Issue Analysis

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It's Time to Admit that SOX Doesn't Fit:
The Case Against Applying Sarbanes-Oxley Act Governance Standards to Non-Public Insurance Companies

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Executive Summary

The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (also known as the Sarbanes-Oxley Act) was passed in response to a series of governance and accounting scandals at public companies. The collapse of the 1990s stock market boom and a hotly contested mid-term congressional election further encouraged legislative action.

The National Association of Insurance Commissioners (NAIC) has developed a proposal to incorporate elements of the Sarbanes-Oxley Act into the insurance laws of every state. The Sarbanes-Oxley rules would then be applied to thousands of mutual insurance companies, which by definition are non-public companies. This report examines the rationale and potential implications of the proposal to apply provisions of the Sarbanes-Oxley Act to insurance companies, with particular emphasis on non-public insurance companies. Its principal findings are as follows:

- ***Congress chose not to subject non-public companies to the Sarbanes-Oxley Act***. The Act is structured as a series of amendments to the Securities Exchange Act of 1934, and therefore applies to public companies as opposed to non-public companies such as mutual insurers.

- ***The Sarbanes-Oxley Act was designed to benefit investors, not insurance policyholders***. To prosper, public companies must not only market their products and services to purchasers, they must also attract and retain investors. Recognizing that investors can be misled by faulty or fraudulent accounting and corporate governance practices, Congress designed the Act to increase transparency in corporate transactions for the benefit of investors. Insurance regulation, in contrast, is not investor-oriented, but rather is directed at maintaining the integrity of the insurer's promise to indemnify its policyholders.

- ***Insurers are subject to a rigorous regulatory regime that is designed to address the unique features of the insurance enterprise***. Because the business of insurance is structurally complex and economically indispensable, state insurance commissioners possess extraordinary powers to protect the interests of consumers and policyholders. Accordingly, insurers are subject to an extensive regime of rules and periodic examinations pertaining to financial solvency, disclosure, and reporting, which go well beyond what is required by the Sarbanes-Oxley Act.

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The National Association of Mutual Insurance Companies is a full-service trade association with more than 1,400 member companies that underwrite 43 percent ($194.6 billion) of the property/casualty insurance in the United States.

Managers of mutual and non-public companies have no incentive to manipulate financial statements in order to inflate share prices, which is the particular abuse that the Sarbanes-Oxley Act is primarily designed to correct.

- ***The objectives that the Sarbanes-Oxley Act seeks to achieve have no relevance to mutual insurers and non-public companies.*** The incentives that motivate public company managers and directors are different from those that apply to mutual insurers and other non-public companies. The performance of mutual insurance companies is evaluated not by profit-seeking investors, but by rating agencies applying objective standards that are consistent over time. Mutual insurance companies are therefore free to adopt a long-term outlook, concentrating on maintenance of capital and revenues, rather than on meeting or exceeding short-term earnings targets to influence share prices on the public equity markets. Managers of mutual and non-public companies have no incentive to manipulate financial statements in order to inflate share prices, which is the particular abuse that the Act is primarily designed to correct.

- ***Early reports indicate that the Sarbanes-Oxley Act has generated inordinately high compliance costs, greatly exceeding government estimates***. Major costs are related to management and auditor attestations required by the Act; other costs could include redirection of corporate resources toward lawsuit avoidance rather than toward company growth enhancement. If these costs were imposed on non-public insurers, they would be passed on to policyholders, either through higher premiums or by depleting resources that would otherwise be available to service policyholders.

- ***The NAIC has failed to identify specific social or economic benefits that would result from its proposal to apply elements of the Act to non-public insurers.*** Nor has it seriously attempted to justify the substantial costs involved, which would ultimately be borne by policyholders.

Insurers, consumers, and regulators have a shared interest in securing insurance company solvency. Rather than beginning deliberation with an ill-fitting set of requirements that will result in substantial new costs for insurance policyholders, insurance regulators should undertake a three-step evaluation to explore how the current system of solvency regulation might be improved. The process would include:

1. A detailed study of the causes and effects of insurer insolvencies across the country. To the extent possible, the study should make use of existing data and source material collected by state insurance departments, and should avoid focusing on a single jurisdiction.

2. An examination of the existing body of financial regulation law to identify what shortcomings, if any, can be linked to recent insolvencies.

3. Development of targeted, cost-effective remedies to address the identified weaknesses.

Until this evaluation is complete, state regulators and legislators should reject proposals to apply investor-oriented protections to non-public companies, particularly through revisions in the NAIC Model Audit Rule. This would leave companies free to adopt provisions of the Act voluntarily, as indeed many have. However, if adherence to selected provisions of the Sarbanes-Oxley Act by non-public companies is to be made mandatory, such a policy choice should be made solely by state legislatures and governors acting in accordance with constitutionally prescribed legislative procedures.

Introduction

Three years ago, a declining stock market combined with a series of corporate governance and accounting scandals in publicly-held companies inspired Congress to pass The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (P.L. 107-204; short title: The Sarbanes-Oxley Act). Prominent scandals included those involving Enron, Global Crossing, Qwest, and WorldCom.[2]

The National Association of Insurance Commissioners (NAIC) – a voluntary organization of insurance regulators from the 50 states, the District of Columbia and the four U.S. territories – has proposed that its Model Regulation Requiring Annual Audited Financial Reports, generally referred to as the Model Audit Rule (MAR), be amended to incorporate certain elements of the Act. The NAIC proposal is apparently predicated on the belief held by some regulators that adopting new corporate governance and accounting rules derived from Sarbanes-Oxley will significantly enhance regulators' ability to monitor insurer solvency.

The NAIC proposal raises vital questions concerning the Act's statutory intent, its effects, and its applicability to insurance regulation. The situation of non-public insurers and their policyholders with respect to insurer solvency is very different from the situation of public corporations and investors with respect to corporate earnings. Hence there is ample reason to doubt that a regulatory regime designed expressly to prevent and punish public company abuses can also be deployed to somehow prevent insurer insolvencies.

Concerns about the use of the MAR as a potential vehicle for implementing the proposal's substantive provisions arise in part from the MAR's unusual "incorporation-by-reference" feature, which could be used by the NAIC unilaterally to insert the proposed amendments directly into the laws of dozens of states.[3] The amendments, however, entail far more than the typical accounting adjustments that the incorporation-by-reference feature was intended to facilitate. Rather, the proposed amendments constitute a major public policy initiative that would substantially increase the nature and scope of financial regulation in an already heavily regulated industry. Ordinarily, such an initiative would be formally introduced and publicly debated as a free-standing legislative proposal by democratically-elected state legislatures. It is therefore important to consider whether the process used to enact the NAIC proposal is consistent with democratic norms and procedures.

This paper explores these issues, and proceeds as follows. The second section discusses the federal Sarbanes-Oxley Act, taking account of its origins, purpose, and effects to date. The third section examines issues related to the application of selected provisions of the Act to the insurance industry. The fourth section assesses the proposed process for applying these provisions of the Act to insurance companies. The final section offers conclusions and policy recommendations.

There is ample reason to doubt that a regulatory regime designed expressly to prevent and punish public company abuses can also be deployed to somehow prevent insurer insolvencies.

The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (Sarbanes-Oxley Act)

The Act contains a wide range of provisions aimed at public companies. Major titles of the law:

- establish the Public Company Accounting Oversight Board (PCAOB) to regulate independent audit firms (the PCAOB is to be paid for by the shareholders of public companies);

- restrict the performance of non-audit services by auditors;

- make public company audit committees responsible for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services;

- require that the principal executive officer and principal financial officer certify periodic financial reports and attest to financial controls;

- require enhanced financial disclosures;

- prohibit personal loans by a corporation to its executives and directors; and

- strengthen criminal and civil penalties for securities fraud.

