SARBANES-OXLEY: The Insurance Company Perspective
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SARBANE[S-OXLEY:]

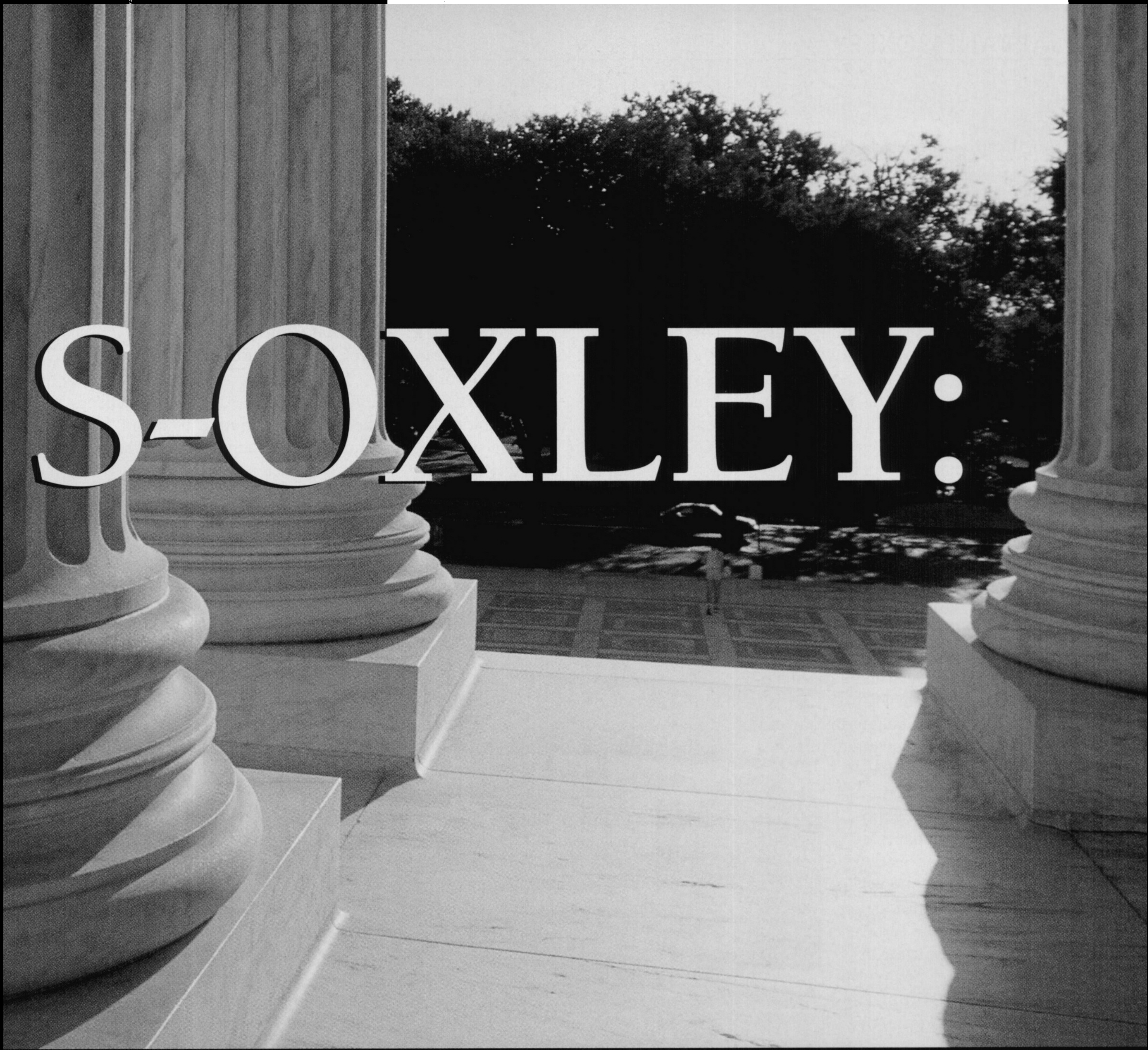
The Insurance [illegible]

by Theodore P. Augustinos

M[illegible] has been written about the Sarbanes-Oxley Act of 2002, which was enacted in response to the wave of corporate scandals. [illegible] changes to this legislation [illegible] burdens imposed on corporate America have been historic. But [illegible] worthwhile?

[illegible] article reviews some of the [illegible] and burdens imposed on Ameri-can businesses, particularly on the insurance industry, and considers their effectiveness, reasonableness and, in some cases, redundancy. For example, [illegible] may have [illegible] reaction in the [illegible] that require [illegible] shrinking stable [illegible] ing firms. [illegible] vices industry in [illegible] exist-ing protections and enforcement mechanisms that may call into question whether Sarbanes-Oxley imposed some redundant safeguards at high cost to American business and capital markets.

