own were inadvertently not sold by the July 31, 1998 deadline.

[77] There were a total of three members of senior management who were selected for the Random Sample Study. All three of those individuals had unreported violations, although one individual had only one, which is being investigated further to determine if it is in fact a violation.

As part of that process, PwC sent all partners of the merged firm a Merger Confirmation that required the partners to state whether they were in compliance with PwC's Transition Independence Policy, and specifically whether they had disposed of any prohibited investment within 30 days of the Merger (no later than July 31, 1998). The Merger Confirmation, which was sent in August 1998, further required that each partner report any instances of non-compliance.

LSW attempted to ascertain the completeness of the disclosures in the Merger Confirmations.[78] In that process, 281 partners reported one or more Independence violations. By contrast, in the March 1999 Confirmation Process, 842 partners reported merger violations, according to PwC's review.[79] It therefore appears that violations were under-reported in the Merger Confirmation process. In addition, LSW's review of selected March 1999 Confirmations confirmed the existence of merger violations that were disclosed for the first time in 1999. See infra Part III, Section A.3(j)(iii).

(ii) The November 1998 Audit Partner Confirmation Process

As set forth above, in November 1998, PwC sent partners in the audit line of service an Audit Partner Confirmation requiring them to report whether during 1998 they owned securities of any client on whose audit engagement they were serving.[80] Only two

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[78] PwC did not analyze or tabulate violations reported in the Merger Confirmation process.

[79] We did not attempt to ascertain how many of the violations reported in the Merger Confirmation process were in fact merger violations, as opposed to other types of violations. The majority of them appear to be merger violations, however.

[80] The confirmation also asked each audit partner to identify anyone else working on his or her audit engagements who, to the partner's knowledge, owned securities of the audit client.

audit partners responded affirmatively.[81] One legacy PW partner reported that he owned shares of a legacy C&L client that he sold on August 6, 1998, six days after the deadline in PwC's Transition Independence Policy.[82] That partner became the "second partner," effective October 1998, for the calendar year 1998 audit of the client. Thus, he did not work on the audit while he held the stock. Another legacy PW partner reported that he was the engagement partner for a legacy PW client in which his wife, without his knowledge, had held a $250 interest as a member of a neighborhood investment club that had purchased the stock.[83]

The results of the March 1999 Confirmation Process are not materially inconsistent with the results of the Audit Confirmation Process in November 1998. In the March 1999 process, four audit partners (other than the two discussed above) reported that either they, their spouses or a relative owned securities in a client or client affiliate while they worked on the audit of the client. The only individual who held the investment himself asserted that he did not realize until January 1999 that the entity he invested in – which was an audit client affiliate rather than an audit client – was a prohibited entity.[84] Two other audit partners reported violations by virtue of spousal

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[81] Another audit partner disclosed that he had an account with a substantial balance at a client affiliate bank that had a sweep feature into a tax-free account. However, in his March 1999 Confirmation response, which reports this matter, the partner stated that he did not perform any services for the client affiliate or the client.

[82] The partner had reported this situation in both his Merger Confirmation and his March 1999 Confirmation response.

[83] In December 1998, PwC advised the SEC and the client of this situation.

[84] The Audit Confirmation did not specifically refer to securities ownership in a client affiliate, as opposed to the client itself, but it is doubtful that "client" would have been restrictively interpreted by the respondents to exclude affiliates.

holdings in their March 1999 Confirmation responses. The other reported violation was held by a trust for which the audit partner was the trustee, and of which his non-dependent mother was the beneficiary.

(j) Other Information From The March 1999 Confirmation Process

LSW reviewed a number of selected Confirmation responses and reported matters from the March 1999 Confirmation Process for the purpose of general oversight. The following sets forth some of our observations from this review.

(i) Misunderstanding of the Independence Rules

As reflected in the Reported Matters Database, see supra Part III, Section A.3(e), approximately 1,561 violations reported in the March 1999 Confirmation responses were characterized as attributable to misunderstandings of the Independence Rules. Those reported misunderstandings included: belief that mutual funds were not covered by the Independence Rules; lack of awareness that the Rules could apply to non-client investors in a client; lack of awareness that members could not be trustees or executors of trusts or estates that held client stock; belief that a UIT that holds client stock was analogous to a mutual fund; belief that cash holdings at a client brokerage house or client money market holdings were analogous to cash or a money market held at a client bank;[85] belief that investments in client IRAs were permissible even if they were not FDIC-insured; belief that the Rules did not prohibit holding cash or securities in a client brokerage account or client money market account; and belief that spousal holdings were legally separate from the member's holdings. These explanations indicated a significant lack of understanding

[85] Client bank account deposits are permissible only to the extent that (1) the balances are fully insured, or (2) any uninsured portion is immaterial to the member's net worth. See AICPA Ethics Ruling No. 70.

of certain Independence Rules and underscored the need for PwC to conduct internal Independence educational programs that it is now implementing. See infra Part III, Section B.3(c)(v).

(ii) Difficulties With Client Name Searches

Numerous individuals who reported violations asserted that in earlier searches of the electronic Independence lists they failed to find the entities in which they were investing or had invested. We confirmed that slight errors in the query could result in a failure to create a "match" between the name on the list and the name queried, although there were ways in which to search electronically that minimized these problems, as well as other available tools to check whether investments were prohibited. See infra Part III, Section B.3(c)(iii).[86]

(iii) Past Violations That Were Previously Unreported Until The March 1999 Confirmation Process

As set forth in Part III, Section B.3(b), infra, many Independence violations were not disclosed in the March 1999 responses. However, the March 1999 process did result in the disclosure of violations that had existed but were not disclosed in connection with prior confirmations.

For example, at least one legacy C&L partner reported that the November 5, 1998 letter from PwC's leaders (see Ex. 5) prompted him to give greater scrutiny to his holdings, whereupon he discovered for the first time five violations that existed between 1996 and 1998. Another partner had overlooked his wife's employee stock options and

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[86] Additionally, other types of problems with names arose. For example, one partner reported that one of his violations was attributable to the almost identical names of a client and non-client. He had intended to buy a non-client, but purchased a client fund with a slightly different name by mistake.

another spousal holding when he submitted his Merger Confirmation the previous summer. Similarly, another partner stated that he had forgotten about a money market fund investment in his Merger Confirmation. One partner previously had reported his wife's client stock, but forgot to disclose her client stock options, which were greater than five percent of the couple's net worth. A legacy PW partner reported that an internal e-mail in early 1999 prompted him to check the legacy C&L Independence list again, whereupon he discovered merger violations that he had previously missed. In other instances, individuals reported violations in their March 1999 Confirmation responses that existed at the time of, but were not reported in, their fiscal 1997 confirmation responses.

In sum, presumably because of the Tampa situation and the SEC Order, PwC professionals appeared to have reported Independence violations with greater accuracy in the March 1999 Confirmation Process than they did in prior confirmation processes. Unfortunately, as revealed in the Random Sample Study, many violations still were not reported in the March 1999 Confirmation Process. See infra Part III, Section B.3(b).

B. The Random Sample Study

To determine the accuracy of the firmwide self-reporting of Independence issues in the March 1999 Confirmation Process, 400 of the March 1999 Confirmation respondents were randomly selected for audit in the Random Sample Study. The individuals selected were required to submit certain financial records, including tax returns and securities account statements. The financial and other interests revealed in these records were compared to the disclosures made by the selected individuals in their March 1999 Confirmation responses in order to determine the accuracy and completeness of their reporting.[87]

1. The Random Selection Process

In consultation with a retained statistical consultant, LSW directed that PwC randomly select a total of 400 individuals (200 partners and 200 non-partners) from the universe of approximately 36,170 professionals in the March 1999 Confirmation Process. We decided to sample 200 partners because the partner population was divided in roughly equal parts between those who reported matters in the March 1999 Confirmation Process and those who did not.[88] By randomly selecting 200 partners, we would obtain a sizable sample of both groups, in order to determine whether there was a difference in the rates of inaccuracy between the groups.[89] The random selection of partners and non-

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[87] Before the Random Sample Study began, PwC discovered that six individuals failed to report violations in their March 1999 Confirmation responses. Five of those six individuals either resigned or were terminated.

[88] By contrast, a much smaller percentage of non-partners (3%) reported any matter in their March 1999 Confirmations.

[89] A total of 87 partners selected in the Random Sample reported matters in the March 1999 Confirmation Process, while the remaining 113 submitted Confirmation responses

partners was made by computer,[90] using the "with replacement" method of sampling.[91]

2. Mechanics of the Random Sample Study

(a) Notification

On June 18, 1999, PwC sent all persons selected in the Random Sample Study ("selectees") an e-mail (initially drafted by PwC and revised and approved by LSW) advising them that they had been selected for audit and were required to submit certain documents by July 2, 1999. See Ex. 12. Additionally, each individual selected received a follow-up telephone call from a member of PwC's Independence compliance group.

(b) Document Submission

The documents that selectees were required to submit ("Required Documents") included: (1) for the calendar years 1996 through 1998, tax returns and 1099s; and (2) for the period January 1, 1997 through the date the selectee submitted his or her March 1999 Confirmation response, statements for any securities account (including mutual funds, money market and retirement accounts) held by or on behalf of the selectee or his or her spouse or dependents,[92] and documents sufficient to identify loans, credit extensions, or uninsured bank deposits.

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that did not report any matters. All but four of the partners who reported matters reported at least one violation.

[90] The computer programs used are included as Ex. 11.

[91] Sampling "with replacement" means that no one was removed from the pool even after selection. Consequently, individuals could be – and in six cases were – selected twice. Because six people were selected twice, the ultimate number of individuals chosen for the Study was 394: 196 partners and 198 non-partners. However, in referring to tabulations of "selectees" herein, we consider each selectee distinctly, for a total of 400.

[92] The request encompassed accounts for trusts and estates of which the selectee or his or her spouse or dependent was a trustee, executor or beneficiary.

Selectees submitted Required Documents to Wilmer Cutler & Pickering ("WCP"), the law firm representing PwC in this matter. WCP logged in the documents as they were received and requested additional documents from selectees when it appeared that documents were or might be missing. Additionally, WCP redacted identifying information from the documents[93] using a protocol for redaction approved by LSW. See Ex. 13.[94] WCP then shipped the Required Documents to teams of PwC auditors ("the PwC Audit Teams")[95] who reviewed the documents for possible Independence violations.

Approximately 263 of the selectees had submitted Required Documents by July 2, 1999, and by mid-July nearly 90% of the selectees had submitted such Documents, although follow-up was needed for missing items in almost all cases. Additionally, 26 of the original selectees were no longer employed by PwC, or were on leave from PwC, at the time of the notification. In those cases, PwC informed LSW, and upon LSW's approval, the selectee was replaced with another individual from the appropriate population. Each replacement to the Random Sample Study was given two weeks to submit the Required Documents. Aside from certain instances of recalcitrance[96] and

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[93] The identifying information was redacted so that the PwC Audit Teams would not know the identities of the selectees. Of course, LSW and certain PwC representatives were privy to the identities of the selectees, as well as to the unredacted Required Documents.

[94] LSW supervised the redaction process and, with PwC, performed several quality-control checks of the redaction.

[95] The Audit Teams were made up of members of PwC's audit staff (and some cases tax staff) in New York and other cities. They typically performed the audit in teams of two.

[96] For example, one partner who was in the midst of arbitration with PwC regarding an unrelated dispute initially failed to submit any Required Documents, but ultimately did

logistical problems,[97] the initial submission of Required Documents was not unreasonably protracted. However, a number of selectees did not complete their submission of Required Documents for an extended period of time. In some cases, those individuals were pursuing documents from brokerage firms where they maintained accounts. In some cases, selectees still have not provided all Required Documents.[98]

(c) Random Sample Study Audit by PwC

The PwC Audit Teams, under the supervision of audit managers, conducted Independence audits of the files of selected individuals using the Required Documents, along with selectees' charged-hours reports (which summarize time spent on engagements for particular clients), March 1999 Confirmation responses, and Reported Matter Forms, to determine whether selectees had any Independence violations that were not reported in the March 1999 Confirmation Process. The Audit Teams' work was performed according to a protocol (the "Work Program") initially drafted by PwC, extensively revised by LSW and PwC, and approved by LSW. See Ex. 14.

Following the Work Program, the PwC Audit Teams used the Required Documents to create spreadsheets listing all investments and financial or other pertinent interests, including spousal employment, and to chart the acquisition, holding and disposition of investments during the relevant period. The Audit Teams "rolled forward"

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so. The spouse of a manager initially refused to make his records available but was eventually persuaded to do so.

[97] For example, certain individuals had not yet filed their 1998 tax returns and others had filed tax returns telephonically or electronically and needed to obtain a copy from the IRS. A few other individuals did not receive the June 18, 1999 notification e-mail on a timely basis because of overseas assignment or absence.

[98] Six non-partner selectees who have not completed their submissions have left PwC since the audit process began.

the investments to ensure that all investments were accounted for. The Audit Teams then compared the list of investments and other interests to the Independence lists of both PwC and its legacy firms during all relevant periods (collectively, the "Independence Lists"). The Independence Lists include clients and their affiliates, as well as non-clients whose relationship with clients (e.g., as investor, investee or financial advisor) requires Independence by members.

Additionally, per the Work Program, the PwC Audit Teams examined the Required Documents to make sure that all relevant documents had been provided. The Audit Teams not only searched for relevant documents such as missing tax returns or brokerage statements from certain time periods, but also for documents that would reveal pertinent details about holdings that were reflected elsewhere in the documents submitted. For example, the Audit Teams checked to verify that any security whose sale was reflected on a tax return was also reflected in a brokerage statement submitted as part of the Required Documents. The Audit Teams created a record of any relevant missing documents in "coaching notes," which subsequently became the basis for requests sent to selectees asking for additional documentation and information.

Audit Teams then analyzed any matches between entries on the Independence Lists and investments or interests reflected in the Required Documents, according to Checklists developed as part of the Work Program, to determine whether the matches represented Independence violations, based on the timing of the investment and of the investee's status as a client, and on whether the selectee was a "member" with respect to the client. The PwC Audit Teams subsequently determined whether a selectee's Independence violations were reported in the selectee's March 1999 Confirmation

response. In addition, the Audit Teams checked both reported and unreported Independence violations against the selectees' charged-hours reports.[99] The review of each file included an examination at the managerial level. All of the materials created by the Audit Teams were entered into an "audit database" to which LSW also had access.