The law also requires the SEC to adopt rules governing securities analysts' potential conflicts of interest regarding the companies on which they report.

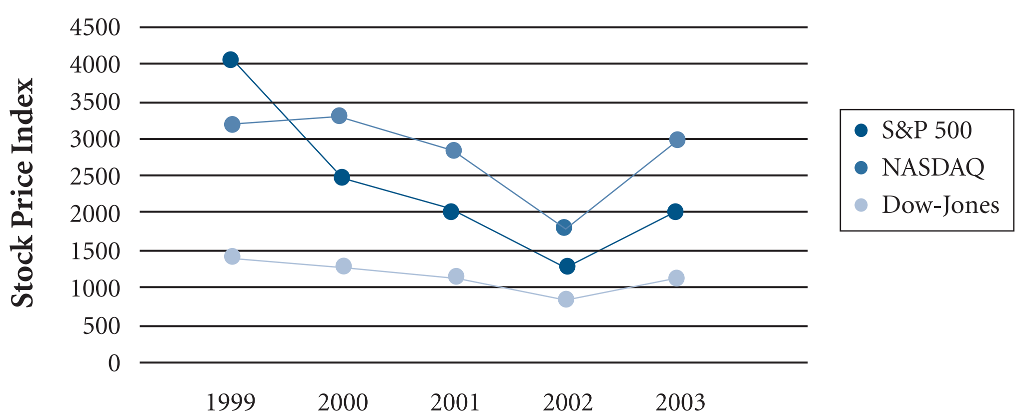
Background of the Act

To properly evaluate whether elements of the Act should be adopted by state regulators for purposes other than those expressly intended by Congress, it is first necessary to review the circumstances that led to the law's enactment. The Sarbanes-Oxley Act was passed in a difficult economic, business, and political environment that was shaped in part by diminished investor confidence in the stock market by the spring of 2002. The financial expansion of the 1990s had ended in March, 2000, triggering a period of stock-market decline and stagnation (Chart 1). Many market indices reached six-year lows in mid-2002.

The major impetus behind the Act, however, was the series of large-scale accounting and corporate governance scandals that unfolded at the same time that the investing public was witnessing the erosion of its savings and 401(k) plans brought on by the market crash. Though the market decline and ensuing stagnation were caused by a variety of factors, the scandals provided names and faces to blame.

A brief review of the Enron, Global Crossing, Qwest, and WorldCom scandals provides a context for understanding the congressional intent behind the Sarbanes-Oxley Act.[4]

Chart 1
Selected U.S. Stock Market Composite Indices
1999 - 2003



Source: Author's tabulation based on U.S. Bureau of the Census, *Statistical Abstract of the United States: 2004-2005* (Washington, D.C.: U.S. Government Printing Office, 2004), Table 1199.

Enron

The full extent of Enron's problems is the subject of ongoing litigation and cannot be chronicled here.[5] Originally a natural gas drilling and pipeline company, Enron had become by the late 1990s a "fiction trading nothing with itself to bank false revenues," in the words of one observer.[6] As of this writing, the collapse of Enron is estimated to have generated $60 billion in losses to shareholders.[7]

Accounting and disclosure improprieties were integral to Enron's collapse. In late 2001, the company admitted that it failed to properly disclose certain related party transactions and to account correctly for off-balance sheet transactions that cost the company billions of dollars. Bankruptcy followed not long after the earnings restatements these disclosures required. In addition to many other accounting problems, the company allowed senior executives to participate in transactions with the company that would otherwise have been prohibited under the company's code of ethics; the board of directors issued waivers of the code when needed.

Global Crossing Ltd.

Global Crossing was a telecommunications company that also was felled by accounting fraud. Global Crossing's difficulties arose from its practice of so-called "pro forma" financial reporting, whereby companies report their financial results as if Generally Accepted Accounting Practices (GAAP) rules do not apply—even in instances where they do apply. The SEC initiated an investigation and the company filed for bankruptcy in 2002. As of this writing, the collapse of Global Crossing is estimated to have caused $47 billion in losses to shareholders.[8]

Qwest

Qwest was another telecommunications company that succumbed to faulty accounting procedures—in this case, improper accounting for capacity swaps. Capacity swaps legitimately allowed rival telecom companies to fill gaps in each other's networks. Qwest abused the process by reporting revenue based on the value of the swapped capacity, whereas conservative accounting practices would have resulted in booking no revenue at all and could even have reduced the company's bottom line. The company's executives were also indicted for insider trading. Losses to shareholders are estimated at $9.7 billion.[9]

WorldCom

Lapses in adherence to accounting conventions are supposed to be corrected by internal controls. WorldCom displayed both accounting and internal control failures.

The accounting failures took the form of mischaracterized line costs, which were the payments the company made to local networks for making phone calls and other connections. Such expenses would normally be characterized as the costs of generating current income, not as capitalized assets to be depreciated over future periods. Indeed, the company's original books properly recorded these costs as expenses. But managers were allowed to override internal control systems. Consequently, in the process of closing accounts, these costs were transferred to the asset accounts. The result was that what should have been large losses in 2001 and the first quarter of 2002 became apparent paper profits. The WorldCom collapse is estimated to have cost shareholders $180 billion.[10]

In addition to the downsized stock market and corporate governance scandals of 2002, the third factor that defined the environment in which the Act was passed was the 2002 mid-term congressional elections scheduled for November. This was the voters' first opportunity to express themselves after a controversial 2000 presidential election that left Congress closely divided and highly partisan. With Republicans holding a six-seat margin in the House of Representatives and Democrats a one-seat margin in the Senate, a normally delicate environment for policy-making was made even more so. Neither party could afford to be seen as blind to corporate crime when every mail delivery or stock market report brought devastating news to millions of individual shareholders—especially retirement plan participants.[11] Extensive media coverage of investors and retirees who had lost prodigious sums in the failure of Enron and other companies added to an environment that one observer has called "frantic."[12]

Congress responded with uncharacteristic alacrity. The House-Senate conference committee reported out a bill the day after the Standard & Poor's composite index reached its July 2002 low, and two business days after WorldCom filed for bankruptcy.[13]

Assessments of the Sarbanes-Oxley Act by scholars and other commentators have cast doubt on its effectiveness as a shareholder protection tool.

Rationale and Purpose of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act applies to public companies. The Act is structured largely as a series of amendments to the Securities Exchange Act of 1934.[14] Therefore, its major provisions apply exclusively to public companies – that is, companies (including banks and bank holding companies, as well as insurers and insurance holding companies) that have a class of securities registered under Section 12 of the Securities Exchange Act of 1934, or are otherwise required to file periodic reports (e.g., 10-Ks and 10-Qs) under Section 15(d) of the 1934 Act. Bank holding companies, state member banks, and foreign banks that meet these qualifications are subject to the requirements of the Act, as well as any rules and regulations that the Securities and Exchange Commission (SEC) may adopt to implement the Act. Public companies whose securities are not registered under Section 12 are not subject to the Act.

When President George W. Bush signed the Act, he underscored its intended purpose by pointedly observing that it "says to *shareholders* that the financial information you receive from a company will be true and reliable, for those who deliberately sign their names to deception will be punished."[15]

The Sarbanes-Oxley Act is intended to bolster investor confidence in public companies and their securities. The law's caption itself provides a concise summary of its goal: "To protect *investors* by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws[.]"[16] Companies subject to the Act are not referred to as companies, but rather as "issuers" of registered securities.[17] Since it is issuers who must comply with the law, an entity that is not an issuer is not subject to it. Writing in the *Wall Street Journal*, former Federal Reserve Board Chairman Paul Volcker and former SEC Chairman Arthur Levitt, Jr., noted that "Sarbanes-Oxley was passed to reinforce the duties that directors, executives, and auditors have to the *investing public*."[18] Likewise, Rep. Michael G. Oxley (R-OH), the bill's co-sponsor, observes, "[The Sarbanes-Oxley Act] reinforced corporate integrity and enhanced *investor confidence* …"[19]

Probable future effects and effects thus far. Upon signing the Act into law, President Bush said it included " … the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[20] Yet assessments of the Act by scholars and other commentators have cast doubt on its effectiveness as a shareholder protection tool. These analysts note that many of the governance provisions contained in the Act were already being adhered to by most U.S. public companies. Interestingly, two companies—Enron and Global Crossing—are mentioned in the Act by name. This unusual reference suggests that the Act's main purpose may have been to prevent future occurrences of the specific abuses committed by particular companies that hadn't played by the same rules as the rest of corporate America. To that end, the Act prescribed a set of formal compliance standards for all public companies to meet.