One can debate whether the high costs and burdens imposed by Sarbanes-Oxley are worthwhile, but the fact remains that these costs and burdens were necessary to address an erosion of confidence in American



S-OXLEY:

Company Perspective

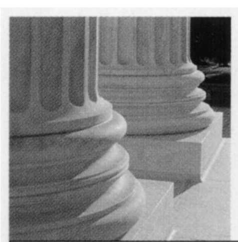
Certification of Periodic Reports

Under Section 302 of Sarbanes-Oxley, the CEO and CFO of a public company must personally sign a certification that the financial statements and other information included in the periodic report fairly present in all material respects the financial condition, results of operations and cash flows of the company.

In the insurance industry, all insurance companies—public, private and mutual—have long been required to file annual financial statements sworn and certified by (depending on the requirements of the domiciliary jurisdiction) the president or a vice president, and the secretary or assistant secretary, and a treasurer or assistant treasurer as "full and true," and completed in accordance with the NAIC Annual Statement Instructions and Accounting Practices and Procedures manual.

Are these requirements redundant? The insurance industry requirements are qualified to the best knowledge, information and belief of the deponent. Sarbanes-Oxley requirements under Section 906 do not have a knowledge exception, although penalties for a false certificate require a knowing or willful failure to comply. In view of this knowledge requirement for criminal sanctions, the Department of Justice permits a knowledge qualifier in the certification. Section 302 certifications are expressly qualified with a knowledge exception.

One could argue that the Sarbanes-Oxley requirements of Sections 302 and 906, which have cost public company officers sleepless nights and countless hours and dollars, are redundant in view of the existing insurance company certification requirements for annual statements. However, if the Sarbanes-Oxley requirements are truly redundant, then insurance company officers are already exercising the degree of care and diligence that is now required of their public company counterparts. Alternatively, if the requirements of Sarbanes-Oxley Sections 302 and 906 constitute additional burdens as are applied to CEOs and CFOs of publicly held insurance companies, they would represent a higher standard of required care. Given the nature of recent corporate financial scandals, and the defenses asserted by some alleged senior officers that they were unaware of transactions by subordinates, any such increase in the standard of care imposed by Sarbanes-Oxley is probably justifiable and merited.



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Disclosure Controls and Procedures

Related to the Section 302 certification is the requirement that the CEO and CFO establish and maintain disclosure controls and procedures. All information related to both financial and nonfinancial disclosures must be accumulated, quality tested and communicated to management for review prior to disclosure in the periodic reports. The responsibilities of the CEO and CFO extend to require evaluation of the effectiveness of the disclosure controls and procedures, and the disclosure of conclusions about their effectiveness.

Aside from the annual statement certification requirement described above, insurance companies have not been subject to specific requirements related to disclosure controls and procedures. Therefore, the Sarbanes-Oxley requirements are not redundant as applied to public insurance companies, and they should prove to be effective, although costly, measures for improving the quality of disclosures by all public companies.

Internal Controls over Financial Reporting

Under Section 404 of Sarbanes-Oxley, the SEC was required to adopt rules requiring an internal control report in each annual report. The report must state that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and provide management's assessment of the effectiveness of the internal control structure and procedures for financial reporting. The company's registered public accounting firm must attest to, and report on, management's assessment in accordance with the standards adopted by the Oversight Board established under Sarbanes-Oxley.

The NAIC Market Conduct Examiners Handbook requires examiners to assess the adequacy of internal controls as part of examinations of financial conditions. However, the Sarbanes-Oxley requirement for annual attestations and reports related to internal controls related to financial reporting goes far beyond the current insurance industry standards, which are assessed by examiners as part of financial examinations. The Sarbanes-Oxley requirements for reporting by management and outside auditors on internal controls over financial reporting would be adopted by the proposed revision to the Model Regulation. This will certainly increase costs of annual reports and audits, both in terms of expenses incurred to outside auditors and time and resources devoted within each insurance company. The adoption of these requirements for most insurance companies, even private and mutual insurance companies, should improve financial reporting standards and controls throughout the industry, despite the high cost of implementation.

MD&A Requirements

The regime of requirements for management's discussion and analysis (MD&A) is much more fully developed for public companies under Sarbanes-Oxley than for insurance companies under the NAIC Annual Statement Instructions. To the extent that Sarbanes-Oxley applies to publicly held insurance companies, the requirements for preparing their MD&A have been increased. However, these increased requirements are not redundant, and should be effective in improving the adequacy of MD&A disclosures among public insurance companies. To date, these increased requirements have not been adopted by the NAIC for all insurance companies.