As unresolved violations were detected by the PwC Audit Teams, PwC personnel, in conjunction with WCP, notified Random Sample selectees of the need to dispose of relevant holdings, and required the submission of additional documentation confirming appropriate resolution.[100]

(d) Selected Review by LSW

LSW spent considerable time observing and working with the PwC Audit Teams in their review of the Required Documents for possible Independence violations. In addition, LSW conducted a review of selected files, after the completion of the PwC review, to assess the accuracy and completeness with which the PwC Audit Teams recorded all Independence violations that were not disclosed in the March 1999 Confirmation responses. LSW reviewed all aspects of the Audit Teams' file audits for the first 15 partners and the first 15 non-partners drawn in the random sample,[101] using the Required Documents; the Work Program, the Checklists, investment spreadsheets and

[99] Previously reported matters were checked in order to ensure that mistakes were not made in earlier determinations that no client services had been provided in connection with the violation.

[100] However, according to the database, documentation from 62 individuals confirming the resolution of approximately 132 violations has not yet been received.

[101] LSW's statistical expert stated that this method of selection would provide a random sample of selectees' files.

"coaching notes" created by the Audit Teams; the March 1999 Confirmation responses and RMFs; the Independence Lists; and charged-hour reports.

LSW reviewed the Required Documents for completeness, cross-checking documents to determine whether any information revealed by the Required Documents submitted indicated that other Required Documents might not have been provided, or whether any other information should have been sought. LSW then checked the Required Documents against the investment spreadsheets created by the PwC Audit Teams, examining whether all pertinent information for the investments reflected in the Required Documents had been recorded accurately on the spreadsheets, including dates of acquisition and disposition. LSW reviewed all information in the audit database for each of the 15 partners and 15 non-partners, including the coaching notes made by the PwC Audit Teams. LSW also reviewed document requests made to the selectees by WCP on the PwC Audit Teams' behalf. LSW checked all investments recorded on the spreadsheets, as well as any additional investments missed by the PwC Audit Teams, against the Independence Lists. Additionally, LSW reviewed the PwC Audit Teams' Checklists, the charged-hours reports, and in the case of managers, the listing of offices that performed client audits,[102] in order to assess the Audit Teams' conclusions about whether a match between an investment and the Independence Lists constituted a

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[102] LSW did not conduct an independent investigation of what other offices, if any, performed a significant portion of the audit besides the main office identified in the Independence Lists. The determination of any such other offices was made primarily by supervisors of the PwC Audit Teams, who obtained this information from the audit engagement partners or managers. It should be noted that in connection with the implementation of PwC's new Independence system, see infra Part IV, Section A, PwC has undertaken a comprehensive evaluation for each audit client of the offices that would be considered "significant" under the Rules. That evaluation, in some cases, may identify

violation. In addition, LSW reviewed the charged-hours report for each investment to determine whether the selectee had provided services to the client.

Based on this review, LSW believes that the results of the Random Sample Study audit by the PwC Audit Teams for the 30 files that LSW reviewed were substantially accurate. LSW did note certain inaccuracies in the work of the PwC Audit Teams.[103] Not surprisingly, the bulk of errors occurred in the audit of partner selectees, whose files were often significantly larger, and reflected many more investments, than non-partner selectees' files. However, most of the errors that LSW found did not result in a failure to detect Independence violations; in the 30 files it reviewed, LSW detected only four

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offices additional to those known to the PwC Audit Teams and their supervisors in connection with the Random Sample Study.

[103] LSW noted that certain investments reflected in the Required Documents were not listed on the investment spreadsheets; this oversight occurred most frequently when a file was voluminous and contained a large number of investments. Certain investments that did not appear on an investment spreadsheet may have nonetheless been examined by a PwC manager at the review stage; additionally, certain investments may not have been placed onto spreadsheets because Audit Teams made determinations that some holdings or relationships were unlikely to be violations, e.g., an account at a client bank with a very small amount of interest income, pre-graduation employment at a client university, or a dependent's seasonal employment with a client.

LSW also observed that there were certain problems that arose in connection with checking investments against Independence Lists. Specifically, Audit Teams had not compared certain investments to certain of the Independence Lists, and Audit Teams did not appear to have reviewed one particular Independence List in a number of instances. However, the particular list contained information that was available in a non-alphabetical format in the other Independence Lists used by auditors, and was created to help the Audit Teams identify certain non-client restricted entities. It was added to the Audit Work Program several weeks after the audit began, which may account for its omission in certain cases. Additionally, in several instances, for investments held after the Merger by partners of one legacy firm, the Audit Teams apparently did not review one of the applicable 1998 or 1999 Independence Lists of the other legacy firm. Finally, Audit Teams failed to catch several existing matches between investments and Independence Lists, which may in some cases have resulted from names appearing differently on financial documents than they appeared on Independence Lists.

violations not noted by the PwC Audit Teams.[104] None of those violations were client service violations.

3. Statistical Information Concerning the Random Sample Study

The results of the Random Sample Study were entered into a database (the "Unreported Matters Database") similar to the Reported Matters Database that was created for the March 1999 Confirmation Process, so that the data could be more specifically tabulated and analyzed.[105] The same ground rules that were used in tabulating data in the Reported Matters Database were used in tabulating data for the Unreported Matters Database. See supra n. 42.

(a) The Make-Up of the Random Sample

The random samples of 200 partners and 200 non-partners are characteristic of the PwC partner and non-partner populations as a whole in several respects. As Tables 24 and 25 illustrate, the distribution by legacy firm[106] of the 200 partners and 200 non-

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[104] The previously undiscovered violations included one individual's holdings in two funds that were listed in the Independence Lists under names slightly different from the names that appeared on the brokerage statement; one individual's holding in a fund that was very similar in name to another fund held by the individual that was detected by the PwC Audit Team; and one other violation that was missed in checking an Independence List.

[105] Because additional Required Documents are being sought from certain selectees, see supra Part III, Section B.2(b), and because PwC is re-checking the entry of information into the Unreported Matters Database and certain other matters, the final tally of the Random Sample Study data reflected in this section may change somewhat. Any change is more likely to affect the numbers of unreported violations than it would affect the number of individuals with unreported violations.

[106] Payroll records were used to compile essential data for all individuals subject to the March 1999 Confirmation Process. All individuals who joined PwC after the Merger date, July 1, 1998, were added to the PW payroll system. Accordingly, it is not possible to easily obtain the statistics on the breakdown between PwC and legacy PW staff in the firmwide population. As a result, Tables 24 and 25 aggregate legacy PW and PwC professionals.

partners selected for the Random Sample roughly approximates the legacy firm distribution in the total population.[107]

TABLE 24
(Partners by Legacy Firm)

	C&L	PW	PwC	Total
Percent of Random Sample Partners	54.5%	45.5%		100%
Percent of Firmwide Partner Population	55%	45%		100%

TABLE 25
(Non-Partners by Legacy Firm)

	C&L	PW	PwC	Total
Percent of Random Sample Non-Partners	37%	63%		100%
Percent of Firmwide Non-Partner Population	38%	62%		100%

Additionally, the breakdown of the non-partners between managers and employees in the Random Sample is roughly parallel to the breakdown of those groups in the total population: 78, or 39%, of the 200 randomly selected non-partners are managers, while 122, or 61% of the randomly selected non-partners are employees. As of mid-December 1999, 35% of non-partners at PwC were managers and 65% of non-partners were employees.

[107] See also Apps. CC and DD.

The breakdown of both partners and non-partners by line of service[108] in the Random Sample is also roughly similar to the population as a whole, as illustrated by Tables 26 and 27.[109]

TABLE 26
(Partners by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Percent of Random Sample Partners	46.0%	5.5%	8.0%	18.0%	2.0%	20.5%	100%
Percent of Firmwide Partner Population	46.8%	3.4%	5.2%	18.2%	3.9%	22.5%	100%

TABLE 27
(Non-Partners by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Percent of Random Sample Non-Partners	32.5%	3.0%	2.0%	44.0%	3.5%	15.0%	100%
Percent of Firmwide Non-Partner Population	33.6%	3.3%	4.7%	36.6%	3.6%	18.2%	100%

[108] The data in Tables 26 and 27 describes the 39,424 individuals to whom the Confirmation was sent. The Random Sample, however, was drawn from the smaller population of 36,170 individuals whose Confirmation responses were tabulated in the Reported Matters Database, as noted in Part III, Section A.1, supra.

[109] See also Apps. EE and FF.

(b) The Results of the Random Sample Study

(i) Partner and Non-Partner Selectees With Previously Unreported Violations

As shown in Table 28, PwC found that, during the relevant period,[110] approximately 77.5% of the partners in the Random Sample Study had at least one unreported violation.[111]

TABLE 28
(Partners with Unreported Violations)

	PTR
Total Random Sample Partners	200
Random Sample Partners with Unreported Violations	155
Percent of Random Sample Partners with Unreported Violations	77.5%

[110] This period was the approximate time frame for which reporting was required in the March 1999 Confirmation Process, i.e., from the end of the fiscal year (1997) in which the last annual confirmation took place through the date of response to the March 1999 Confirmation. The tabulations in this section exclude any violations that were resolved prior to July 1, 1997.

[111] See also App. GG.

PwC also found that approximately 8.5% of the non-partners in the Random Sample Study had at least one unreported violation during the relevant period, as shown in Table 29.[112] As indicated in Table 29, all unreported non-partner violations in the Random Sample Study were by managers.

TABLE 29
(Non-Partners with Unreported Violations)

	MGR	EMP	Total Non-Partner
Total Random Sample Non-Partners	78	122	200
Random Sample Non-Partners with Unreported Violations	17	0	17
Percent of Random Sample Non-Partners with Unreported Violations	21.8%	0%	8.5%

[112] See also Apps. HH and II.

a. By Legacy Firm

Tables 30 and 31 reflect the distribution by legacy firm of partner and non-partner selectees, respectively, with at least one unreported violation, compared to the breakdown of selectees by legacy firm in the total Random Sample.[113] For partners, the breakdown by legacy firm of selectees with at least one unreported violation roughly mirrors the breakdown of the Random Sample by legacy firm. Table 32 offers a breakdown of the data in Table 31 for managers only.[114] (Employees, as set forth supra, had no unreported violations.)

TABLE 30
(Partners with Unreported Violations by Legacy Firm)

	C&L	PW	PwC	Total
Percent of Random Sample Partners	54.5%	43.0%	2.5%	100%
Percent of Random Sample Partners with Unreported Violations	57.4%	41.3%	1.3%	100%

TABLE 31
(Non-Partners with Unreported Violations by Legacy Firm)

	C&L	PW	PwC	Total
Percent of Random Sample Non-Partners	37.0%	42.0%	21.0%	100%
Percent of Random Sample Non-Partners with Unreported Violations	41.2%	58.8%	0%	100%

TABLE 32
(Managers with Unreported Violations by Legacy Firm)

	C&L	PW	PwC	Total
Percent of Random Sample Managers	39.7%	53.9%	6.4%	100%
Percent of Random Sample Managers with Unreported Violations	41.2%	58.8%	0%	100%

[113] See also Apps. JJ and KK.

[114] See also App. LL.

b. By Line of Service

Tables 33 and 34 reflect the distribution by line of service of partner and non-partner selectees with unreported violations, respectively, compared to the breakdown of selectees by line of service in the Random Sample.[115]

As Table 33 illustrates, the percentage of partners in the Random Sample by line of service with unreported violations is roughly proportionate to the distribution of partners by line of service in the Random Sample as a whole, although the percentage of partners with unreported violations comprised by audit (ABAS) partners is slightly lower than the percentage of audit partners in the Random Sample partner population.

TABLE 33
(Partners with Unreported Violations by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Percent of Random Sample Partners	46.0%	5.5%	8.0%	18.0%	2.0%	20.5%	100%
Percent of Random Sample Partners with Unreported Violations	40.6%	5.2%	9.7%	21.3%	1.9%	21.3%	100%

[115] See also Apps. MM and NN.

Only one non-partner in the audit line of service (ABAS) had an unreported violation.[116]

TABLE 34
(Non-Partners with Unreported Violations by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Percent of Random Sample Non-Partners	32.5%	3.0%	2.0%	44.0%	3.5%	15.0%	100%
Percent of Random Sample Non-Partners with Unreported Violations	5.9%	5.9%	0.0%	41.2%	0.0%	47.0%	100%

c. Firmwide Projection of Partners and Non-Partners with Unreported Violations

As set forth in Table 28, supra, 155 (or 77.5%) of the partner selectees had at least one unreported violation. According to principles of statistical analysis, these results allow one to project that, as shown in Table 35, at a 90% confidence level,[117] between 72.1% and 82.3% of PwC's partner population as a whole – or between approximately

[116] In addition, only one audit (ABAS) non-partner selected for the Random Sample Study had a reported violation in the March 1999 Confirmation Process. Non-partners in the tax line of service seem to have a disproportionate share of unreported violations. However, because so few tax non-partners were selected in the Random Sample, and so few non-partners had unreported violations, it is difficult to draw a conclusion from this data.

[117] The degree of accuracy of a random sample depends upon the "exception rate" (in this case, the percentage of individuals who failed to disclose Independence violations in the March 1999 Confirmations) of the sample. As an exception rate approaches 0% or 100%, the sample provides a more precise estimate for the actual exception rate in the entire population. For example, for a sample of 200, an exception rate of 5% or 95% means that one can say with 90% confidence that the actual exception rate for the entire population would be within a band of 5.6 percentage points. An exception rate of 10% or 90% for the same size sample would permit one to say with 90% confidence that the actual exception rate for the entire population would be within a band of 7.5 percentage points. However, an exception rate of 50% would permit one to say with 90% confidence that the actual exception rate for the entire population would be within a band of 12 percentage points.

1,945 and 2,220 partners – had at least one unreported violation during the relevant time period.[118]

TABLE 35
(Firmwide Projection of Partners with Unreported Violations with 90% Confidence)

	PTR
Total Partner Population Firmwide	2698
Projected Percent of Partners with Unreported Violations Firmwide	72.1% to 82.3%
Projected Number of Partners with Unreported Violations Firmwide	1945 to 2220

As set forth in Table 29, supra, 17 (or 8.5%) of the non-partner selectees had at least one unreported violation. These results allow one to project that, at a 90% confidence level, as shown in Table 36, between 5.49% and 12.5% of PwC's non-partner population as a whole – or between approximately 1,838 and 4,184 non-partners – had at least one unreported violation during the relevant time period.