One goal of the Act was to reassure financial markets that had been shaken by corporate scandals. To be sure, the market did trend upward for about a month after the bill was signed into law.[21] But an act of Congress can only do so much to comfort investors. By October, the market was back to its July 2002 low point, suggesting that by then, any reassurance offered by the new law was overtaken by other events, both foreign and domestic, that the Congress was unable to affect.

Another goal of the Act was to make corporate executives and boards of directors behave more responsibly. However, a number of in-depth research studies of the law are skeptical of its likely efficacy in improving either executive behavior or corporate performance. According to legal scholar Lawrence Cunningham, many companies were already in compliance with key governance provisions of the Act "as a matter of custom or practice and/or due to requirements imposed by stock exchanges, regulators, state law, or other provisions of federal law[.]"[22] After exhaustively surveying the empirical financial and accounting research literature, Yale Law School professor Roberta Romano concluded that the Act's provisions "are not likely to improve audit quality or otherwise enhance firm performance and benefit investors as Congress intended."[23] Romano based her assessment on published studies that examined the statistical relationship between compliance with the Act's corporate governance measures and various measures of audit quality and firm performance.

In sum, the evidence gathered by scholars suggests that most of the Act's governance provisions were not particularly new and are unlikely to have a significant positive impact on corporate performance or behavior. If the Act's provisions do little or nothing to achieve Congress's objective of improving the performance of public companies with respect to corporate governance and accounting methods, it seems doubtful that they could serve to enhance the solvency of non-public insurance companies—a matter that the drafters of Sarbanes-Oxley were free to address, but chose not to.

Costs associated with Section 404. Section 404 of the Sarbanes-Oxley Act directs the SEC to require by rule that annual reports include an internal controls report that: (1) attests management responsibility for maintaining adequate internal control mechanisms for financial reporting; and (2) evaluates the efficacy of such mechanisms. It also requires the public accounting firm responsible for the audit report to attest to and report on the assessment made by the company.[24] In June 2003, the SEC estimated the economy-wide annual costs of implementing Section 404 to be around $1.24 billion (or $91,000 per company)—not including the cost of the auditor's attestation report.[25]

Less than a year later, there were growing indications that the SEC projections were overly conservative. During the first half of 2004, Financial Executives International (FEI), a professional membership organization, conducted two surveys of company costs of compliance with the Section 404 internal controls requirements.[26] The surveys, conducted in January and July, measured costs in several ways: e.g., internal and external person hours, external consulting and other vendor fees, software packages, and the percentage increase in audit fees required for the public auditor attestation report.

Both surveys found that larger firms expected to pay more, both in hours and in dollars, for compliance than smaller firms. However, in both surveys and on all cost measures other than additional audit fees, the projected costs of compliance were larger in relation to revenues for smaller firms than for the larger firms surveyed.[27] The burden of compliance is thus heaviest on smaller firms. Moreover, every cost measure increased dramatically for both larger and smaller firms between the time of the first survey and the time of the second. FEI attributes this increase to the fact that by July, firms had begun to receive quotes from auditors, hire consultants, and purchase software needed for compliance. Their later estimates reflected firms' actual experience with compliance, whereas the initial estimates were based on expectations. In the July survey, the cost of the annual Section 404 auditor attestation was estimated to increase current audit fees by 53 percent, a percentage that did not vary by firm size.[28] The average cost per company was estimated at more than $3 million, of which the average expected increase in outside auditor fees totaled $823,000.

The most recent evidence confirms that even these dire forecasts underestimated the true cost of Section 404 compliance. In April 2005, accounting professors Burch Kealey and Susan Eldridge of the University of Nebraska, Omaha, found that in 2003, 606 Fortune 1,000 companies paid auditing firms a total of $2.1 billion (or $3.5 million per company) to comply with Section 404. In 2004, company-

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wide compliance costs jumped to $3.4 billion, with individual companies paying $5.7 million on average.[29]

One company's plight foreshadows the burden that others are likely to face. Met Life, a publicly-held life insurance company, incurred more than $10 million in internal costs to document the existence of controls that were, for the most part, already in place. In a presentation to the NAIC working group that is deliberating the transfer of Sarbanes-Oxley elements to insurance solvency regulation, the company reported that to comply with Section 404, it had to devote 100,000 internal person hours to create 500 new business process templates and 300 new system templates.[30] Bear in mind that Section 404 costs are not the only direct dollar cost resulting from the Act. Moreover, many public companies report difficulties in attracting and retaining financial experts and outside directors. Both compensation costs and the costs of liability insurance for directors and officers have increased in response to the perceived increase in risk.[31]

Disparate effects on companies. Researchers have examined whether markets might treat firms already in compliance with major provisions of the Act differently from those that would have to institute changes, such as altering the composition of audit committees. The results of these investigations have been mixed.

One study found no significant differences in stock returns between firms already in compliance and firms not in compliance.[32] These results suggest that financial markets are indifferent to the Act's provisions. Two other studies suggest that the Act will hurt companies with good governance practices and help those with bad practices.[33] In this view, companies with bad governance practices would benefit from increased investor confidence in their (presumably improved) reporting, while those already in compliance with the law would face increased costs for documenting what they were already doing.

Yet another study suggests the reverse—that firms with the best practices would benefit the most from the Act.[34] One possible explanation for this latter prediction could be that "clean" firms could face lower incremental compliance costs than those with questionable practices. In any case, the most that can be said on the basis of available evidence is that the jury is still out on the question of which type of firm is most likely to be helped or harmed by the Act.

The value of the auditor attestation has been questioned. Notwithstanding the costs of Section 404 compliance, the value of the auditors' attestation itself is unclear. While the Act requires corporate executives to affirm the accuracy of any data they publish, auditors must only confirm that management followed approved procedures in making its own attestation.[35] For example, auditors are not required to test information they receive against independent empirical evidence, nor are they required to express every reservation they may have about the accuracy of the reports they audit.

It would thus appear that the additional work involved in complying with Section 404 does not necessarily provide a higher level of accuracy or additional security even in the public companies to which Congress intended the Act to apply. The auditor's attestation regarding a company's internal controls does not necessarily mean the numbers investors read reflect the true state of the company's operations; it only means the numbers were derived according to "adequate" procedures, not that the auditor considers them to be accurate.

Conflicts with state law. Some of the Act's provisions overlap with or contradict state law.[36] The Act's substantive governance provisions in particular have been judged to cross the traditional division between state and federal jurisdiction.[37] For example, one researcher concludes that the Act "forcibly seiz[es] on traditional state corporate territory in prohibiting loans to directors and executives."[38] Another researcher points to the benefits that flow from competition among the states that are inherent in a state-based regime for regulating corporations; states with corporate regulatory regimes that are economically inefficient or unresponsive to local conditions are likely to lose corporations to states whose regimes are more innovative and adaptive. Accordingly:

> The absence of state codes or corporate charters tracking the … [Act's] mandates … suggests that board composition, the services corporations purchase from their auditors, and their credit arrangements with executives … are not proper subjects for federal government action[.][39]

Finally, it should be noted that some states have established corporate requirements that are unique to insurance corporations. The NAIC has not studied this matter, nor has it indicated how conflicts between existing law and the NAIC proposal are to be resolved.