Directors and Officers

As long as loans by insurance companies to their officers and directors are not abusive, they are not currently prohibited by the statutes and regulations generally regulating insurance company transactions. However, pursuant to Sarbanes-Oxley Section 402, most loans by an issuer to an executive officer or director made, modified or renewed after July 30, 2002 are banned. For the banking industry, there is an exception for FDIC-insured banks and thrifts that are subject to existing insider lending restrictions under the Federal Reserve Act. To the extent that the Sarbanes-Oxley prohibition covers public insurance companies, and to the extent that privately held and mutual insurance companies or their regulators adopt these restrictions, there would be increased cost and burden related to tracking and monitoring these transactions, and in providing replacement benefits to executive officers and directors. However, the Sarbanes-Oxley prohibition should be effective in curbing the use of often poorly disclosed insider loans to the Boards of Director, regulators and the investing public, and the source of actual or potential abuse.

Audit Committees

Much of Sarbanes-Oxley has implications for audit committees, either directly or indirectly. In the insurance industry, there was generally no requirement for audit committees of the Board of Directors of an insurance company. However, in response to

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Sarbanes-Oxley, the NAIC has proposed amendments to its Model Regulation that would adopt the Sarbanes-Oxley requirements for audit committees, or provide that in the absence of a designated audit committee, the entire Board assumes the functions, requirements and responsibilities of an audit committee. In particular, the Model Regulation would adopt the Sarbanes-Oxley requirement that audit committee members be independent of the insurance company. Audit committee members cannot be members of a company's management, or recipients of any compensation from the company, other than as a member of the company's Board of Directors or any committee thereof.

This requirement, which would be particularly burdensome for small insurance companies located outside major population centers, will increase the costs and burdens related to attracting and retaining qualified directors who could serve on the audit committee. The Model Regulation does not, however, incorporate the additionally burdensome requirements of financial expertise imposed on audit committee members under Sarbanes-Oxley.

The current requirements of insurance companies do not overlap with the Sarbanes-Oxley requirements for audit committees of public companies. Even the requirements inspired by Sarbanes-Oxley for audit committees pursuant to the Model Regulation would not be quite as burdensome as the actual Sarbanes-Oxley requirements. For example, the Model Regulation does not include a requirement disclosure about audit committee financial experts. Public companies, particularly smaller companies, have found it difficult and expensive to comply with the audit committee requirements. With their standards of independence and financial expertise, the audit committee requirements imposed by Sarbanes-Oxley may represent costs worth bearing in the post-Enron world.

Auditor Independence

Sarbanes-Oxley imposes strict requirements for auditor independence. Generally, the audit firm of a public company cannot provide other services, including consulting and valuation services, to the company. In addition, partners directly engaged in the audit must be rotated every five years. In recent years, the world of certified public accountants has undergone significant consolidation, with the Big Eight firms reduced to the Big Six and now the Big Four. At the same time, accounting firms have expanded their menu of valuable financial services offered to clients, either directly or through affiliated firms. Therefore, it is increasingly difficult for public companies to identify and engage qualified outside auditors. It is also more costly to engage other services from firms that do not have an audit relationship with the company. The competitive market for both audit and other related services has presumably suffered as a result.

The Model Regulation would adopt the general principals of Sarbanes-Oxley for auditor independence. The current standards for audit partner rotation are not as stringent as those under Sarbanes-Oxley or those that would be adopted under the Model Regulation. The Model Regulation would, however, maintain the current provision permitting the insurance commissioner of an insurance company's domiciliary jurisdiction to grant relief from the audit partner rotation requirements in unusual circumstances. The other Sarbanes-Oxley requirements for auditor independence, prohibiting the engagement of auditors who provide other services to the insurance company, would also be incorporated into the Model Regulation.

The cost of imposing the auditor independence requirements on the insurance industry would be even higher than on other industries, given the special expertise required for insurance accounting compared to accounting requirements for American businesses generally. The proposal to increase the audit partner rotation requirements under the Model Regulation to adopt the Sarbanes-Oxley requirement only incrementally increases the burden on the insurance industry and does provide for exceptions.

A Burden Worth Bearing

Given the pre-existing safeguards and requirements of the insurance industry, there is clearly some redundancy and overreaction by Sarbanes-Oxley, as it applies to publicly held insurance companies, and as it may be applied by the NAIC Model Regulation to most insurance companies regardless of ownership structure. However, there are several areas where the Sarbanes-Oxley requirements will raise the bar for corporate and financial practices in ways that will be helpful in avoiding the kinds of scandals and other failures that created the environment that made Sarbanes-Oxley necessary. For public insurance companies, these requirements will be applied directly. For others, they will be imposed by Sarbanes-Oxley inspired changes to the NAIC Model Regulation and other regulatory initiatives. RM

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