As noted earlier, all of the 17 non-partners with at least one unreported violation were managers. Therefore, as set forth in Table 36, these results allow one to project that, at a 90% confidence level, between 14.4% and 30.9% of PwC's manager population as a whole – or between roughly 1,687 and 3,620 managers – had at least one unreported violation during the relevant time period.[119] The fact that no employees had an

[118] This projection, and all those that follow, are based on the results of the Random Sample Study, which, as noted at n. 105, supra, have not yet been finalized.

[119] In this Table and those that follow, where numbers are set forth regarding the division between managers and employees in the firm's non-partner population, we have assumed that the distribution between managers and employees in the 33,472 non-partners from which the Random Sample non-partners were drawn mirrors the distribution among managers (35%) and employees (65%) in the December 1999 non-partner population.

unreported violation allows one to project that, as illustrated in Table 36, at a 90% confidence level, between 0% and 2.43% of PwC's employee population as a whole – or between approximately 0 and 529 employees – had at least one unreported violation during the relevant time period.

TABLE 36
(Firmwide Projection of Non-Partners with Unreported Violations with 90% Confidence)

	MGR	EMP	Total Non-Partner
Total Non-Partner Population Firmwide	11715	21757	33472
Projected Percent of Non-Partners with Unreported Violations Firmwide	14.4% to 30.9%	0% to 2.43%	5.49% to 12.5%
Projected Number of Non-Partners with Unreported Violations Firmwide	1687 to 3620	0 to 529	1838 to 4184

(ii) Number of Unreported Violations By Partner and Non-Partner Selectees

In the Random Sample Study, PwC found that partner selectees had a total of 1105 unreported violations among them, while non-partner selectees had a total of 28 unreported violations among them. We set forth below certain breakdowns of the number of unreported partner violations.[120] As set forth at n. 105, supra, because the tabulation of the Random Sample Study is not final, statistics concerning the numbers of violations could change.

[120] Because there were so few violations in the non-partner sample, breakdowns of non-partner selectee violations likely would not be useful. However, as noted in Part III, Section B.3(b)(i)(b), supra, only one of the unreported violations was by a non-partner in the audit line of service.

a. By Numbers of Unreported Violations Per Partner

The distribution of unreported violations among partner selectees is illustrated in Table 37.[121]

TABLE 37
(Distribution of Partners with Unreported Violations)

	PTR
Random Sample Partners with 1-5 Unreported Violations	83
Random Sample Partners with 6-10 Unreported Violations	47
Random Sample Partners with 11-15 Unreported Violations	9
Random Sample Partners with 16-20 Unreported Violations	7
Random Sample Partners with 21-30 Unreported Violations	3
Random Sample Partners with 31-50 Unreported Violations	5
Random Sample Partners with 51-70 Unreported Violations	0
Random Sample Partners with 71+ Unreported Violations	1
Total Random Sample Partners with Unreported Violations	155

There were 51 partner selectees with one or two unreported violations.

b. By Legacy Firm

Table 38 shows the breakdown by legacy firm of the unreported violations by partner selectees.[122]

TABLE 38
(Average Unreported Violations per Partner by Legacy Firm)

	C&L	PW	PwC	Total
Total Random Sample Partners	109	86	5	200
Unreported Random Sample Partner Violations	625	457	23	1105
Average Unreported Violations per Random Sample Partner	5.7	5.3	4.6	5.5

[121] See also App. OO.

[122] See also App. PP.

c. By Line of Service

Table 39 shows partner selectees with unreported violations by line of service. Notably, the Random Sample partner selectees in the management consulting (MCS) line of service had a disproportionately larger share of unreported violations relative to their numbers. This is illustrated in Table 39, which shows that these partners had a higher average of unreported violations per partner selectee (10.28) than the average per Random Sample partner overall (5.53).[123] Conversely, partners in the audit (ABAS) line of service had a lower average of unreported violations per partner selectee and hence a disproportionately lower share of the unreported partner violations.[124]

TABLE 39
(Average Unreported Violations per Partner by Line of Service)

	ABAS	FAS	GHRS	MCS	NATL	TLS	Total
Total Random Sample Partners	92	11	16	36	4	41	200
Unreported Random Sample Partner Violations	260	119	116	370	23	217	1105
Average Unreported Violations per Random Sample Partner	2.8	10.8	7.3	10.3	5.8	5.3	5.5

(iii) Mean Number of Unreported Violations for Partners and Non-Partners

The mean number of unreported violations per partner is 5.53. The mean number of unreported violations per non-partner is 0.14. As set forth above, all the unreported

[123] While the management consulting line of service had one individual with an unusually large number of violations (72), this line of service also had 22 other individuals with six or more unreported violations. Financial advisory services partners and human resources partners also had high averages of unreported violations, but because relatively few of each were selected, it cannot be determined whether these results have any significance.

[124] See also App. QQ.

violations among non-partners were by managers. The mean number of unreported violations per manager is 0.36.

(iv) Unreported Partner Violations By Reporting Status in the March 1999 Confirmation Process

As set forth in Part III, Section A.3(c), supra, in light of the fact that approximately half of PwC's partners reported at least one matter in the March 1999 Confirmation Process, LSW directed that the Random Sample Study include 200 partners. We then examined whether there was any difference between partners with reported violations and partners without reported violations, with respect to both the number of partners with unreported violations and the number of unreported partner violations.

As set forth in Table 40, the percent of partners with reported violations who had at least one unreported violation in the Random Sample Study was approximately the same as the percent of partners without a reported violation who had at least one unreported violation in the Random Sample Study.[125]

TABLE 40
(Partners With and Without Reported Violations)

	Random Sample Partners with Reported Violations	Random Sample Partners without Reported Violations	Total Random Sample Partners
Random Sample Partners	83	117	200
Random Sample Partners with Unreported Violations	65	90	155
Percent of Random Sample Partners with Unreported Violations	41.9%	58.1%	100%

[125] See also App. RR.

However, as shown in Table 41, those partners who did not report any violations in the March 1999 Confirmation Process did have a greater share of the total unreported violations than those who reported a violation in March.[126]

TABLE 41
(Unreported Violations for Partners With and Without Reported Violations)

	Unreported Violations for Random Sample Partners with Reported Violations	Unreported Violations for Random Sample Partners without Reported Violations	Total Unreported Random Sample Partner Violations
Number of Unreported Violations	401	704	1105
Percent of Unreported Violations	36.3%	63.7%	100%

(v) Partner and Non-Partner Selectees With Reported and Unreported Violations

We tabulated the number of Random Sample Study selectees who had at least one Independence violation, whether reported in the March 1999 Confirmation Process or revealed in the Random Sample Study.

[126] See also App. SS.

As set forth in Table 42, approximately 173 (or 86.5%) of the Random Sample Study partner selectees had at least one reported or unreported violation.[127] This statistic allows one to project that, as shown in Table 43, at a 90% confidence level, between 81.9% and 90.3% of PwC's partners as a whole – or approximately between 2,210 and 2,436 individuals – had at least one reported or unreported violation during the relevant time period.[128]

TABLE 42
(Partners with Violations)

	PTR
Random Sample Partners with Only Unreported Violations	90
Random Sample Partners with Only Reported Violations	18
Random Sample Partners with both Reported and Unreported Violations	65
Total Random Sample Partners with Violations	173
Percent of Total Random Sample Partners with Violations	86.5%

TABLE 43
(Firmwide Projection of Partners with Violations)

	PTR
Total Partner Population Firmwide	2698
Projected Percent of Partners with Violations Firmwide	81.9% to 90.3%
Projected Partners with Violations Firmwide	2210 to 2436

[127] See also App. TT.

[128] As set forth in Part III, Section A.2, supra, the figures for reported violations include matters that are only firm violations and not violations of the SEC or AICPA rules, while the Random Sample Study figures include only violations of the SEC or AICPA rules.

As set forth in Table 44, approximately 21 (or 10.5%) of the Random Sample Study non-partners had at least one reported or unreported violation.[129] This statistic allows one to project that, as shown in Table 45, at a 90% confidence level, between 7.14% and 14.8% of PwC's non-partners as a whole – or approximately between 2,390 and 4,954 individuals – had at least one reported or unreported violation during the relevant time period. Specifically, based on the results of the Random Sample Study and statistical principles, one can project that, at a 90% confidence level, between 18.8% and 36.4% of PwC managers had at least one reported or unreported violation and, at a 90% confidence level, between 0% and 2.43% of PwC employees had at least one reported or unreported violation during the relevant time period.

TABLE 44
(Non-Partners with Violations)

	MGR	EMP	Total Non-Partner
Random Sample Non-Partners with Only Unreported Violations	14	0	14
Random Sample Non-Partners with Only Reported Violations	4	0	4
Random Sample Non-Partners with both Reported and Unreported Violations	3	0	3
Total Random Sample Non-Partners with Violations	21	0	21
Percent of Total Random Sample Non-Partners with Violations	26.9%	0%	10.5%

[129] See App. UU.

TABLE 45
(Firmwide Projection of Non-Partners with Violations)

	MGR	EMP	Total Non-Partner
Total Non-Partner Population Firmwide	11715	21757	33472
Projected Percent of Non-Partners with Violations Firmwide	18.8% to 36.4%	0% to 2.43%	7.14% to 14.8%
Projected Non-Partners with Violations Firmwide	2202 to 4264	0 to 529	2390 to 4954

(vi) Number of Reported and Unreported Violations By Partner and Non-Partner Selectees

The Random Sample partners had a total of 1575 violations (1105 unreported violations and 470 reported violations) among them, an average of 7.875 violations per Random Sample partner. The Random Sample non-partners had a total of 41 violations (28 unreported violations and 13 reported violations) among them, an average of .205 violations per Random Sample non-partner.

(vii) Other Random Sample Study Results

a. Merger Violations

In the March 1999 Confirmation Process, approximately 50% of reported partner violations were attributable to the Merger. See supra Table 19. However, as shown in Table 46, only 34% of the Random Sample partners' unreported violations were attributable to the Merger.[130]

TABLE 46
(Partner Merger Violations)

	Percent of All Reported Partner Violations Firmwide	Percent of All Unreported Random Sample Partner Violations
Merger-Related Violations	50.2%	33.7%

The percent of Random Sample non-partners' unreported violations that are merger violations is 29%. As illustrated by Table 47, this figure is roughly the same as the percent of non-partner merger violations reported in the March 1999 Confirmation Process.[131]

TABLE 47
(Non-Partner Merger Violations)

	Percent of All Reported Non-Partner Violations Firmwide	Percent of All Unreported Random Sample Non-Partner Violations
Merger-Related Violations	27.0%	29.0%

[130] See also App. VV.

[131] See also App. WW.

b. Type of Interest

The breakdown of unreported partner violations by type of interest roughly corresponds to the breakdown of partner violations reported in the March 1999 Confirmation Process, as illustrated by Table 48. However, unreported violations appear to include a slightly higher percentage of stock holdings and a slightly lower percentage of mutual fund holdings than were reported in the March 1999 process.[132]

TABLE 48
(Partner Violations by Type of Interest)

	Percent of All Reported Partner Violations Firmwide	Percent of All Unreported Random Sample Partner Violations
Bank Deposit	1.3%	1.6%
Brokerage Account	6.7%	7.5%
Debt Instrument	1.5%	1.4%
Insurance Product	0.8%	1.1%
Loan	0.7%	0.9%
Mutual Fund	52.1%	43.4%
Stock Option	0.2%	0.2%
Stock	31.1%	36.9%
Sweep Account	4.7%	6.2%
Other	0.9%	0.8%
TOTAL	100%	100%

[132] See also App. XX. Non-partner data for unreported violations did not correspond as clearly to the breakdown of reported violations by type of interest in the March 1999 Confirmation Process. However, because the number of unreported non-partner violations in the Random Sample Study was so small, it is not useful to attempt to draw any inferences from this result.

c. Source of Violation

Table 49 compares, for partners,[133] the sources of violations for all violations reported in the March 1999 Confirmation Process to the sources of violations for the unreported violations uncovered in the Random Sample Study.[134] Although it appears that the percentage of unreported violations arising from direct investments by the reporting person, for both partners and non-partners, was greater than the percentage of such investments that was reported in the March 1999 Confirmation Process, this discrepancy may be attributable at least in part to potential imprecision in distinguishing between the reporting person and that person's spouse or dependents in classifying unreported violations. This potential imprecision derives from the fact that the Random Sample Study audit was designed to keep the identity of the selectees unknown to the PwC Audit Teams.[135]

[133] For non-partners, the number of unreported violations likely is too small to permit any useful inferences.

[134] See also App. YY.

[135] Because the PwC Audit Teams reviewed files for which identifying information had been redacted, see supra Part III, Section B.2(b), it was difficult for them initially to determine whether certain prohibited investments were held by the reporting person or by spouses or dependents. While an attempt was made later to clarify these determinations, it is possible that the Unreported Matters Database reflects an overclassification of unreported violations by the reporting person and an underclassification of unreported violations by spouses or dependents.

TABLE 49
(Partner Violations by Source of Violation)

	Percent of All Reported Partner Violations Firmwide	Percent of All Unreported Random Sample Partner Violations
A. Direct Investment by the Reporter	36.6%	59.4%
B. Spouse/cohabitant direct investment	11.2%	3.3%
C. 401(k) - former employer (Reporter)	1.4%	1.1%
D. Spouse/cohabitant 401(k) - current employer	2.2%	4.9%
E. Spouse/cohabitant 401(k) - former employer	1.2%	0.6%
F. IRA (Reporter)	8.6%	7.3%
G. Spouse/cohabitant IRA	7.0%	1.8%
H. Dependent Investment	9.5%	1.9%
I. Non-dependent close relative investment	1.0%	0.8%
J. Family member's employment	0.1%	0.3%
K. Gift/Inheritance	1.5%	0.5%
L. Executor/Trustee	4.9%	0.5%
M. Beneficiary	0.3%	0.2%
N. Broker/Dealer Cash/Securities Account	5.3%	7.5%
O. Margin Account	0.2%	0.2%
P. Sweep Account	4.1%	3.7%
Q. Loan/Bank Deposits	1.6%	2.7%
R. Other	3.3%	3.3%
TOTAL	100%	100%

(viii) Client Service Violations in the Random Sample Study

In the Random Sample Study, PwC found that twelve individuals (ten partners and two managers) had unreported violations with respect to a total of eleven SEC registrant clients while the individuals performed professional services for the SEC registrant client or an affiliate.[136] The ten partners constitute 5% of the 200 partner

[136] PwC has notified the eleven clients of these violations; in addition, PwC is in the process of reporting these matters to the SEC. Also, PwC is in the process of reporting to the SEC service violations regarding four additional clients. These four situations did not arise out of the Random Sample Study, but were not included in the initial submission of materials to the SEC following the March 1999 Confirmation Process. PwC has already notified these four clients of the violations. Additionally, with respect to one of the 52

selectees, and 6.5% of the 155 partners with unreported violations. The two managers constitute 1% of the 200 non-partner and 2.5% of the 78 manager selectees, and 9.5% of the 21 non-partners with unreported violations.