De-listing and going private. Early signals of the Act's long-term effects can also be gleaned from specific cases. There is evidence that some smaller companies with thinly traded shares are "going dark"—that is, while their shares will still be publicly traded, they are de-listing their stocks from major exchanges.[40] De-listing removes the need to file reports with the SEC, and thus puts companies outside the Act's jurisdiction. While some companies may choose de-listing as an alternative to cleaning up their accounting, others are likely doing so to reduce both their annual audit costs and the risk that their internal controls have some unknown (and unknowable) weakness.

There is also some indication that the Act increased the tendency of small firms and those with greater inside ownership to go private.[41] However, these tend to be smaller firms, for which the pre-Act benefits of being a public corporation were also small. For these firms, the Act may have tipped the balance against being a public corporation by further decreasing the liquidity of shares held by insiders. Both de-listing and going private can reduce economic growth and innovation by reducing the ability of some smaller companies to attract more investment capital at reasonable rates.

Ambiguous and/or contradictory statutory provisions can attract aggressive litigation and lead executives to direct corporate resources to protect themselves from risk. Protective behavior of this sort may help prevent the next Enron—even as it stymies the development of " … the next Cisco, Microsoft and Starbucks."[42]

Because of its complexity and compliance costs, the Sarbanes-Oxley Act—particularly Section 404—has already proved difficult for federal regulators to implement.

Implementation Difficulties

Because of its complexity and compliance costs, the Act—particularly Section 404—has already proved difficult for federal regulators to implement. The Securities and Exchange Commission has twice extended the deadline for small public companies and foreign private issuers to comply with Section 404, most recently to July 15, 2006, nearly four years after the Act's enactment. The SEC appears to understand the practical difficulties that public firms face as they struggle to comply with Section 404. In announcing the delay, the SEC observed:

> [W]e wish to emphasize that this extension should not be viewed as a basis for smaller companies and foreign private issuers to slow down or delay their Section 404 compliance efforts. *Smaller companies or foreign private issuers may find that they need all the time available, including the time afforded by this extension, to comply fully with the internal control reporting requirements*."[43]

In a press interview, Treasury Secretary John Snow explained that "the concern is with balance [in enforcing the law]. … [T]he system may have become too prosecutorial, Whereas the federal Act applies to public firms at the holding company level, the NAIC could decide to apply its proposed version of the Act to individual subsidiary companies comprised within a holding company structure. That would add substantially to the regulatory burden of public insurers already subject to the federal Act.

and without enough consultation between and among the regulators and the prosecutors."[44] The upshot is that federal officials have acknowledged encountering unanticipated difficulties in implementing the Act. If state policymakers are to make an informed decision about whether to apply elements of Sarbanes-Oxley to non-public insurance companies, it is critical that they be aware of the numerous problems that have arisen thus far in the course of administering the federal version of the Act.

Sarbanes-Oxley and the Insurance Industry

This section examines the NAIC proposal, the issues it raises, and how it fits with the particular regulatory environment facing insurers, with special focus on mutual insurance companies.

The Role of the NAIC

The NAIC provides a forum for the development and coordination of administrative policies and procedures throughout the state-based system of insurance regulation. The NAIC's actions are predicated on the assumption that effective regulation requires some degree of national uniformity. To that end, the NAIC regularly adopts model laws and regulations. These model laws are purely advisory, however, and have no binding effect unless they are enacted by the legislatures of the individual states.[45]

The Regulators' Proposal

Sub-groups of the NAIC-AICPA Working Group are currently debating the application of Titles II, III, and IV of the Sarbanes-Oxley Act to all insurers:

- Title II governs auditor independence. It amends the Securities Exchange Act of 1934 to prohibit an auditor from performing specified non-audit services contemporaneously with an audit. It also requires pre-approval by the company's audit committee for those non-audit services that are not expressly forbidden.

- Title III governs corporate responsibility. It makes audit committees of public companies responsible for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It also requires an audit committee member to be a member of the company's board of directors, and to be otherwise independent.

- Title IV enhances the financial disclosures required of public companies. Section 404 of this title addresses internal accounting controls.

It is important to note that while the federal Act already applies to publicly-held insurance companies, it is conceivable that the NAIC's version of Titles II, III, and IV will differ somewhat from the federal version of those elements. Moreover, whereas the federal Act applies to public firms at the holding company level, the NAIC could decide to apply its proposed version of the Act to individual subsidiary companies comprised within a holding company structure. Either of these scenarios would add substantially to the regulatory burden of public insurers already subject to the federal Act.

Mutual Insurance Company Structure and Governance

There are fundamental differences between mutual insurance companies and public companies in terms of institutional structure and governance, as well as objectives and incentives. Unlike mutual insurers, public companies succeed not only by selling their products or services to purchasers, but by selling shares of their equity to investors, who seek to profit from their investment. This dynamic imposes special demands on public companies. Often these demands are oriented toward short-term goals, such as achieving quarterly earnings targets.

Lacking shareholders, mutual insurance companies have neither the same advantages nor the same pressures as public companies whose shares trade on the capital markets. Instead, mutual companies face a different type of financial discipline. Their performance is evaluated not by profit-seeking investors, but by rating agencies applying objective standards that are consistent over time, and by regulators applying an extensive and rigorous regime of solvency rules designed to ensure that companies can meet their contractual obligations to policyholders. Free from the demands of profit-seeking investors, mutual insurance companies concentrate on maintenance of capital and revenues rather than on short-term earnings targets.

Like public company shareholders, the policyholders of a mutual insurance company are considered to be "owners" of the company. However, there are important distinctions between public company stock ownership and the concept of ownership as it applies to a mutual insurance company policyholder. The owner of a share of corporate stock has the right to dispose of that property. In contrast, mutual insurance company policyholders "do not have the ability to sell or otherwise transfer individual ownership. The ownership interest … does not survive the termination of the policy of insurance."[46]

Mutual insurance company policyholders have certain interests in the issuing company that holders of a stock company insurance policy do not have. Chief among these are governance and participation rights:

- ***Governance***. Members participate in the governance of the company through the selection of a board of directors. Members also generally have the right to vote on corporate transactions such as mergers, demutualizations,[47] and asset sales. State law governs how these rights are implemented and exercised.

- ***Participation rights.*** Mutual insurance company members acquire participation rights, defined as the right to participate in the company's profit or surplus. A company's profits may be added to surplus, or may be directed to members as premium credits, policy dividends, or premium reductions.[48] The board of directors makes decisions concerning participation rights.

By the same token, owners of freely-traded securities have rights that mutual insurance company policyholders do not have. As noted above, no policyholder has a right to sell or "cash out" an individual membership interest. Value to the policyholder is realized instead through the mutual company's ability to meet its promise to indemnify the policyholder's losses according to the terms of the insurance contract. An elaborate system of solvency regulation has been developed over the last 160 years to ensure that companies maintain sufficient resources to make good on that promise. Since the value of an insurance policy differs fundamentally from the value of a share of stock, imposing a set of investor-oriented regulations on mutual insurance companies would provide no material benefit to mutual company policyholders. Indeed, to the extent that the cost of complying with the proposed regulations would reduce the availability of resources needed to pay claims, policyholders would be worse off.

The NAIC governance proposals patterned after portions of Sarbanes-Oxley are therefore particularly ill-suited to the mutual insurance company environment. For example, one element of the NAIC proposal would require boards of directors to be independent from the company's management. That may be appropriate in a public company setting, where the interests of shareholders and corporate executives often diverge. But the goals of mutual insurance company boards, executives, and policyholders are closely aligned; each of these

Since the value of an insurance policy differs fundamentally from the value of a share of stock, imposing a set of investor-oriented regulations on mutual insurance companies would provide no material benefit to mutual company policyholders.

Unlike securities regulation, the purpose of insurance regulation is to maintain the value of the policyholder's purchase, not to convey information about investment risk.

parties has a common interest in maintaining the company's ability to pay claims and provide service to the policyholder "members." No one party stands to benefit from accounting machinations that would harm the other parties or impair the solvency of the company. For example, mutual company managers do not receive compensation in the form of stock options; hence they have no personal incentive to artificially inflate share prices. A primary motivation behind the accounting improprieties engaged in by the previously mentioned companies was to meet or exceed the expectations of Wall Street analysts, which typically resulted in hefty bonuses and salary increases for the companies' managers. Such incentives to engage in self-dealing are simply not present in a mutual company environment.

This is not to suggest that no manager of any non-public company stands to benefit personally from his firm's positive financial performance. But any improper behavior intended to manipulate a non-public company's performance data would not involve the kind of accounting subterfuge that is calculated to mislead investors. Share price-oriented accounting deception is the singular malady that the Sarbanes-Oxley Act was intended to remedy; it speaks not at all to the accounting and management practices of private companies that have no investors.

The Insurance Regulatory Environment

The scandal-mongering hysteria that led to the enactment of the Sarbanes-Oxley Act and the difficulties that have arisen in the areas of enforcement and compliance suggest that states should think twice before adopting the Act as a model. This section elaborates on the reasons why applying elements of the Act to insurance companies—especially non-public (i.e., mutual) insurers—would be especially problematic.[49]

We have already noted that the federal Sarbanes-Oxley Act is directed toward public companies and that its purpose is to protect the interests of the investing public. Sarbanes-Oxley, then, is essentially a form of securities regulation. To review, securities regulation and insurance regulation have different purposes. The former is intended to ensure that investors have accurate information about the financial status of the company in which they hold shares. The latter seeks to ensure that the insurer is able to honor its promise to indemnify the policyholder according to the terms of the policy agreement. Unlike securities regulation, the purpose of insurance regulation is to maintain the value of the policyholder's purchase, not to convey information about investment risk.

In particular, policyholders benefit from the following aspects of the current insurance regulatory regime:

- Insurance commissioners can demand that insurers cease practices that they consider harmful to policyholders.
- Insurance commissioners can approve or deny many insurer actions before execution.
- The insurance accounting system is directed at the preservation of capital and is specifically tailored to insurance-entity transactions.
- Insurers are subject to risk-based capital standards, which require major changes in operations if insurers fail to meet the standards.
- Insurers must comply with an elaborate set of formal requirements for filing financial and related information.
- Insurers are subject to periodic examinations by state regulators, which may require managers to produce records and be examined under oath.
- Insurers must face audits by independent accountants.

- Insurers must comply with rigorous standards regarding the nature and quality of their investments.

- Insurers are subject to a central system of financial analysis capable of initiating inquiries into insurers' solvency, which supplements additional analyses performed by each state.

- Insurers must comply with special laws requiring licensing and authorization of business partners such as agents and reinsurers.

Table 1
Estimates of Added Costs Required by Section 16
Number of Companies Responding in Parentheses

Company's Premium Revenue in millions of dollars	First-Year Cost Increase %		Ongoing Cost Increase %	
	Internal	External	Internal	External
Less than $100	81 (7)	67 (7)	51 (7)	60 (7)
$100 to $500	84 (7)	61 (7)	48 (7)	45 (7)
Over $500	123 (3)	76 (4)	57 (3)	64 (4)

Source: "Survey of Members," as cited by William Boyd, letter to Douglas C. Stolte, Chair, and Members, NAIC/AICPA Working Group, May 19, 2004. The survey was conducted among mutual insurance companies that are NAMIC members.

Over the past several years, state regulators have adopted several solvency tools to strengthen oversight of the insurance industry. These tools include the statutory financial audit, risk-based capital measures, the actuarial opinion, IRIS and FAST ratios, Examination Jumpstart Reports, Company Profile Reports, the NAIC Financial Analysis Handbook, and the Management Discussion and Analysis Report.

Regulators also have improved the financial analysis process, including the separate evaluation of compliance with financial analysis standards in the NAIC Accreditation Program, the Financial Analysis Working Group's peer review with regard to Nationally Significant Insurers, and recent improvements to the NAIC Analyst Team Project. The codification of statutory accounting principles, which became effective on January 1, 2001, has improved the consistency and comparability of insurance company statutory financial statements. In sum, insurance solvency regulation is already more potent than what is contemplated by the Sarbanes-Oxley Act.

Costs and Benefits of the NAIC Proposal

What will it cost? A survey of mutual insurance companies conducted by the National Association of Mutual Insurance Companies (NAMIC) measured the internal and external costs that compliance with the Act's Section 404 (as incorporated within the NAIC proposal) would impose on mutual insurers. The survey found that respondent firms expected somewhat higher cost increases than those responding to the FEI survey. Respondents expected their first-year external (auditor) costs to increase by 61 percent to 76 percent, and their ongoing costs to increase by 45 percent to 64 percent (Table 1).

A separate study by the Property Casualty Insurers Association of America projects that compliance with Section 404 will cost insurers $1 billion per year, and substantially more if the rules are imposed at the legal entity level—that is, the level of the individual company rather than the group or holding company level.[50] These costs would have to be absorbed by someone, most likely policyholders in the case of companies that are not publicly owned.

Who benefits? Inasmuch as the federal Sarbanes-Oxley Act was intended to benefit investors in public companies, and mutual insurers are non-public companies with no investors, the answer to this question is far

Proponents of the NAIC proposal have yet to explain exactly how the addition of Sarbanes-Oxley provisions to the Model Audit Rule would reduce the incidence of insolvencies or otherwise benefit policyholders.

from obvious. One possible set of beneficiaries is the state guaranty funds, assuming that the proposed rules would reduce the number of insurer insolvencies and hence the amount of claims against those funds. But it is not at all clear that the proposal would have that effect.

In the first place, there is no reason to assume that the proposed rules will significantly improve the existing insurance regulatory scheme. Any changes proposed to current insurer governance and/or financial reporting rules should be based on a systematic evaluation of those rules. If the evaluation were to reveal specific defects, regulators could reasonably propose changes that would correct those flaws. There is no evidence, however, that the NAIC proposal resulted from such a process. Indeed, when urged to examine the existing system of solvency regulation for the purpose of identifying particular areas in need of improvement, regulators have declined.

A letter written by the chairman of the NAIC/AICPA Working Group provides some insight into the mindset behind the regulators' infatuation with Sarbanes-Oxley. Responding to the observation that the Act was intended to protect investors from the possibility of fraudulent accounting practices by publicly-traded corporations, the chairman of the working group wrote:

> If you replace the initial reference to investors with "regulators," the second reference to investors with "policyholders" and the reference to corporations with "insurers," it is clear why the implementation of a revised Model Audit Rule would be seen as an enhancement to our current regulatory structure.[51]

Of course, changing these words has the effect of changing the entire nature and purpose of the Act, and it is by no means clear why this particular way of revising the Model Audit Rule would represent an "enhancement" of the current structure—especially when no reason has been given as to why the current structure needs to be enhanced in the first place. To be sure, proponents of the NAIC proposal have cited a handful of insolvencies during the past decade as evidence that insurers are not immune from insolvency. But no one has demonstrated that any insolvency occurred because of overly lenient accounting rules or enforcement mechanisms, or that any particular insolvency could have been prevented by the additional regulation embodied in the NAIC proposal.