Two of the twelve individuals, both audit partners, had unreported service violations that were related to audit services. Neither of these situations involved securities holdings in the client for which services were provided; both involved interests held in an affiliate of the client for which the partner performed services. The service violations of the remaining ten individuals (three management consulting partners, two financial advisory services partners, two tax partners, one human resources partner, one management consulting manager, and one tax manager) were related to non-audit services.

The two situations that relate to audit services are as follows. In his March 1999 Confirmation response, one audit partner reported that the balance of his joint account with his spouse at a bank[137] had at times exceeded the FDIC insured limit by a material amount, but did not mention that he charged a total of thirteen hours during 1996, 1997, and 1998, as a concurring partner, for audit-related services to a subsidiary and affiliated mutual funds of the bank. Another audit partner held, through an IRA, approximately $20,000 in a mutual fund client. He had held the fund for approximately 17 years, and sold his holdings in it in November 1998. The partner was the audit engagement partner

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clients discussed in Part III, Section A.3(f), supra, PwC has recently advised the SEC, as well as the client, of additional client service violations.

[137] These funds had been at a non-client bank that was acquired by the client bank in 1996.

for, and provided seven hours of audit-related services to, a subsidiary affiliate of the mutual fund's corporate family between May 1998 and November 1998.

The client service violations found in the Random Sample Study that were not audit-related are outlined below.

One management consulting partner held approximately $5,000 in the stock of a client from October 5, 1998 through October 15, 1998. He was the management consulting partner for the client, directing the implementation of a computer system, and charged 40 hours to the client in October 1998, with a total of 256 hours between July 1998 and January 1999.[138]

From July 1998 to October 1998, a management consulting partner held an account at a client bank that swept cash into a client fund, and also held funds in the account that at certain points exceeded the FDIC insurance limit by an amount material to his net worth, during which time he also provided 106 hours of non-audit service to the bank (but not to the client fund).

A number of the non-audit service violations were attributable to spousal holdings. One management consulting partner had two service violations relating to his spouse's long-term ownership of a small number of shares in the stock of two clients for which the partner charged 1,578 hours and 216 hours, respectively, in consulting services between 1996 and 1998. The two stocks were sold for under $1,700 in March 1998 as part of an oddlot program. One management consulting manager had a service violation stemming from his spouse's ownership of 350 shares of client stock during a time when

[138] LSW's review of news databases concerning the client contained no indication that the partner was motivated by any material non-public information in buying or selling the stock.

the manager provided over 3,200 hours of computer systems implementation work for the client. Both the partner and the manager stated that they were unaware of their spouses' prohibited holdings. Additionally, the spouse of one financial advisory services partner held 300 shares of stock in a client, through an IRA, between October 1998 and August 1999. The partner charged seven hours of non-audit services to the client from September 1997 to June 1999. The partner stated that he had not realized that his wife's investments posed an Independence problem because they were in a discretionary account controlled by her employer. The spouse of one financial advisory services partner participated in the employee stock purchase plan of a client employer; when PwC acquired the partner's former company in August 1998, the spouse sold the client stock. However, because of a dividend reinvestment program, a small number of additional shares later appeared in the spouse's account. The shares were finally disposed of in January 1999. Between October 1998 and January 1999, the partner charged 318 hours of non-audit services to the client.

Finally, a human resources partner charged three hours to an engagement with a client at a time when his wife owned a small number of shares of client stock that she had received from her mother. Additionally, the partner had two brokerage accounts with a large brokerage firm client, and also invested in five mutual funds advised by the brokerage firm client, and four client mutual funds affiliated with the brokerage firm client. From February 1996 to June 1999, the partner charged 161 hours to a non-audit client that was part of the same large corporate family as the client brokerage firm, and twelve hours to the brokerage firm client.

There were also several violations that involved very few hours charged to the relevant client. One tax partner, who owned 40 shares of client stock that she stated was purchased for her children years earlier, charged two hours of non-audit services to the client between February and March 1999. The partner said she did not recall the stock until after she submitted her March 1999 Confirmation. Another tax partner, who had reported loans and a brokerage account with a client bank in his March 1999 Confirmation response, was also found by the PwC Audit Teams to have an additional brokerage account, as well as mutual funds and sweep accounts at the client bank. The partner billed a total of five hours to the client – one hour in May 1997 and four hours in October 1998 – while he held the prohibited interests in the client. Additionally, one tax manager provided approximately 14 hours of non-audit service to a client bank in 1998, while holding a prohibited client money market fund at that bank.

In addition to the unreported client service violations revealed in the Random Sample Study, two partner selectees and three non-partner Random Sample selectees (all managers) reported client service violations in their March 1999 Confirmations. Therefore, in the Random Sample Study, there were a total of 12 partners and four non-partners with at least one reported or unreported client service violation, and two partners (1% of total partner selectees) and one non-partner (0.5% of total non-partner selectees) with at least one reported or unreported audit-related client service violation.

According to statistical principles, these results allow one to project that, at a 90% confidence level, there were between 3.50% and 9.54% of partners and between 0.69% and 4.52% of non-partners with at least one client service violation in the firmwide population during the relevant period, and between 0.178% and 3.11% of partners and

between 0.0256% and 2.35% of non-partners with at least one audit-related client service violation in the firmwide population during the relevant period.

The discovery of unreported client service violations in the Random Sample Study indicates that there were additional client service violations in the firmwide population at PwC during the relevant period that are still unknown. As explained in Part IV, Section A, infra, apart from the Internal Investigation, PwC's new Independence system is designed to uncover unresolved partner and manager violations.

(c) Interviews of Certain Random Sample Selectees

Together with PwC representatives, we interviewed numerous Random Sample Study selectees to question them about the reasons they did not report certain violations in the March 1999 Confirmation Process, to explore the details of both reported and unreported violations, and to gauge the extent to which they were aware of Independence Rules and made efforts to comply with them. As of December 13, 1999, 46 selectees had been interviewed. Most of the interviewees were represented by counsel. We set forth below a summary of some of the reasons or explanations given by the selectees for failing to report violations.

In reviewing this summary, the reader should keep in mind the circumstances of the interview process. Interviewees were not chosen based on statistical principles. All but one of the interviewees were partners. Forty-five of the 155 partner selectees[139] and

[139] Of the 45 partner selectees interviewed, 20 were legacy PW partners and 25 were legacy C&L partners. Nineteen were management consulting partners; thirteen were audit partners; eight were tax and legal services partners; four were human resources partners; and one was a financial advisory services partner. However, legacy firm and line of service were not criteria used for designating interviewees. See infra. In addition, we interviewed one partner in senior management who was not one of the Random Sample selectees.

one of the 17 manager selectees[140] with unreported violations had been interviewed as of December 13, 1999.[141] In addition, the criteria for designating interviewees have been based on several factors. Many interviewees were chosen because, according to the PwC audit, they appeared to have a large number of unreported violations. In addition, some persons were selected because they performed or may have performed client services in connection with one or more of their unreported violations.

Moreover, the designation of interviewees was made while the review of the files of Random Sample Study selectees was ongoing. Therefore, interviewee designations were made primarily from a universe of files that had been given substantial (although not necessarily complete) review at that time; names were added to the interview list as information about additional files became available. Individuals were scheduled for interviews based primarily on their availability and the availability of other participants in the process, although in a few cases (e.g., selectees with a particularly large number of previously unreported violations), an effort was made to schedule certain interviews ahead of others. In addition, as set forth at n. 105, supra, PwC is still seeking documents from certain selectees and reviewing certain matters disclosed by the Random Sample Study.

Thus, the summary set forth below addresses the most common explanations given for a failure to report violations, and is not intended to be representative of the

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[140] This was a legacy PW management consulting manager.

[141] LSW participated in all but three of these interviews, and received detailed reports from PwC of the three interviews that LSW did not attend. As part of its internal disciplinary process, PwC is continuing to interview both Random Sample Selectees and individuals who reported violations in their March 1999 Confirmations but who were not selected for the Random Sample Study. PwC has invited LSW to attend those interviews.

circumstances of all selectees, or to encompass individual cases of particular significance. In the main, it appears that reasons other than an intentional omission account for the large numbers of partners with unreported violations, although one individual admitted a knowing failure to report a violation. However, in the summary below, we have not set forth the details of specific situations, or provided any evaluation of whether, in any given instance, the explanation given by a particular interviewee was or was not credible.

(i) Failure to Remember Holdings

Some selectees stated that they failed to report certain interests because they simply forgot that they held the interests. In some cases, selectees said they forgot about interests held by a spouse or dependent, or the restricted interest was acquired many years before the March 1999 Confirmation Process. Some partners who stated that they forgot holdings were less active investors who said they made the mistake of attempting to recall all of their holdings without referring to brokerage statements or tax returns. Some partners stated that they failed to focus on holdings that they had previously sold for Independence reasons when responding to the March 1999 Confirmation.

(ii) Failure to Check the Independence Lists

A number of partners attributed their failure to report violations in their March 1999 Confirmations to a failure to check the Independence lists, or to check them carefully. In several cases, interviewees stated that they had relied on a broker, financial advisor, or secretary to ensure that either existing holdings or new acquisitions did not pose Independence problems. Others said they did not check their legacy firm Independence list at the time of the Merger or the March 1999 Confirmation Process because they believed they had checked at the time they made certain investments.

Some partners explained that, rather than checking the Independence lists, they or a broker checked an entity's audited financial statements or contacted the entity directly to determine who the auditor was before acquiring the holding. This method of checking for Independence could fail to identify new audit clients or restricted audit client affiliates, e.g., a material investor in or investee of an audit client of the firm, or a client investment advisor of a non-client mutual fund.

(iii) Difficulties in Checking the Electronic Independence Lists

Numerous partners explained that, when they initially checked the electronic Independence lists, they were unable to find the names of restricted entities that were in fact on the list at the time that they checked, because of the way in which they searched the lists.[142]

In the Lotus Notes databases that contained the list of restricted entities for the legacy firms and PwC, the way a name is entered can mean the difference between success and failure in finding it on the list, even apart from such factors as typographical errors in entering the name or in the spelling of the name in the list. If one enters a name that is specific but incorrect, the database will respond merely by advising that there are no matching entries; the user will not automatically be taken into the body of the list. For instance, a search for "Acme Stores Inc." will advise that there are no matching entries if the company is identified in the list as "Acme Stores Corporation."[143] However, by

[142] This explanation was cited also by many individuals who reported violations in the March 1999 Confirmation Process as the reason that they had incurred those violations. See supra Part III, Section A.3(j)(ii).

[143] Similarly, a name search for "Acme Stores Inc." would not yield a match if the company is identified in the list as "Acme Stores, Inc.," simply because of the omission of the comma.

merely entering "Acme Stores," one would not miss the entry under either name.[144] Moreover, a more general search of the list, i.e., entering the beginning word – or even the beginning letter or letters – of the entity, would be even safer. Thus, if one simply entered "Acme," the user would be taken to the first entry in the list beginning with "Acme," and could then scroll down to search for a more specific name. Such a search technique was particularly useful in the case of mutual fund families – whose members can be quite numerous and whose names in the Independence lists sometimes vary from their commonly known names or names as they appear on account statements[145] – and with entities whose names have no space or a hyphenation between two words ("AcmeStores" or "Acme-Stores"). Some partners stated that they were unaware that they could do a more general search, or were not aware of this fact until a later point in time.[146] In some instances, even the more general name search could be unsuccessful.[147]

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[144] At set forth at n. 149, infra, users of the legacy C&L list were warned to avoid including words such as "Inc." and "Corp." in their electronic searches.

[145] In some cases, there were significant disparities between the way that an entity was identified in the Independence list and the way in which an entity was otherwise known. This was an issue particularly with mutual funds, which might appear on account statements with a name like "Acme Growth Fund" but on the list as "Acme Equity Portfolio Series: Acme Growth Fund," making the search more prone to error. Moreover, mutual fund families in some cases comprise multiple pages of single-spaced text in the lists.

[146] One partner, however, stated that his experience searching in other databases and on the internet made it clear to him that more general and persistent methods of searching (including entering the first word or first letters of a name, and scrolling the list) would be far less prone to error than an attempt to search using the specific names that appeared in his brokerage statements.

[147] A standard search query of the legacy PW and C&L electronic lists defaulted to a "begins with" function. Thus, using that function, a search for "Acme" would be unsuccessful if the name in the list is "First Acme Corporation."

However, many shortcomings of the electronic list could be avoided by using other tools. One could use a hard copy of the list, if available, or print a hard copy of it and search manually through the listings, which were alphabetical. One also could check the public filings of a company,[148] or materials sent to shareholders, to ensure at least that PwC or its legacy firms were not the company's auditors. In fact, the electronic lists and Independence policies in effect from the time of the Merger through May 1999 warned the user of the limitations of searching the lists, advised that the existence of the lists did not diminish personal responsibility for ensuring Independence compliance, and cautioned that other sources of information should be consulted.[149] While one interviewee recalled these warnings, other interviewees said that they did not recall

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[148] The SEC's website, www.sec.gov, allows the user easily to find any company's public filings since 1994 in its EDGAR database. Both the 1998/99 PwC Independence Policy and the warnings contained at the front of the March 1999 list of legacy C&L clients direct individuals to EDGAR as one source for identifying an entity's auditor. Additionally, a company's public filings are generally available on its own corporate website, and may also be accessible thorough internet brokerage sites or exchange sites such as www.nasdaq.com.

[149] At the front of the legacy C&L list, users also were specifically warned, when searching the database for an entity, to "[a]void entering noise words such as 'Inc.' and 'Corp.'" The notes at the front of the March 1999 legacy PW list were not as clear, and might inadvertently have encouraged an overly specific search by advising that the user "must be aware of the **precise** name of the entity for which he or she is searching" (emphasis in original). However, users of the PW database were warned to exercise extra care in searching the list, particularly with regard to names containing numbers, spaces and punctuation marks. The legacy PW policy also indicated that the Independence list was available both through Lotus Notes and in printed copies delivered to the practice offices each July, and that updates were published periodically via Lotus Notes. All PwC professionals were reminded not to rely exclusively on the Independence lists in e-mails introducing PwC's Independence policy in late December 1998. See infra Part III, Section B.2; Ex. 7.

seeing or reading them.[150] Finally, PwC professionals could check with the regional, line of service or national Independence partners for assistance in checking their compliance.

(iv) Lack of Knowledge of or Access to Independence Lists

Some interviewees explained that they were not even aware of the existence of Independence lists until after the time of the March 1999 Confirmation. Others said that computer glitches made it difficult or impossible for them to access the Independence lists. Three partners who claimed to have difficulty accessing the electronic Independence lists were assigned to offices outside the United States.

(v) Lack of Understanding of Independence Rules and Policies

Many interviewees said that neither PwC nor its legacy firms provided any training or education concerning the Independence Rules and the Independence process.[151] Many of these interviewees attributed their failure to report certain violations to a lack of awareness that the Rules prohibited the particular interests that constituted violations.[152] In some cases, interviewees admitted that they had never read, or had never read carefully or in their entirety, the Independence policies of their legacy firm or PwC. Some interviewees reached an understanding of the scope of the rules based at least in

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[150] A user would only be taken directly to the screen containing these warnings on the first occasion that the user accessed the electronic databases. On subsequent occasions, the user would automatically be returned to the screen that was displayed when the database was last exited.

[151] There seemed to have been little formal education on Independence issues at PwC's legacy firms, although C&L conducted ethics seminars in which Independence topics were discussed from time to time, and a portion of the orientation for new C&L partners was devoted to Independence.

[152] This explanation was cited also by many individuals who reported violations in the March 1999 Confirmations process as the reason that they had incurred violations. See supra Part III, Section A.3(j)(i).

part on things they heard from colleagues. Some partners said they believed that the rules did not apply to holdings in audit clients that were mutual funds. Other individuals said that they were unaware that the Rules extended to such interests as spousal holdings, inherited securities, investors in or investees of audit clients, brokerage accounts, UITs, IRAs, variable life insurance and annuities, money market accounts, sweep accounts, bank account balances materially in excess of the FDIC-insured limit, loans, or monthly credit card balances in excess of $5,000. Some partners said they believed that holding immaterial investments in audit clients where a broker or investment advisor had complete discretion to select the investments was permissible under the Rules, by analogy to an investment in a non-client mutual fund that maintained immaterial investments in audit clients.

In some instances, partners said that they believed they were permitted to invest in firm audit clients as long as they did not work on the engagement or in the office performing the engagement;[153] one partner said he believed that he could invest so long as he did not work on the engagement, regardless of whether the client was audited out of his office. Those who asserted such an understanding stated that they were not aware that the restrictions on their holdings broadened once they became partners.[154]

It is worth noting that, while recent educational initiatives pursuant to the Order are doubtless more effective, see infra Part IV, Section B, PwC made efforts after the Merger and before the March 1999 Confirmation Process to address possible deficiencies

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[153] None of those asserting that understanding were audit partners.

[154] However, unlike the legacy C&L policy, which was relaxed in 1993 to conform to the SEC and AICPA definitions of "member," the legacy PW policy until the time of the Merger prohibited any manager or employee – not just partners – from buying stock in any audit client (other than certain mutual funds) of the firm. See supra n. 4.

in knowledge about the Rules. In late December 1998, in distributing the new Independence policy of the merged firm to all professionals, PwC included an e-mail primer summarizing the policy and its differences from the policies of the legacy firms. See Ex. 7. The e-mail reviewed the definition of "member" and explained the rules regarding variable life and annuity policies, non-client UITs, and brokerage accounts. It also cautioned that investments in non-client mutual funds were prohibited where PwC audited the funds' advisor; that PwC professionals were responsible for their spouses' holdings for Independence purposes; that they could not rely on third-parties to screen their investments; that they could not rely solely on the Independence lists to check their Independence; that there was no materiality standard for direct financial interests; and that PwC professionals should consult the regional or line of service Independence partners with any questions about Independence.

(vi) Belief That the March 1999 Confirmation Only Asked About Present Compliance

As set forth in Part III, Section A.1, supra, the March 1999 Confirmation was sent to PwC professionals in the wake of the firm's well-publicized Tampa Independence problems. The text of the Confirmation itself advised respondents that the process was being conducted pursuant to SEC oversight, and contained in the middle of the first page a warning, printed in bold, upper case letters, that false statements could subject the respondent to criminal prosecution. The Confirmation then specifically required reporting of any instances of non-compliance that existed during three separate periods – from the end of fiscal 1997 to the Merger date, from the Merger date to the time of the Confirmation response, and as of the time of the Confirmation response – in three

separate and distinct questions, each of which respondents were required to answer. See supra Part III, Section A.1 and n. 34; Ex. 9.[155]

Nonetheless, a number of the Random Sample interviewees said that they misunderstood the March 1999 Confirmation, and believed that they were being asked only if they were in compliance at the time of response. As a result, they said, they did not report violations that had been resolved prior to the time that they responded. These individuals generally said that they had not taken the time to read the Confirmation carefully.[156]

(vii) The Pressures of Client, Firm and Personal Obligations

Interviewees frequently cited their busy schedules, business travel, the pressures of client and firm obligations, and the large volume of e-mails received daily as reasons that they did not pay attention or give sufficient priority to internal communications about Independence issues, the workings or requirements of the Independence process, or such tasks as scrolling the Independence lists to check investments. Several interviewees also cited personal reasons, such as divorce, illness, serious injury, or a death in the family, for their failure to turn their attention to Independence issues in a timely manner.

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[155] PwC professionals were advised by e-mail in late December 1998 that they would be asked in January 1999 to confirm their Independence during these three distinct periods. See Ex. 7. As set forth supra, the Confirmation was not sent until March 3, 1999, but it was preceded by another firmwide e-mail from PwC's chairman and chief executive on March 1, 1999 reminding them of the importance of the process and the fact that it was being conducted pursuant to SEC oversight. See Ex. 15.

[156] As set forth in Part III, Section C.1, infra, respondents may have understood that the legacy firm confirmations for fiscal year 1997 (and in prior years), in view of the wording of those forms, asked only whether the respondent was presently in compliance.

C. The Internal Controls Study

The Internal Controls Study was an examination of the confirmation process in PwC's legacy firms in fiscal year 1997, the last time those firms conducted a firm-wide Independence confirmation before the March 1999 Confirmation Process. The Study involved two principal tasks: (1) an examination of the mechanics and procedural aspects of the process, including the form of the confirmation, the extent to which the legacy firms collected Independence confirmations from individuals who were supposed to submit them, and the processing of reported matters; and (2) a review of whether reported matters were appropriately reviewed and resolved. LSW selected 12 offices or groupings in each of the legacy firms (the "Selected Offices") for the Internal Controls Study.[157]

Like the March 1999 Confirmation Process, and in contrast to PwC's new Independence system, see infra Part IV, Section A, the Independence confirmation processes at both legacy firms relied primarily on individual professionals to examine their own holdings to determine whether any of them posed Independence issues, and to then report only those that they determined did pose such issues.

[157] The PW offices or groupings were: New York, Chicago, Boston, Philadelphia, San Francisco, Rochester, Charlotte, Southern California, Kansas City, Houston, and Fort Worth (audit professionals), and all PW partners. The C&L offices were: New York, Boston, Los Angeles, Houston, Pittsburgh, Miami, Fort Worth, Portland (Oregon), Raleigh, Rochester, San Juan, and Chicago. PW partners were chosen as a group because their confirmations were reviewed on a centralized basis, separate from their assigned office. Subsequent to the initial selection, all C&L partners were made part of the Study when it was determined that C&L partner confirmations also had been collected and reviewed centrally. In addition, because the confirmation process for the management consulting ("MCS") practice was handled separately by each legacy firm, the Study included the MCS group for C&L New York and the MCS East group for PW.

1. The Fiscal 1997 Confirmation Forms

The most significant fact about the confirmation forms used by both of PwC's legacy firms is that they could be read as asking only whether the respondent was presently in compliance with the Independence Rules. As a result, respondents likely were not encouraged to report in their confirmation responses violations that existed during fiscal year 1997 but were resolved by the time of confirmation.[158]

In addition, in contrast to the March 1999 Confirmation Process, matters were reported manually, not electronically, in the fiscal 1997 confirmation processes of both legacy firms.

(a) PW's Fiscal 1997 Confirmation Form

PW's fiscal 1997 Independence confirmation was included in a two-page form that also required confirmation of compliance with policies concerning client and firm confidentiality, security, government contracting and codes of conduct. See Ex. 16. The PW form advised that the Independence list was available in hard copy in all offices and also on the firm's Lotus Notes database, and was supplemented by periodic updates appearing in PW Alert, the firm's internal electronic bulletin board. The form also directed the respondent to review PW's Independence policy, as well as the HELP feature of the Independence List database for summaries of the Independence Rules.

The PW form required professionals to "confirm that [they] will continue to conduct [their] affairs in such a manner as to maintain independence." (Emphasis added.) See id. This formulation, suggesting past compliance, might be read in isolation as encouraging a response that affirms full compliance. The form did, however, direct

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[158] However, at least four partners (two from each legacy firm) did report violations that had occurred in the past but had since been rectified.

the reporting of exceptions and required an affirmation that professionals "will discuss promptly, with the appropriate partner, any situation that could be a departure from the firm's Independence requirements." See id. Nonetheless, the confirmation did not specifically direct the respondent to report in the Confirmation response Independence violations that had occurred sometime since the prior confirmation period but were resolved before the date of the current confirmation. In addition, the confirmation was sent with a cover memorandum that likely reinforced an interpretation that the confirmation asked only whether the respondent was presently in compliance.[159] Legacy PW representatives indicated that as a general rule, respondents likely did interpret the form in that manner.

In addition, the PW fiscal 1997 confirmation, in the case of non-partners, generally did not indicate whether the respondent was a manager or employee. This information would have aided in the determination of whether SEC or AICPA rules (as opposed to firm policy) were violated.[160]

(b) The Fiscal 1997 C&L Confirmation Form

Unlike its PW counterpart, C&L's fiscal 1997 Independence confirmation form was one page and, aside from Independence, covered only client and firm confidentiality policies. See Ex. 18. The C&L form made more explicit demands of the respondent than did its PW counterpart. It required the respondent to affirm that he or she had read the firm manual concerning Independence and related matters and was in compliance with

[159] See Exs. 16 and 17.

[160] Under legacy PW rules, staff classification was less important since those rules prohibited all professionals from acquiring an interest in a non-mutual fund audit client after they joined PW, regardless of whether they were "members" with respect to the clients under the SEC or AICPA rules.

Independence Rules "except as described below." See id. It further required an affirmation that the respondent in fact had described "[a]ll known financial interests in and/or positions with a client of myself, members of my immediate family (spouse, cohabitant, dependent children, and other dependents), and non-dependent close relatives (such as parents, parents-in-law, brothers, sisters, grandparents, and non-dependent children [citation to firm manual omitted])" as well as "[a]ll loans with clients or affiliates [citation to firm manual omitted]," and "[i]nvestments, other relationships or other matters on which I have any question as to whether independence restrictions may apply, regardless of my conclusion." See id.

PwC Independence personnel familiar with legacy C&L's Independence policies have informed us that, as suggested by this language, C&L's policy was to encourage the reporting of all existing client interests and relationships even if the respondent did not believe that they were violations. Such a policy would help identify situations that were not at the time violations but could become so later (e.g., an associate whose future assignment or promotion to manager or partner could make him or her a "member" under the Rules). The fact that legacy C&L had far more reported matters in fiscal 1997 than did legacy PW may reflect this policy.

However, like the fiscal 1997 PW form, the C&L fiscal 1997 confirmation did not specifically direct the respondent to report Independence violations that had occurred sometime since the prior confirmation period but had been resolved before the date of the current confirmation. Indeed, the phrasing of the affirmation in the present tense ("I am also in compliance with [the Independence policies]") made it likely that respondents

would interpret the confirmation as asking only about present compliance, and would therefore fail to report violations that had been resolved prior to response.

The C&L confirmation form, unlike the PW form, also specified that the description of matters should include certain details (e.g., whether the financial interest is direct or indirect and whether it constitutes over five percent of the holder's net worth). The form also asked whether the individual performed work for the client with respect to loans and prohibited family relationships; one defect in the form was that it did not ask for this information with respect to a financial interest in the client.

2. PwC's Review of Whether Required Confirmations Were Submitted

During the late summer and fall of 1999, as part of the Internal Controls Study, PwC conducted an audit to determine whether fiscal year 1997 confirmation forms were collected from all professionals in the Selected Offices who were required to submit them, and whether those forms were appropriately maintained thereafter.

For the larger Selected Offices, the PwC audit team conducting this portion of the Internal Controls Study examined confirmations of non-partners in the course of site visits to those Offices.[161] For smaller Selected Offices[162] the PwC audit team examined the confirmations in New York after copies had been forwarded there by the individual responsible for maintaining the confirmations. For the partners of both legacy firms and

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[161] Those C&L Offices were: Chicago, Los Angeles, Miami, New York, Portland and San Francisco. Those PW Offices were: Boston, Charlotte, Chicago, Los Angeles and New York. Although the PwC audit plan indicates that the audit team examined confirmations submitted by non-partners only in the audit line of service for these offices, it appears that in fact confirmations submitted by those in other lines of service also were examined.

[162] Those C&L Offices were: Fort Worth, Houston, Raleigh, Rochester and San Juan. Those PW offices were: Fort Worth, Houston, Kansas City, Philadelphia, and Rochester.

for legacy C&L MCS New York and legacy PW MCS East non-partners, fiscal 1997 confirmations were maintained separate from the particular Office to which those professionals were assigned. Those confirmations also were reviewed by the PwC audit team in New York.[163]

The PwC audit team, often in conjunction with a designated contact person from the Selected Office, reviewed the Selected Offices under a multi-step "program." In step one, each Selected Office was asked to present or obtain completed fiscal 1997 signed Independence confirmations for all non-partners (excluding professionals whose confirmations were collected separately). The PwC audit team and/or the contact person then separated the confirmations without reported matters from those with reported matters, and listed those individuals who reported matters in their 1997 confirmations.[164]

In step two, each Selected Office provided a "head count" of employees on the appropriate date – July 1, 1997 for legacy PW Offices, and October 1, 1997 for legacy C&L Offices – so that a list of non-partners who were required to submit confirmations could be compiled. One of the problems noted by the PwC audit team is that the source of the "control lists" from which the Selected Offices obtained their head counts varied

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[163] See supra n. 157. The PwC audit team leader also noted that the legacy PW offices collected most of the 1997 confirmation forms within two months of their distribution, whereas the legacy C&L offices took approximately four months to collect fiscal 1997 confirmations. These observations comport with our review of the fiscal 1997 confirmations.