Even the best system of regulation can be improved. But the NAIC proposal, based as it is on a federal law that has nothing to do with insurance solvency issues, is tantamount to a repudiation of the extensive overhaul of state solvency rules that occurred in the early 1990's. That overhaul led to the creation of the Financial Regulation Standards and Accreditation Program, the crown jewel of NAIC-generated regulation. Adopted by the NAIC in 1990 and subsequently enacted by state legislatures, the Accreditation Program substantially improved the quality of solvency regulation. The program involves a rigorous review of the individual state insurance departments by an independent review team. As of June 2004, the insurance departments of 49 states and the District of Columbia had achieved accreditation.[52] Compliance with the Model Audit Rule (MAR) is a prerequisite for accreditation.

Proponents of the NAIC proposal have yet to explain exactly how the addition of Sarbanes-Oxley provisions to the Model Audit Rule would reduce the incidence of insolvencies or otherwise benefit policyholders. Their assumptions appear to be grounded in little more than conjecture – or faith. The "problem" of insufficient insurer accounting safeguards seems to have been discovered by regulators only after Sarbanes-Oxley went into effect. The NAIC proposal would thus appear to be a classic case of a regulatory "solution" in search of a real-world problem.

Is there a crisis? The short answer is that the financial health of the insurance industry is improving rather than declining. The number of insurance companies that failed in 2004 declined 48 percent, to 13 compared to 25 insurer insolvencies in 2003, according to Weiss Ratings Inc., an independent provider of ratings and analyses of financial services companies, mutual funds, and stocks. Three life and health insurers and 10 property and casualty insurers failed in 2004, compared to four and 21, respectively, in 2003.[53] Property and casualty insurer failures in 2004 were at a five-year low.[54] In short, proponents of changes to the MAR have proven neither that there is a problem with the integrity of financial reporting by insurers, nor that the proposed changes are an appropriate remedy.

Process Proposed for Applying the Act to Insurance Companies

The NAIC consists of elected and appointed public officials charged with regulating insurance companies. It is a private, voluntary organization that seeks through various means to influence the development of public policy. Like other interest groups, the NAIC lacks authority to make public policy, and is not accountable to the public in the way that elected members of the legislative or executive branches of federal and state governments are accountable.

The purpose of the Model Audit Rule (MAR) is to facilitate insurance regulators' surveillance of the financial condition of insurers by requiring that independent certified public accountants examine insurers' financial statements yearly.[55] The rule defines the structure and content of the audited report and the responsibilities of the certified public accountant performing the audit. The rule is intended to make it easier for insurers and auditors to carry out their routine responsibilities related to financial reporting.

But the application of selected provisions of the Sarbanes-Oxley Act as contemplated in the proposed MAR revisions is not routine, nor is it noncontroversial. The NAIC proposal would apply the Act to mutual insurance companies, potentially conflicting with state corporate laws and at great cost to insurance consumers. Its imposition would amount to a *de facto* extension of the federal Act to non-public companies that were excluded from the scope of the law as passed by Congress and signed by the President.

To be sure, many state laws do have a broader scope than federal legislation on the same topic. For example, many states have anti-discrimination laws that cover more types of discrimination than do federal statutes. Similarly, many states have more stringent labor laws than corresponding federal laws. A few states, such as California, have stricter environmental standards. Because of their substantive breadth and importance to the public, however, such measures are rarely, if ever, enacted solely at the behest of a third-party, nongovernmental organization. Rather, they are openly debated in public policymaking forums, with opportunities for input by legislators, citizens, and affected groups.

Policy Issues Surrounding Incorporation by Reference

As originally presented, the extension of Sarbanes-Oxley requirements to private insurers was on a path to be adopted through new Annual Statement Instructions to which insurers with over $1.2 million in premium are subject each year. Under this approach, the proposed changes to the Model Audit Rule would become part of a state's law without any affirmative action by the state legislature. This would occur because the proposed changes fall into a category of NAIC model policies—in this case, annual financial statement instructions—that can be incorporated into state law *by reference*. As applied to the Model Audit Rule, incorporation by reference is intended to streamline the adoption of routine, non-controversial changes to accounting procedures. Incorporation by reference means that the proposed changes would generally become state law as soon as they are added to the statement instructions by the NAIC.

Proponents of changes to the Model Audit Rule have proven neither that there is a problem with the integrity of financial reporting by insurers, nor that the proposed changes are an appropriate remedy.

Using incorporation by reference to implement the proposed changes in the Model Audit Rule could lead to a perception that the NAIC has betrayed the trust of state legislatures, which agreed to accept the MAR's incorporation-by-reference mechanism with the understanding that it would be used only to effect technical, non-controversial changes to existing audit rules.

The mode of incorporation by reference can take several forms. Maryland has a statute that incorporates the NAIC Model Audit Rule by reference. Nineteen other states and the District of Columbia have taken the language of the Model Audit Rule and used it as the basis for the language of their statute or regulation. Another 30 states have adopted NAIC forms, instructions and manuals by reference. In these states, a change in the forms, instructions or manuals could have the effect of automatically changing the law in that state.[56] A state-based version of selected provisions of the Sarbanes-Oxley Act could thus be applied to all insurers, including non-public mutual insurance companies, without any input by state legislators or governors.

The legal status of incorporation by reference has been debated for nearly 90 years. A 1947 Presidential conference convened to report on fire prevention examined in detail the validity of municipal ordinances that incorporated various technical codes by reference.[57] The report produced by the conference noted:

> The reconciliation of the advantages and disadvantages of incorporation by reference, in accordance with the pertinent State constitutional and statutory provisions, may not be a simple task.

The report quoted at length from the 1919 case of *Kansas v. Crawford*,[58] which assessed the validity of a state statute requiring that all electric wiring be in accordance with the National Electric Code. The Kansas Supreme Court held the statute unconstitutional as a delegation of legislative authority to private individuals and associations, and void for uncertainty. Part of the court's decision as quoted in the 1947 report reads:

> If the legislature desires to adopt a rule of the national electrical code as law of this State, it should copy that rule, and give it a title and an enacting clause, and pass it through the senate and house of representatives by a constitutional majority, and give the Governor a chance to approve or veto it, and then hand it over to the Secretary of State for publication.

A full legal analysis of the principle of incorporation by reference is outside the scope of this report, but the language of the Kansas Supreme Court decision seems particularly compelling. In the case then before the Court, no one had explicitly rejected the National Electric Code as inappropriate to a particular industry or sector of the economy. Rather, the issue was simply how the Code was to be recognized in state and local laws. By contrast, when Congress enacted the Sarbanes-Oxley law, it explicitly rejected the option of applying it to non-public companies. Furthermore, the law was the product of hearings, testimony, and congressional conferences, all of which have created a substantial public record. In addition, all the participants were accountable in some way to the public, whether at the voting booth in the case of elected officials, or in the court of public opinion in the case of private individuals or government officials testifying before congressional committees in the course of their deliberations.

Using incorporation by reference to implement the proposed changes in the Model Audit Rule could also lead to a perception that the NAIC has betrayed the trust of state legislatures, which agreed to accept the MAR's incorporation-by-reference mechanism with the understanding that it would be used only to effect technical, non-controversial changes to existing audit rules. Attempting to use the mechanism to unilaterally enact what amounts to a major new legislative initiative would almost certainly generate ill will among state legislators. Indeed, the potential legal and constitutional ramifications of this approach have not been lost on state legislators who are familiar with the controversy. Writing on behalf of the National Conference of Insurance Legislators (NCOIL), which steadfastly opposes the NAIC proposal, the group's president, Texas State Rep. Craig Eiland, warned NAIC officials that "[t]here is a formidable body of case law that holds that the material public policy changes to state insurance law envisioned by the NAIC [proposal]… may only properly be achieved through legislation in the individual states."[59]

As of this writing, regulators have apparently reconsidered the path of incorporation by reference and have elected instead to pursue the proposed changes to the MAR in the form of a model law. The proposal must now make its way through the NAIC committee system. Opportunity for comment will be provided to national groups of state elected officials such as NCOIL, the National Conference of State Legislatures (NCSL), and the National Governors Association (NGA). Under the new approach, regulators will be required to provide:

- An explanation of how the proposal is directly related to solvency surveillance and why the proposal should be included in the Model Audit Rule;
- a statement as to why the ultimate adoption of the proposal by every jurisdiction may be desirable;
- a statement as to the number of jurisdictions that have adopted and implemented the proposal or a similar proposal and their experience to date;
- a statement detailing the provisions needed to meet the minimum requirements of the proposal;
- an estimate of the cost to insurance companies of complying with the proposal and the impact on state insurance departments charged with enforcing the proposal; and
- an explanation of the potential or likely impact on insurance consumers should the proposal not be included in the Model Audit Rule.[60]

All six requirements are important; however, the first and fifth items speak to the core of mutual company opposition to the NAIC working group proposal. To date, regulators have shown great reticence—if not outright intransigence—in responding to questions related to these items.