[164] Confirmations were considered "without reported matters" if they contained nothing but a confirmation of Independence and a signature. Confirmations were considered to have reported matters if there was anything reported at all, even if the reporting individual was not certain whether a particular holding was or was not in fact an Independence violation. In this phase of the Internal Controls Study, the audit team did not exercise any judgment in determining whether reported matters were or were not Independence violations, or whether or how any violations were resolved.

among the Offices. Some Offices had the control list that had been used by the person responsible for collecting fiscal 1997 confirmations. For other Offices the audit team used a payroll list from the approximate time period as the confirmation control list. In certain cases, neither of those resources was available and the Office and audit team had to attempt to reconstruct a control list using a current payroll list, adding individuals who had been terminated since the relevant date and subtracting individuals who joined the firm after the relevant date.

Additional inconsistencies in the personnel listed in the different control lists raised questions about the reliability of those lists. Some lists contained employees, such as administrative staff or interns, who would not have been required to submit confirmations, whereas other lists did not. Also, some control lists contained personnel, such as partners or MCS employees, whose confirmations were maintained separately.[165] Finally, some Offices reported receiving completed fiscal 1997 confirmations for individuals not named on the control lists.

In step three, for each Selected Office, the PwC audit team worked with the Office to compare the names on the submitted confirmations with the names on the control list. Where there was an individual named on the control list for whom no confirmation could be found, the Office was asked to report and/or investigate the reason for the discrepancy. In step four, the Office was asked to prepare a "reconciliation," in some instances with the assistance or oversight of the audit team, explaining the reasons why confirmations did not exist or could not be found for individuals on the control

[165] The audit team relied on the contact person in each office to distinguish between those employees who should have completed Independence confirmations and those who were not obliged to do so or whose confirmations were separately maintained.

lists.[166] "Reconciling items," i.e., reasons for discrepancies between the number of fiscal 1997 confirmations amassed and the number of employees on the control list, included, among other things: (1) MCS employees or partners whose 1997 confirmations were maintained separately but who were included on the control list;[167] (2) administrative staff, support staff, temporary workers or interns who were named on the control list but were not obligated to complete Independence confirmations; (3) in the case of the legacy PW office in Philadelphia, certain employees in non-audit lines of service who were named on the control list, although their fiscal 1997 confirmations were or may have been processed or maintained separately; (4) individuals on the control list who left the firm due to retirement, resignation or termination during the period in which the fiscal 1997 confirmation forms were being distributed and collected and who therefore likely never submitted confirmations; (5) individuals on the control list who were on extended leave or disability during the period when the forms were being distributed and collected; (6) individuals who had since been transferred to other PwC offices and whose personnel files were presumably in the transferee office; and (7) individuals who were up for partnership consideration and whose personnel files were presumably in New York for review. For those in the latter two categories (non-partners who were transferred to other offices or being considered for partnership), it appears that some Offices sought to

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[166] In most of the Selected Offices steps three and four were conflated.

[167] However, it does not appear that the PwC audit team or the contact persons for the Selected Offices generally sought to confirm whether the partners or MCS employees on their control lists had in fact submitted 1997 confirmations separate from their resident offices. Accordingly, some of the reconciling items in this category may in fact be missing.

determine whether confirmations did in fact exist for those individuals in the transferee office or in New York, but met with only limited success.[168]

Where the absence of a 1997 confirmation could not be reconciled, i.e., where there should have been a confirmation for a particular individual but one could not be found, the confirmation was reported as "missing." At the Selected Offices where site visits were conducted by the PwC audit team, the team attempted to locate missing confirmations or to determine why confirmations were missing. Other Selected Offices not subject to site visits followed up on their own, sometimes contacting individuals for whom confirmations were missing to inquire whether they recalled submitting confirmations in 1997, or otherwise seeking explanations for why confirmations could not be found for particular individuals.

Assuming the validity of the reconciling items provided by each office, there were 1,022 confirmations missing from a total of 12,496 persons who should have submitted confirmations.[169] Missing confirmations therefore comprised approximately eight percent of the entire audit sample.[170] However, the majority of the missing forms were

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[168] However, even where such efforts were made, there was not always cooperation from the transferee office. It is possible that the reconciling items in these two categories (i.e., transferees and partnership candidates) may in fact be missing.

[169] As set forth at n. 175, infra, there is contemporaneous documentation affirming that all 1997 PW non-partner confirmations were collected for the Selected Offices.

[170] The PwC audit team's spreadsheet for the two legacy Boston offices apparently overestimated missing confirmations by neglecting to count partners, partners-in-process, transfers and those on leave as reconciling items in those offices. Accordingly, for the sake of consistency, in our calculation we did not treat these confirmations as missing. Also, in calculating the percentage of missing confirmations, for the total head count for the audit sample we did not include individuals in the reconciling categories, to eliminate individuals that were not required to submit confirmations, to put aside individuals that were not within the scope of the Internal Controls Study (e.g., an MCS professional apart from PW MCS East or C&L MCS New York), or to avoid double-counting of individuals

attributable to four Selected Offices or parts thereof: legacy PW Chicago (102 of 421 missing), legacy C&L MCS New York (328 of 792 missing), legacy PW MCS East (125 of 2,426 missing), and legacy PW New York (audit non-partners) (285 of 623 missing). If those four groups are excluded from the sample, the ratio of missing confirmations within the audit sample drops to approximately two percent, or 182 missing confirmations out of a total of 8,243 persons who should have submitted confirmations.

For legacy C&L MCS New York, the missing confirmations appear to be unrecoverable.[171] Other Offices with a substantial number of missing confirmations attempted to account for them.[172] Many of them were believed to have been sent at some

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(partners and MCS professionals) whose confirmations were maintained separately at another office or group.

[171] The contact persons for C&L MCS New York informed the audit team that for human resources professionals (who were then part of the MCS line of service) confirmation responses with no reported matters were discarded, and confirmation responses with reported matters were sent out for storage and subsequently lost. The leader of the audit team suggested that the figure of 328 missing confirmations for legacy C&L MCS New York may be inappropriately high, because it may include partners who were counted separately, or employees who were terminated before the date the completed confirmations were due. However, LSW cross-checked the control list for C&L MCS New York with the control list for C&L partners and found no overlap, except perhaps in one case.

[172] The legacy PW Chicago Office categorized its 102 "missing" confirmations as follows. Forty-five were listed as having been sent to processing centers in Tampa, New York or Los Angeles. Thirty-two were for individuals whose employment with the firm terminated in 1998 or 1999, and who presumably could not readily be contacted to ascertain whether they submitted confirmations. In seven instances, the personnel file had been "checked out" by an unidentified person. In three instances, no explanation was given for the missing confirmation. In 18 instances, the Office provided an explanation for the missing confirmation that was akin to the reconciling items provided by other Offices, i.e., partners, transfers, temporary employees, or persons on disability or other leave. In those instances, it is unclear whether the confirmations should in fact be treated as missing. In four instances, the Office explained "independence confirmation found," apparently meaning that the confirmation had been found after the number of missing forms had been tabulated.

point to off-site storage although in the case at least of PW, the stated policy was to keep confirmations on-site for three years. See Ex. 19.

3. Mechanics of the Fiscal 1997 Confirmation Process for Non-Partners

(a) The PW Non-Partner Process

PW's Auditing Services Department in Stamford, Connecticut had overall responsibility for the Independence confirmation process for non-partners in fiscal 1997. By memorandum dated December 22, 1997, that Department instructed human resources directors for particular offices or regions to distribute, collect and maintain confirmations for all non-partner client service and practice support staff, and to communicate by January 16, 1998, using an attached form, any exceptions to PW policy that were reported, and to confirm that each non-partner for whom they were responsible had submitted a completed confirmation. See Ex. 19.

Most of the fiscal 1997 confirmation responses for legacy PW non-partners in the Selected Offices are dated in late December or January 1998.[173] Many of the confirmations lack written indicia of review or resolution of possible Independence

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The PW New York Office categorized its 285 missing audit non-partner confirmations as follows. In 133 instances, just the confirmation form was missing. In 64 instances, the individual's entire personnel file was missing. In 28 instances, the individual's file had been checked out and the person who checked out the file was contacted via Lotus Notes. In one instance, the file was signed out by an unidentified person. In one instance, the file was out but there was no "outcard" for the file. In ten instances, the file had been archived in a storage facility and was requested from that storage facility. In 48 instances, the individual whose form was missing confirmed that he/she had submitted a confirmation form in 1997. In addition, according to the leader of the PwC audit team, in legacy PW New York the employees moved into new offices after 1997, and an entire binder of completed confirmation forms may have been misplaced in the course of the move.

[173] Two of those Offices (Ft. Worth ABS (audit) and Kansas City) did not have any non-partner reported matters.

issues.[174] In cases where there is written evidence of review, the reviewer's identity is sometimes lacking or the reviewer's comments do not set forth the basis for a conclusion that the reported matter does not constitute an Independence violation.

However, other records, separate from the confirmations, document that oversight of the process took place. These were contained in a binder from PW's Auditing Services Department (the "PW Auditing Services Binder") that included memoranda tracking the results of the confirmation process. Some of these memoranda concern the status of collecting completed confirmations.[175] There are also memoranda discussing Independence issues raised by certain matters reported in the confirmations or reported by means other than a confirmation. These memoranda often contain lengthy discussions of the facts underlying the situations presented and the application of the Rules or PW policy to those facts, and are generally well-executed and conscientiously done.

It appears that the PW Auditing Services Binder primarily addresses only matters that are reported to be "exceptions" to the Rules or firm policy or that raise significant Independence issues. Thus, even with the Auditing Services Binder, there is not always a written record specific to each reported matter of the evaluation and resolution of reported issues. In some cases where the confirmation does not have a sufficient factual recitation, it is not readily apparent what the resolution should have been. The fact that PW confirmations generally do not record the reporting person's classification as a

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[174] Where the confirmations themselves indicate review or evaluation, it is generally in the form of hand-written notes that are initialed and, in one office, signed by the reviewer. In the Charlotte office, however, two of the four the confirmations are attached to copies of apparent e-mail memoranda between the reviewing person and the respondent in which Independence issues were conscientiously discussed and resolved.

[175] For each of the Selected Offices, there appeared to be a memorandum confirming that the process of collecting confirmations for non-partners had been completed.

manager or employee also makes it more difficult for an outside reviewer to determine Independence issues from the face of the confirmation.

In particular, we did not find any documentation addressing the twelve confirmations in which PW MCS East non-partners reported matters, despite the fact that some of these individuals reported interests in a number of PW clients and some even indicated in their confirmations an intent to dispose of their interests. The MCS East confirmations themselves contained no written indication of review or evaluation of the reported matters (except for two marked “okay”).

In addition, the PW Auditing Services Binder did not contain evidence of a formal procedure to ensure that, once an appropriate resolution of Independence issues was determined, the resolution was in fact carried out by the reporting person.[176] However, there were indications in the Auditing Services Binder that Independence or reviewing officials at least intended to follow up on agreed-upon resolutions.

While legacy PW apparently did not have a formal procedure for placing assignment restrictions on non-partners who reported holding interests in clients, there is documentary evidence in the PW Auditing Services Binder that the PW National Independence Partner directed human resources personnel and others, both generally and

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[176] For instance, in the New York office, certain reported matters were noted as exceptions to PW policy in a PW Auditing Services Binder memorandum concerning tax and human resources personnel. These matters were promptly addressed in a return memorandum by the PW National Independence Partner, but there is no documentation that his prescriptions for addressing the matters were in fact carried out. Moreover, the memorandum concerning New York tax and human resources personnel predated the submission of a confirmation by another New York tax professional who submitted a three-page list of investments. Her confirmation bears no indication of having been reviewed, and we were unable to find documentation in the PW Auditing Services Binder addressing it.

as to specific reported matters, to monitor assignments or promotions in connection with reported interests.

A matter reported by a senior associate of the Charlotte office is illustrative of the seriousness and thoroughness with which PW representatives addressed an Independence issue that they believed to be significant. The matter involved the associate's mortgage loan, which was purchased by a Charlotte client for which the associate performed services. PW policy at that time required "professional staff working on an audit engagement to extinguish any loan from that client if they become aware that the financial institution has purchased or otherwise acquired the loan."[177] Moreover, it was firm policy not to reimburse professionals for the cost of refinancing the loan to comply with this rule. The associate asked for an exemption from the rule because of the significant expense he would incur in refinancing. After an extensive internal debate, captured in the PW Auditing Services Binder, on whether to change the rule,[178] PW granted the exemption request, subject to the client's approval, in part because the firm did not want to have to change policies again after the Merger was consummated.

In sum, the documentation relating to Independence confirmations for PW non-partners in fiscal 1997 indicates that PW made a conscientious effort to evaluate certain

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[177] See AGS - U.S. National Guidance AAR 7960 Independence .33 at 5. This is more restrictive than SEC or AICPA rules, which permit the continuation of the loan so long as it meets the criteria for "grandfathered" loans. See supra Part II, Section A.2.

[178] In the course of this debate, PW representatives considered the policy of the other "Big 6" firms (the PW policy was consistent with some and more stringent than others, such as C&L). They also expressed sensitivity to the "appearance" issue for bank clients, some of which, a PW representative noted, did not want staff on the engagement to hold any loans from the client, whether or not they were grandfathered.

reported matters. However, the documentary record for the review, evaluation and resolution of other reported matters was not always clear.

(b) The C&L Non-Partner Process

The oversight of the fiscal 1997 confirmation process at legacy C&L appears to have been less centralized than at legacy PW. Accordingly, to supplement our review of the available documentation, we asked those involved in the fiscal 1997 C&L confirmation process to describe what happened after confirmation responses were received. The practice was not uniform from office to office. However, some elements were common to many offices. Managers or other non-partner personnel frequently assisted RIPs in the collection and review of confirmation forms. In general, once confirmation responses were received, the procedure was supposed to include notice to reporting persons of any action that the RIP determined was necessary, such as the need to dispose of a security or to observe an assignment restriction. The human resources department was also involved, as a general matter, in an effort to ensure that assignment restrictions were noted and observed.[179] In many offices, memoranda were written or e-mail was sent advising the reporting person and the assignments coordinator of assignment restrictions resulting from reported client interests.[180] In other offices, the procedure was less formal and oral rather than written.

C&L distributed confirmations for fiscal year 1997 in October 1997. Most of the responses to the fiscal 1997 confirmations for legacy C&L non-partners are dated in

[179] In some offices, the confirmation form specifically asked for the identity of the "assignments coordinator (scheduler)," whereas in the confirmations for other offices this information was not demanded.

[180] Similar procedures were apparently in place in certain other offices that were not among the Selected Offices.

October, November and December 1997, although a number are dated in 1998.[181] Review and resolution of reported matters generally occurred throughout the first quarter of 1998. As with PW, where a reported matter is apparently not deemed to be a violation or to raise a substantial issue, the documentation for the C&L non-partners frequently does not set forth the basis for the determination and sometimes does not contain enough information to allow an outside observer to make any determination. There is frequently no documentary evidence of follow-up to determine if a person directed to dispose of interests in fact did so, although the New York office did attempt to document that part of the process.

4. Mechanics of the Fiscal 1997 Confirmation Process for Partners

(a) The PW Partner Process

As with PW non-partners, the fiscal 1997 confirmation process for PW partners was administered by PW's Auditing Services Department. Confirmations were sent to PW partners in mid-December 1997, and responses generally were sent directly to the Auditing Services Department. Most were received in late 1997 or early 1998, though some were not received until April 1998. The National Independence Partner generally addressed reported matters that raised substantial issues, often after an initial review by or with the assistance of others. As with the PW non-partners, the documentation relating to Independence confirmations for PW partners in fiscal 1997 indicates that PW Independence overseers gave considerable and well-informed attention to matters that appeared to raise substantial Independence issues. However, the documentation did not

[181] In particular, a substantial number of responses from the New York office are dated in March 1998.

indicate that there was a regular practice of following up to ensure that prescribed or agreed upon resolutions were carried out.

(b) The C&L Partner Process

The fiscal 1997 C&L partner confirmation responses were submitted generally in October 1997 through December 1997; some were submitted in early 1998. It appears that they were sometimes reviewed first by RIPs. In almost all cases they were reviewed between late 1997 and early 1998 by a manager who worked at the National level on Independence oversight assisting National Independence partners.

In a number of cases, apparently where substantial issues were raised by the matters reported, National Independence partners wrote memoranda to the reporting persons to address the issues raised and to prescribe resolutions of them. These memoranda generally were written in the spring and early summer of 1998.[182] The documentation indicates that C&L Independence overseers were conscientious and thorough in addressing matters that appeared to raise substantial Independence issues. The documentation does not indicate that it was standard procedure to follow up and ensure that a prescribed or agreed resolution of Independence issues was in fact carried out, or that unresolved issues were addressed, although in certain instances there was documentary evidence of such follow-up.

[182] It appears that in both legacy firms there was no written communication that went back to the reporting person where the reported matter did not raise a substantial issue.

5. The Substantive Evaluation of Reported Matters in Fiscal 1997

(a) PwC's Review of Whether Reported Matters Were Appropriately Resolved

As part of the Internal Controls Study, PwC reviewed the fiscal 1997 Confirmation process in the Selected Offices to determine whether matters reported in the confirmations were appropriately resolved. This phase of PwC's Internal Controls review was conducted by a legacy C&L audit manager (the "Reviewer") in the New York office who for many years has assisted the RIP for the New York Cluster in overseeing the Independence process, including in fiscal 1997 and in the March 1999 Confirmation Process. The Reviewer took a sample of approximately 109 (or 13%) of the 825 matters reported in the fiscal 1997 process by legacy PW and C&L professionals in the Selected Offices.[183]

The Reviewer then sought to determine whether the evaluation or resolution of Selected Reported Matters was appropriate by examining the confirmations, any reviewer comments, and for legacy PW non-partners, the PW Auditing Services Binder. See Ex. 20. From his review, the Reviewer concluded that the resolution of Selected Matters

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[183] The Reviewer selected his sample as follows: (1) for legacy PW partners, he took every second reported matter starting with the second, for a total of 13; (2) for legacy C&L partners, he took every fifth reported matter starting with the fourth, for a total of 37; and (3) for non-partners, two from each Selected Office (or all, where there were less than three reported matters from that Office), by selecting the third and seventh reported matter where there were more than seven matters reported from the Office, and the first and third matters matter where there were less than seven matters reported from the Office. In reviewing the legacy C&L New York office, which was one of the Selected Offices, the Reviewer apparently reviewed matters in whose review he had participated during the fiscal 1997 process.

was "appropriate in the circumstances," but noted that for four Selected Matters the documentation did not indicate a resolution. Id.[184]

(b) LSW's Observations of PwC's Review of Selected Matters

LSW reviewed each of the Selected Matters.[185] In most instances it appeared that the matters were appropriately evaluated and resolved. However, the treatment of some Selected Matters raised certain issues.

A few Selected Matters reported by PW partners raised issues under the Rules governing members' activities as trustees of a trust. See ET § 101.02(A)(2) (member may not be trustee or executor of trust or estate if trust or estate has direct or material indirect financial interest in a client). In one, PW permitted a partner to remain as trustee even if the trust held client securities, in light of a court order that limited the partner's powers to disbursement of funds and entrusted all investment decisions to a new fiduciary.[186] In another (which was not one of the Selected Matters), PW continued a

[184] Where a matter described by the reporting person did not appear to the Reviewer to constitute a violation, he did not classify the matter as lacking an indication of a resolution, even when there was no indication of analysis by a reviewer. However, in some cases in which the Reviewer did not classify the matter as lacking a resolution, it was difficult for LSW to tell if the matter presented an Independence issue. The Reviewer also said that, even where the documentation indicated that the firm had prescribed a resolution for a reported matter, he classified the matter as lacking resolution if there was no documentation confirming that the prescribed action (e.g., disposal of a security) had taken place. However, there were some matters for which LSW was unable to find documentation that the prescribed resolution took place, but which the Reviewer did not identify as lacking resolution. In one instance identified by the Reviewer as lacking resolution, LSW found a memorandum in the PW Auditing Services Binder determining that the matter was not a violation.

[185] LSW also reviewed additional reported matters from the Selected Offices.

[186] The PW National Independence Partner explained that the partner's father and brother had been killed in an auto accident and that the partner was the sole surviving member of the family apart from his mother.

"waiver" that its Independence office had granted for many years to permit the partner to remain as a trustee of a trust that had held and continued to hold client stock, based on the partner's agreement to isolate himself from any investment decisions regarding the client stock, and the co-trustee's agreement that the trust would not increase the holdings of client stock, the sale of which was undesirable for tax reasons.[187] However, after the Merger, when the partner reported this matter in his March 1999 Confirmation, PwC apparently reversed PW's prior determination and told him that he would have to resign as trustee or cause the sale of the client securities; he chose the latter course.[188]

Three Selected Matters involved C&L partners who reported that their variable annuity policies held client investments. The manner in which these matters were treated does not appear to be consistent. In two cases, C&L advised the partners that the interests were permissible in view of the unsettled nature of the AICPA's position, while in another instance C&L directed the partner to dispose of the interest.[189]

In other Selected Matters there was insufficient documentation to determine if the resolution was appropriate. For example, one legacy C&L partner who reported that her

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[187] In yet another matter involving a trusteeship, a PW partner reported that his co-trustee was a PW client bank. He said he reviewed this matter with the SEC's Assistant Chief Accountant, who he said did not object as long as the partner was not involved in the audit of the client bank.

[188] Another PW partner (whose confirmation was not among the Selected Matters) reported numerous violations in his March 1999 Confirmation resulting from his position as a trustee. He asserted that in prior years he had been permitted to remain a trustee by PW on the grounds that he acted only in an advisory capacity and that investment decisions were made by another trustee. He reported in his March 1999 Confirmation that he had been advised by PwC that the prior grant of permission was incorrect.

[189] Ultimately, in December 1998, the AICPA issued a ruling that these instruments created Independence issues. The two partners who were told in connection with the fiscal year 1997 process that they could maintain their interests were required to dispose of them in connection with the March 1999 Confirmation Process.

husband's 401(k) was invested in client mutual funds (the plan's only option) was apparently told that the holdings were permissible though they constituted 7% of her and her husband's net worth. It is possible that the interest in any one fund did not exceed 5%, but this cannot be ascertained from the documentation.

In still other instances, apart from the four instances in which the Reviewer found this to be the case, LSW could find no documented evidence of any review or resolution, or that a prescribed resolution actually took place. Among the instances in which there was no documentation confirming that a prescribed resolution took place, certain matters are worth noting.

A legacy C&L New York manager reported her husband's holdings in an insurance company client of another office. The National Independence Office, through the RIP, directed the manager to sell the stock based on information that the New York office participated in a significant portion of the audit of a subsidiary of the client, but the manager apparently contested this decision, arguing that the New York office did not audit the subsidiary but rather audited a number of insurance pools managed by the subsidiary and that C&L received only an immaterial amount of fees from the work. The documentation does not indicate if or how this matter was resolved.

A legacy PW partner who is a member of PwC's U. S. Leadership Committee reported many violations in his March 1999 Confirmation arising in part from investments that he had reported to PW in August 1997 before joining the firm. PW advised the partner at that time to dispose of those investments in view of his impending

membership in the firm, which began in December 1997.[190] The PW partner sold some of the investments in early January 1998, but did not sell the others until March, April and June 1998.

Another selected matter concerned a legacy C&L tax partner whose Independence violations eventually were examined in the Tampa investigation. In his fiscal 1997 confirmation, the partner reported holdings in five companies. The RIP advised the partner that four of them were C&L clients, though the RIP did not explicitly direct the partner to dispose of the stocks. The National Independence Partner, who was copied on the communication, sent a return e-mail to the RIP in which he made the following comment:

> Is it clear to [the partner] that he must dispose of the prohibited investments and that he must do so immediately? While I would like to believe that the requirement to dispose is intuitive based on what you sent him, I've been surprised how on occasion I've had to spell it out for someone. More importantly, how does a partner explain the fact that he's invested in companies that most anyone (apparently except him) would recognize to be our clients?

Ex. 21. The partner, however, apparently did understand that he had to take some action with regard to the prohibited securities, and he advised the firm that he had given the securities to his three adult children,[191] a resolution that C&L deemed adequate at the

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[190] The PW partner said in his March 1999 Confirmation that he had understood that he had 90 days after joining the firm to dispose of these investments. PW policy required disposition to take place as soon as possible and no later than 30 days after Independence was required. AGS - U.S. National Guidance AAR 7960 Independence .4 at 21.

[191] He said he did not know if those securities were material to their net worth, but noted that they had good jobs and were financially secure.

time. However, it was revealed in the Tampa investigation, among other things, that the partner had given the securities to only one child.[192] The partner is no longer with PwC.

6. Summary of the Results of the Internal Controls Study

Both legacy firms performed an annual confirmation of Independence in fiscal 1997; the Selected Offices appear as a general matter to have been diligent in getting people to complete and return the forms, although in some instances the forms were returned months after they had been distributed. With the exception of the four Offices or groups that had substantial missing confirmations, the forms appear to have been maintained with reasonable care. The results of the audit, however, cause concern and indicate that a more uniform, tightly monitored process, of the type that PwC is implementing, should be used in the future. The large number of missing confirmations for legacy C&L MCS New York and legacy PW MCS East suggests that it was unwise for the confirmations in this line of service to have been collected and maintained separately from the offices in which they worked, and it is puzzling that certain legacy C&L MCS New York confirmations were discarded soon after collection.[193] Furthermore, because some Offices reported receiving completed fiscal 1997

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[192] In two other Selected Matters involving legacy C&L partners, one relating to the disposition of a trust's stock holdings and the other to a rollover of a 401(k) into a self-directed IRA, the documentation suggests that resolution of these matters – which were originally prescribed in connection with the fiscal 1996 process – took an excessively long time.

[193] The separate treatment of MCS employees and partners also contributed to some of the problems with "control lists" discussed supra.

confirmations for individuals not named on the control list, it is possible that the control lists were in some instances under-inclusive.[194]

In cases where the documentation indicates that the legacy firms discovered serious reported issues, the Independence professionals, particularly at the national level, generally gave them careful and well-documented consideration and evaluation under the applicable Rules and firm policies. It also appears that legacy C&L generally had developed practices to impose assignment restrictions on non-partners whose reported interests required such restrictions and that PW attempted, less formally, to monitor this issue for non-partners.[195] In general, PW's confirmation process for non-partners appears to have been more centralized than C&L's process.

However, particularly from the perspective of the Internal Investigation, there were defects in the confirmation processes of the legacy firms. These defects include the form of the confirmations, which did not encourage individuals to report resolved violations that existed during the fiscal year covered by the confirmation. This defect likely helped obscure the widespread nature of Independence problems later revealed in the Tampa investigation and the Internal Investigation, and may have fostered the

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[194] If the control list used in 1997 to determine who was required to confirm was under-inclusive, it is possible that some individuals who were required to confirm may never have been asked to do so. Also, in cases where the control list was reconstructed in connection with the Internal Controls Study, it is possible that the list did not capture all individuals who were required to confirm in 1997.

[195] As set forth previously, assignment restrictions were, in theory, less important at legacy PW, whose policies prohibited all professionals from acquiring post-employment interests in audit clients. However, the issue was not unimportant at PW, since non-partners could buy certain mutual funds and continue to hold pre-employment interests and interests acquired by gift or inheritance, until a work assignment or promotion made them "members" under SEC and AICPA Rules.

erroneous view that Independence was a once-a-year "snapshot" for which the only thing that mattered was the appearance on the day the picture was taken.

Other defects included a lack of sufficient documentation, particularly among the non-partner confirmations, of the reasons that certain reported matters were found not to be violations. Documenting the evaluation of each reported matter (including the basis for a determination that a matter is not a violation) and advising the reporting individual of that determination and its basis would have facilitated an effective audit of reported matters and assisted in educating those who administer the Independence process at the regional and local levels and those who are required to confirm their Independence. For PwC, such education would have been particularly useful in view of the widespread claims of ignorance of the Independence Rules made in connection with the Internal Investigation. See supra Part III, Section B.3(c)(v). In addition, the Study, in conjunction with the results of the Tampa investigation and the March 1999 Confirmation Process, indicates that the legacy firms should have had a standard practice of following up to ensure that where a disposition of securities or other action was dictated, the disposition or action actually took place as prescribed in a timely fashion. Such a practice is part of PwC's new Independence system. See infra Part IV, Section A. Finally, the discovery in the Internal Investigation of client service violations resulting from securities acquired by a professional in the course of prior employment with the client indicates that procedures to screen the holdings of professionals at the point that they joined the firm were insufficient.