Conclusion

The Sarbanes-Oxley Act was the product of difficult economic and political times. Once-respected corporate giants[61] were collapsing, leaving devastated shareholders in their wake. Simultaneously, the technology bubble of the 1990s was bursting, sending stock markets even lower. Finally, a mid-term congressional election in a closely divided Congress was fast approaching. Something, it seemed, had to be done; someone had to be held accountable.

Whether the response of Congress and the Administration to these problems was "sweeping reform" or sweeping a number of old ideas into one hastily passed piece of legislation is a matter of active debate among researchers who have studied the law. Serious questions have been raised about the compliance costs imposed by the Act and about its likely effects on the accuracy of financial reporting and on the quality of data that public companies make available to current and prospective shareholders.

While much surrounding the Act is in dispute, one fact is not: Congress could have applied the Act to non-public companies, but deliberately chose not to. Nevertheless, the NAIC is considering measures that would do precisely what Congress declined to do. Applying elements of the Sarbanes-Oxley Act, particularly Section 404, to non-public insurance companies is unnecessary and would be overly burdensome and counterproductive. The foregoing

While much surrounding the Sarbanes-Oxley Act is in dispute, one fact is not: Congress could have applied the Act to non-public companies, but deliberately chose not to. Nevertheless, the NAIC is considering measures that would do precisely what Congress declined to do.

examination of several critical issues concerning the NAIC's Sarbanes-Oxley initiative finds that:

- The Act was designed for the express purpose of protecting the interests of investors, and to restore public confidence in the capital markets. Non-public companies, by definition, do not have investors, and are subject neither to the advantages of access to the public equity markets nor, more importantly, to the peculiar pressures, incentives, and temptations that apply to publicly traded companies. The NAIC has not explained who would benefit from the proposed changes, or whether any resulting benefits justify the substantial costs of complying with selected provisions of the Act.

- Insurers are already subject to rigorous regulation relating to financial solvency, disclosure, reporting, and examination. Insurance regulation is a closely woven fabric developed over 160 years, designed to guarantee the integrity of the contract between the insurer and the policyholder.

- Early reports suggest that the cost of compliance with the Act will far exceed the government's early estimates. Major costs are related to management and auditor attestations required by the Act, but other costs could include redirection of corporate resources toward lawsuit avoidance rather than toward company growth enhancement. Should insurance regulators succeed in grafting elements of the Sarbanes-Oxley law onto the existing state-based regulatory regime, the public benefits are likely to be even fewer and less substantial than those generated by their federal cousin, while the costs—ultimately to be borne by insurance policyholders—will be at least as great.

- The proposed revision of the Model Audit Rule to include selected provisions of the Act would enact into law requirements that exceed the rule's purview.

- The timing of this misguided initiative could not be worse, given that powerful forces inside and outside of Congress are scrutinizing the system of state insurance regulation with an eye toward federal intervention. To prevent federal usurpation of insurance regulatory authority, state legislators and insurance commissioners should work together on issues of common interest.

Policy Recommendations

Insurers, consumers, and regulators have a shared interest in securing insurance company solvency. Rather than beginning deliberation with an ill-fitting set of requirements of suspect effectiveness that will result in substantial new costs for insurance policyholders, insurance regulators should undertake a three-step evaluation that would include:

1. A detailed study of the causes and effects of insurer insolvencies across the country. To the extent possible, the study should make use of existing data and source material collected by state insurance departments, and should avoid focusing on a single jurisdiction.

2. An examination of the existing body of financial regulation law to identify what shortcomings, if any, can be linked to recent insolvencies.

3. Development of targeted, cost-effective remedies to address the identified weaknesses.

Until this evaluation is complete, state regulators and legislators should reject proposals to apply investor-oriented protections to non-public companies, particularly through revisions in the NAIC Model Audit Rule. This would leave companies free to adopt provisions of the Act voluntarily, as indeed many have. However, if adherence to selected provisions of the Sarbanes-Oxley Act by non-public companies is to be made mandatory, such a policy choice should be made solely by state legislatures and governors acting in accordance with constitutionally prescribed legislative procedures.

End Notes

[1] Available at *www.namic.org/pdf/roadtoreform.pdf*.

[2] Lawrence A. Cunningham, "Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)", *Connecticut Law Review* 35 (2003): 915-998. The following summary relies on this article as well as other reviews as cited.

[3] As of this writing, representatives of the NAIC have indicated that they do not intend to use the MAR's incorporation-by-reference mechanism to implement the proposal. See the discussion at pp. 15-17.

[4] This summary draws on Cunningham (2003).

[5] Ongoing litigation is too extensive to list here, but several examples can show the extent of proceedings. The federal trial of WorldCom CEO Bernard J. Ebbers ended with a conviction in March, 2005. Two suits have also been filed by federal agencies. In 2003, The U.S. Department of Labor filed a lawsuit against Enron, its executives, directors, and retirement plan officials alleging violations in the management of employee benefit plans (*www.dol.gov/_sec/media/announcements/enron.htm*). The Securities and Exchange Commission initiated civil charges in 2004 against former Enron Chairman and Chief Executive Officer Kenneth L. Lay for his role in falsifying Enron's publicly reported financial results and making false and misleading public representations about Enron's business performance and financial condition (*www.sec.gov/news/press/2004-94.htm*).

[6] Cunningham (2003). Also see Kurt Eichenwald, *Conspiracy of Fools: A True Story* (Broadway Books, 2005).

[7] Credit Suisse/First Boston, "Whither Enron? Or—Why Enron Withered," *The Consilient Observer* 1 (January 15, 2000): 1. Estimates of the losses to shareholders resulting from the failures of the Big Four vary widely and may change over time in the course of litigation. This section cites consensus estimates as available at this writing.

[8] Dennis K. Berman, Phillip Day And Henny Sender, "Global Crossing Files for Chapter 11, Plans to Reorganize With Asia Firms," Wall Street Journal Online (January 29, 2002).

[9] "$236 Billion in Shareholder Losses in 20 Corporations Under Government Investigation" (undated). *www.charttricks.com/Resources/Articles/restate_earnings_2.pdf*.

[10] United States Bankruptcy Court, Southern District of New York, *In Re: WorldCom et al., Debtors*, First Interim Report of Dick Thornburgh, Examiner, November 4, 2002.

[11] Laws federalizing crimes are particularly likely to be passed during election years (see Michael A. Perino, "Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002" (October 2002). Columbia Law and Economics Working Paper No. 212; St. John's Legal Studies Research Paper. *http://ssrn.com/abstract=350540*).

[12] Ibid.

[13] Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," *New York University Law and Economics Research Paper Series Working Paper No. 04-032*, 2004.

[14] It also amends the Securities Act of 1933 and the federal criminal code.