IV. REMEDIAL MEASURES UNDERTAKEN BY PWC

PwC has taken or is taking measures to address the Independence problems revealed by the Tampa investigation and the Internal Investigation. Most of these measures are being implemented pursuant to the Order. A discussion and analysis of these remedial measures is beyond the scope of this report.[196] However, a brief outline of three features of these measures is appropriate at this time.

A. PwC's New Independence System

PwC's new Independence system (the "KnowledgeCurve System") is radically different from the system formerly used by the legacy firms and by PwC. The prior systems relied on professionals to sort through their own investments and interests, to identify which ones were held in audit clients or other restricted entities, and then to report and/or resolve them. The KnowledgeCurve System, by contrast, requires all partners and managers to report all investments, whether or not they believe them to involve restricted entities, to enhance the possibility that any restricted investment is captured.

Specifically, the KnowledgeCurve System includes an electronic database that is designed to be a compilation of all publicly-traded securities (including mutual funds) in the United States (the "Securities List"). The Securities List categorizes each security issue by CUSIP number, ticker symbol and name. This past summer and fall, all partners and managers were required to use the Securities List to find each current security investment attributable to them under the Rules, and then to identify each of those investments to the firm as their holdings by entering them into the firm's database (the

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[196] Section V.B.3.b. of the Order provides for another report on the remedial measures required by the Order.

"Portfolio Database"), without regard to whether those investments were held with clients or other restricted entities. The System is designed so that a partner or manager must find an investment on the Securities List before it can be entered into the Portfolio Database.[197]

Holdings entered into the Portfolio Database are electronically matched by CUSIP number with entities for which Independence is required (the "Restricted Entities List"), thereby reducing the possibility that confusion over entity names and name searches will result in a failure to recognize a restricted investment. Partners and managers are required to search the Restricted Entities List before acquiring any security in the future, and then to enter any new holdings in the system. The KnowledgeCurve System is supposed to automatically advise the firm and the reporting individual of any match, and the individual is required to dispose of the security promptly unless an exemption is granted.[198] The individual must report his compliance with the disposal notice, and the System is designed to follow up automatically when such a report is not made.

Moreover, whenever an individual's security holding becomes impermissible at any time after it is entered into the Portfolio Database, such as when PwC acquires the issuer of the security as a new audit client, a disposal notice is supposed to be generated automatically. An individual's failure to comply with the KnowledgeCurve System's requirements is subject to disciplinary action.

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[197] The Independence Office is available to help individuals who have difficulty finding an entity on the Securities List.

[198] The KnowledgeCurve System prohibits managers from holding securities in any restricted entities, regardless of whether they are considered "members" with respect to those entities under SEC or AICPA Rules. However, managers may apply for exemptions from this firm rule under certain specified circumstances.

Of course, the KnowledgeCurve System does not relieve the individual from responsibility for maintaining his or her Independence, including by refraining from buying securities that are issued by entities appearing on the Restricted Entities List. However, by requiring entry of any investment that is actually made, the KnowledgeCurve System is designed to provide an additional safeguard where an individual does not find an entity on the Restricted Entities List.

To monitor compliance with the requirement of entering their investments into the Portfolio Database, PwC will subject partners and managers to an audit requiring the submission of brokerage statements, tax returns and other financial information. PwC intends to go farther than the requirements of the Order in this regard, by conducting audits on a rolling basis throughout the year instead of once annually. PwC has selected its senior management, see supra Part III, Section A.3(h), as the initial group to be audited.

The KnowledgeCurve System also requires that, when an SEC registrant is accepted as a new PwC audit client, all professionals below the managerial level assigned to the new client must confirm their Independence from that client, whether the individual is providing audit or non-audit services.

The KnowledgeCurve System is important not just because it should improve PwC's Independence compliance in the future, but also because it has helped PwC address its Independence problems of the past. The requirement that all PwC partners and managers enter their investments into the Portfolio Database has prompted the resolution of existing violations, including no doubt many that had not been reported in the March 1999 Confirmation Process or that were committed by individuals other than

those selected in the Random Sample Study. The audit feature of PwC's new system is designed to reveal additional extant violations that for whatever reason have not been rectified in the implementation of the KnowledgeCurve System. Thus, although the specifics of the range of violations suggested by the results of the Random Sample Study will never be known on a historical basis, the KnowledgeCurve System (particularly its audit feature) is structured to address unresolved partner and manager Independence violations not uncovered in the Internal Investigation.

B. Independence Education

In addition to the KnowledgeCurve System, the Order requires that PwC conduct professional education and training on Independence issues for all professionals. As part of satisfying that requirement, PwC has designed a computerized educational program on Independence, including an Independence test, that each professional must complete. Any individual who fails the test must retake it until he or she has passed it. Thus far, approximately 38,700 of roughly 39,000 PwC professionals have taken and passed the test. The remaining individuals, according to PwC, have not yet passed the test, are exempt from Independence requirements and were therefore erroneously included in the group subject to testing, or are no longer employed by PwC.

Notably, several of the Random Sample selectees who were interviewed said that it was in studying for and taking the test that they first became fully aware of the breadth of the Independence Rules. PwC's Independence test should be especially useful with respect to Rules about which PwC professionals have expressed confusion.[199]

[199] Such Rules would include provisions governing employment-related spousal holdings such as 401(k) plans; investments in a non-client fund managed by a client investment advisor (permissible if in self-directed IRA accounts, but impermissible if in discretionary IRAs or in non-IRA accounts); investments in client stocks held by non-client UITs (considered direct investments, whereas such investments held through non-client mutual funds are considered indirect investments); credit card balances over $5,000 and cash in sweep accounts at client institutions (impermissible without regard to materiality, whereas bank account balances in excess of the $100,000 limit of federal deposit insurance are impermissible only if the uninsured excess is material); and cash and securities held at a client brokerage firm (impermissible without regard to materiality despite SIPC insurance, whereas client bank account balances are impermissible only if materially in excess of FDIC limit).

C. Internal Disciplinary Action

In connection with the Tampa investigation, PwC took disciplinary action, including termination, against certain professionals who were found to have committed Independence violations. PwC is also in the process of determining what disciplinary action to take in connection with Independence violations that were reported or discovered in the Internal Investigation. Towards that end, an Evaluation Committee made up of four PwC partners has participated in the interviews of Random Sample selectees, see supra Part III, Section B.3(c), and may conduct additional interviews of selectees.[200] A separate committee of seven partners comprised of certain members of senior management and others, including PwC's new head of U.S. Independence, known as the Sanctions Committee, will review sanctions recommended by the Evaluation Committee.

In addition, the Independence compliance of senior management is being reviewed by a four-partner Disciplinary Committee, comprised of four members of senior management who reported no or few violations in the March 1999 Confirmation Process. This committee will be overseen by PwC's Partner Affairs group (a subset of its Board of Partners). This review of senior management will include an audit of whether they accurately and completely entered their investments into the KnowledgeCurve System.

Possible sanctions include letters of admonishment or censure, monetary fine and a request for resignation. Sanctions also may include a reduction in a partner's shares of

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[200] In addition, PwC has been reviewing violations reported in the March 1999 Confirmation Process, and may conduct interviews of certain of the reporting individuals, as part of the disciplinary review process.

the firm, removal from a leadership or management position, and enforced separation from the firm.

The factors under which PwC will determine sanctions include whether the individual was familiar with the Independence Rules and made efforts to comply with them; whether and when the individual was aware of the violation, and what action he or she took to rectify it; how many violations the individual had, and their monetary significance; whether the violation involved client service and whether it consisted of a direct holding in audit client securities, as opposed to some other interest; and how truthful and accurate the individual was in connection with the March 1999 Confirmation Process. The sanctions decision also will consider the impact of any violations on the firm and its clients, as well as the implications of any sanction to the individual.

V. CONCLUSION

The Internal Investigation revealed widespread Independence non-compliance at PwC. In the firmwide March 1999 Confirmation Process, almost half of PwC's approximately 2,700 partners, and approximately 5% of PwC's 36,000 professionals overall, reported at least one Independence violation. Many individuals, including certain members of PwC's senior management and certain partners who help oversee the firm's compliance with Independence Rules, reported a substantial number of violations. Professionals in the audit line of service accounted for approximately half of the reported violations.

Moreover, despite clear warnings that the SEC was overseeing the March 1999 Confirmation Process, 77.5% of partners and 8.5% of non-partners selected for audit in the Random Sample Study failed to report at least one violation in the March process. Many of the partners had a substantial number of previously unreported violations. A total of approximately 86.5% of partners and 10.5% of non-partners in the Random Sample Study had at least one reported or unreported Independence violation. These results suggest that a far greater percentage of individuals in PwC's firmwide population had Independence violations than was revealed by the self-reporting process in March 1999.

Both reported and unreported violations included instances in which individuals performed services for SEC-reporting clients. One percent of partners and 0.5% of non-partners selected for the Random Sample Study had such violations while they performed services related to the audit of financial statements. Many of the audit-related service violations arose from investments or interests in affiliates of the clients to which a professional provided services, rather than in the clients themselves, or interests owned

by family members rather than by the professional who provided the service. We have not assessed the impact, if any, of the client service violations or of any other violations revealed during the Internal Investigation on audit services performed by PwC, and no such impact has come to our attention during the Internal Investigation. As noted, the SEC has reviewed the client service violations and in all 52 of the cases that were reported in connection with the March 1999 Confirmation Process, the SEC has determined that the public filings of those clients may be processed in the ordinary course of business.

While we have noted certain provisos concerning the statistical tabulations in this report, the numbers of violations alone, as PwC acknowledges, reflect serious structural and cultural problems that were rooted in both its legacy firms. Although a large percentage of the reported and unreported violations is attributable solely to the Merger, an even larger portion is not; thus, the situation revealed by the Internal Investigation is not a one-time breakdown explained solely by the Merger. Nor can the magnitude of the reported and unreported violations be attributed simply to less familiar Independence Rules such as those pertaining to brokerage, bank and sweep accounts. At least half of the reported and unreported violations consisted of interests held by a reporting PwC professional himself or herself, and most of the violations arose from either mutual fund or stock holdings.

There appear to be several reasons that the Independence systems formerly in place at PwC and its legacy firms did not prevent or detect the large numbers of violations revealed by the Internal Investigation. The confirmation processes used before the Merger did not focus on the reporting of violations that had been cured before the

confirmation response was submitted, but only on violations that were unresolved at that time. In addition, the Independence systems of the legacy firms did not, unlike PwC's new KnowledgeCurve System, have a standard procedure requiring verification that resolutions prescribed for reported violations (e.g., sale of an investment) in fact took place.

Most important, the former Independence systems, again unlike PwC's new KnowledgeCurve System, did not require the reporting of all investments, prohibited and unprohibited, but instead relied on individuals to sort through their own investments and interests, to identify which ones were held in restricted entities, and then to report and resolve them. This method increased the chances that a prohibited investment would not be identified. The defect was magnified by the fact that the legacy firms did not make sufficient efforts to educate professionals about the Rules and, more important, to inculcate the view that Independence compliance is inextricably linked to, rather than separate from, client responsibilities.

As a result, Independence compliance at PwC and its legacy firms, until recently, was dependent largely on individual initiative. This system failed, as PwC has acknowledged. To be sure, there were PwC professionals who demonstrated that compliance was attainable even under this approach. They were thorough in reviewing their holdings and in consulting the Independence lists and Independence policies or other available resources. Moreover, there were PwC professionals who tried hard to comply with the Rules but still missed one or more violations by making a mistake, such as overlooking a sweep feature in an otherwise permissible account, or by encountering a circumstance beyond their reasonable control.

However, other PwC professionals appear to have made little or no effort to comply with the Rules or reporting requirements. They did not learn the Rules or use the Independence lists or check other sources of information before making investments, or they submitted confirmations affirming their Independence without a reasonable basis for doing so. There were other individuals who made more effort but not enough to achieve full compliance. They did not effectively search the Independence lists or look to other sources to check a potential or actual investment; they lacked an understanding of certain Rules; or they failed to fully review their investments when it came time to confirm their Independence.

Particularly as accounting firms have grown larger, acquired more clients and provided more services, and as investment opportunities and financial arrangements have increased in number and complexity, well-designed and extensive controls – as reflected in the SEC's Order in this matter – are needed both to facilitate Independence compliance and to discourage and detect non-compliance. The purpose of PwC's new KnowledgeCurve System is to reduce the extent to which the firm relies on individual initiative for Independence compliance. In addition to requiring all partners and managers to report all their investments, whether or not they believe them to involve restricted entities, the System is intended to improve the identification of restricted investments by recording securities with the unique identifier of a CUSIP number. Even more important, it regularly subjects individuals' self-reporting to audit. While we have not yet reviewed the KnowledgeCurve System in depth, information gleaned from the Internal Investigation suggests that a system of this type should be much more effective

than the type formerly used by PwC in preventing violations from occurring, and in diminishing the instances in which violations remain undiscovered.

Yet, even if it makes Independence compliance easier, neither the KnowledgeCurve System nor any other conceivable structure will ensure Independence compliance in the future where an individual has not decided that compliance is an integral part of his or her professional responsibilities and is not delegable – either to the firm or to another individual. In that regard, apart from continuing to refine its new Independence system, PwC has undertaken an Independence education program and an internal disciplinary process with respect to the Internal Investigation.

In addition, the often painful self-examination that took place during the Internal Investigation may prove instructive for PwC and its members. Although PwC management at times did not allocate sufficient resources to complete the Internal Investigation as expeditiously as possible, and some professionals were not prompt in meeting the requirements of the process, the firm significantly improved its commitment of staff over time, and the process afforded a means of stressing, on an individual basis, the importance of Independence compliance to each professional. Moreover, it appears that PwC professionals who conducted the Internal Investigation performed their duties with thoroughness and a firm commitment to the mandate of the Order to find all Independence violations, particularly in view of the magnitude and complexity of the Investigation and the process of applying the Rules to an entity that arose from the merger of two of the largest accounting firms and has thousands of publicly held clients, many of which have multiple affiliates, investees or joint venture or merger partners from which members also must remain independent.

To ensure that the situation revealed by the Internal Investigation does not recur, PwC must be vigilant, must provide the best available tools to maintain Independence compliance, and must insist that those tools be used with diligence by every professional.

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