[15] "Remarks by the President at Signing of H.R. 3763, the Sarbanes-Oxley Act of 2002," July 30, 2002. *www.whitehouse.gov/news/releases/2002/07/20020730-1.html*. (Emphasis added.)

[16] Public Law 107-204, 107th Congress, *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ204.107*. (Emphasis added.)

[17] Ibid., Section 2 (a)(7): "The term 'issuer' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn."

[18] Paul Volcker and Arthur Levitt Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal* (June 14, 2004). (Emphasis added.)

[19] Rep. Michael G. Oxley, "On the Issues: Corporate Accountability." *http://oxley.house.gov/issues.asp?FormMode=Call&LinkType=Section&Section=8* (Emphasis added.)

[20] "Remarks by the President at Signing of H.R. 3763, the Sarbanes-Oxley Act of 2002," July 30, 2002.

[21] Romano (2004).

[22] Cunningham (2003).

[23] In reaching this conclusion, Romano (2004) reviewed 16 studies on audit committee independence, 24 studies on the provision of non-audit services, 3 studies on executive loan programs, and 2 studies on executive certification of financials. Measures of audit quality included discretionary accruals and earnings surprises. Measures of corporate performance included returns on assets, abnormal accruals, earnings restatements, and financial statement fraud. Most of these studies used data predating the passage of the Act, though some of them were not formally published until after the Act was passed.

[24] The SEC adopted rules pursuant to this section in June, 2003. *www.sec.gov/rules/final/33-8238.htm*

[25] SEC, "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274." June 11, 2003. *www.sec.gov/rules/final/33-8238.htm#v*.

[26] Financial Executives International (FEI), "FEI Survey on Sarbanes-Oxley Section 404 Implementation" (Washington, D.C.: FEI, January, 2004; FEI, "FEI Special Survey on Sarbanes-Oxley Section 404 Implementation: Executive Summary," (Washington, D.C.: FEI, July, 2004).

[27] Author's calculations based on FEI (January, 2004) and FEI (July, 2004).

[28] FEI (July, 2004).

[29] Joe Ruff, "UNO team looks at company costs of Sarbanes-Oxley reform law," *Associated Press Newswire*, April 21, 2005.

[30] MetLife 2003 Sarbanes-Oxley 404 Project, Process and Lessons Learned. PowerPoint presentation delivered to NAIC Sarbanes-Oxley Sub-Group, July 27, 2004.

[31] Alan Reynolds, "Sarbanes-Oxley in Retrospect" (Washington, D.C.: The Cato Institute, undated); Richard H. Gifford and Harry Howe, "Regulation and Unintended Consequences: Thoughts on Sarbanes-Oxley," *The CPA Journal Online* (June 2004). *www.nysscpa.org/cpajournal/2004/604/perspectives/p6.htm*.

[32] Haidan Li, Morton Pincus, and Sonja Olhoft Rego, "Market Reaction to Events Surrounding the Sarbanes-Oxley Act: Overall and as a Function of Earnings Management and Audit Committee Effectiveness" (manuscript November 2003), cited in Romano (2004).

[33] Holmstrom and Kaplan (2003), Romano (2004).

[34] Zabihollah Rezaee and Pankaj K. Jain, "The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence" (manuscript 2003), cited in Romano (2004).

[35] This discussion is based on Edward J. Kane, "Continuing Dangers of Disinformation in Corporate Accounting Reports," Boston College, manuscript (August 21, 2003).

[36] Holmstrom and Kaplan (2003); Cunningham (2003). The Act's prohibition on corporate loans to directors and executives is one example where the Act has been judged to encroach on state legal territory.

[37] Romano (2004); Cunningham (2003).

[38] Cunningham (2003).

[39] Romano (2004).

[40] Claudia H. Deutsch, "The Higher Price of Staying Public," *The NewYork Times* (January 23, 2005). nytimes.com.

[41] Ellen Engel, Rachel M. Hayes, and Xue Wang, "The Sarbanes-Oxley Act and Firms' Going-Private Decisions" (May 6, 2004). *http://ssrn.com/abstract=546626*

[42] Gifford and Howe (2004).

[43] SEC, "Management's Report On Internal Control Over Financial Reporting And Certification Of Disclosure In Exchange Act Periodic Reports Of Non-Accelerated Filers And Foreign Private Issuers, 17 CFR PARTS 210, 228, 229, 240 and 249." March 2, 2005. *www.sec.gov/rules/final/33-8545.htm* (Emphasis added.)

[44] "Sarbanes-Oxley: A sense of 'siege,'" *BusinessWeek Online*, January 5, 2005. *http://msnbc.msn.com/id/6798606/*

[45] NAIC, "History and Background: Model Laws and Legal Division," 2005. *www.naic.org*. Also see Peter M. Lencsis, *Insurance Regulation in the United States: An Overview for Business and Government* (Quorum Books, 1997), p. 16.

[46] NAMIC, *Meeting Challenges and Exceeding Expectations in Corporate Governance* (Indianapolis, IN: National Association of Mutual Insurance Companies, 2002).

[47] De-mutualization is the process by which a mutual insurance company converts to a stock insurer.

[48] Members may also have the right to receive a distribution of the company's surplus in the event of its conversion to stock ownership form or liquidation.

[49] This section draws on NAMIC, *Focus on the Future: Options for the Mutual Insurance Company* (Indianapolis, IN: National Association of Mutual Insurance Companies, undated) and NAMIC, *Meeting Challenges and Exceeding Expectations in Corporate Governance* (Indianapolis, IN: National Association of Mutual Insurance Companies, 2002).

[50] "Pulling Up Their Sox 'Will Cost Us [sic] Insurers $1Bn Each Year,'" *InsuranceNewsNet*, February 16, 2005. *www.insurancenewsnet.com/article.asp?a=top_news&lnid=258538601*

[51] March 10, 2005 letter from Douglas C. Stolte to Ernst N. Csiszar.

[52] NAIC, "Financial Regulation Standards and Accreditation Program: Map of Accredited States," 2004. *www.naic.org/frs/accreditation/map.htm*.

[53] "Weiss: Insurance Company Failures Decline 48% in 2004," *Insurance Journal* (January 10, 2005). *www.insurancejournal.com/news/national/2005/01/10/49480.htm*

[54] Weiss Ratings, Inc., "Property and Casualty Insurer Failures," 2005. Different organizations may use different criteria for considering a company insolvent, resulting in a different count of companies. The Weiss Ratings, Inc. data are used here because this was the only source of full-year data for 2004 available as this report was being prepared. In these data, a company is deemed to have failed if at any time it was under supervision of an insurance regulatory authority; in the process of rehabilitation; in the process of liquidation; or voluntarily dissolved after disciplinary or other regulatory action by an insurance regulatory authority. *www.weissratings.com/FailedCompanies.asp?ind=ins&type=PC*.

[55] "Model Regulation Requiring Annual Audited Financial Reports: Section 2," draft date December 14, 2004.

[56] "Compliance Grid - NAIC Model Audit Rule," NAMIC, Indianapolis, IN (January 12, 2005), *www.namic.org/compliance*.

[57] The President's Conference on Fire Prevention, *Report of the Committee on Laws and Law Enforcement*, Washington, D.C., May 6, 7, and 8, 1947. *www.usfa.fema.gov/about/47report.shtm*

[58] 104 Kan. 141, 177 Pac. 360, 2 A. L. R. 880 (1919).

[59] Letter of Rep. Craig Eiland (TX), president of the National Conference of Insurance Legislators, to Cmr. Diane Koken, NAIC President, and Cmr. Alfred Gross, Chair, NAIC/AICPA Working Group, March 10, 2005.

[60] Financial Regulation Standards and Accreditation Program. NAIC, June 2004, pp 17-18.

[61] Reynolds (undated) points out that *Chief Executive* magazine rated Enron's corporate board among the nation's five best in 2000.

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