

The Global Regulatory Maelstrom

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Introduction

Over the past two years, there has been a flurry of new regulatory activity affecting the life insurance industry. This has altered the face of the industry in many countries, and the effects have not all been positive. An increase in the number of regulations affecting the industry as a whole has resulted in greatly increased compliance costs, a reduction in new product development, changes in capital structures, and an expectation of major consolidation as small players find it hard to cope with the regulatory burden. This paper provides an overview of the major themes in regulation, considers the drivers behind the recent and upcoming changes, examines the new regulations that will affect the insurance industry as a result of current deliberations, and assesses how insurers are reacting to this shifting environment.

The paper focuses on factors affecting European companies, although in some cases it addresses regulation in markets beyond Europe: these are issues faced by insurers in all developed markets. Figure 1 illustrates the severity of the situation. For some while, until the late 1990s, insurance-related regulation in the EU underwent a relatively static phase. Some individual EU countries made changes, but these tended to be isolated tweaks to existing regulation. According to the Comité Européen des Assurances (CEA), the number of regulatory initiatives reached 99 in 2003 and looked set to reach a similar level in late 2004.

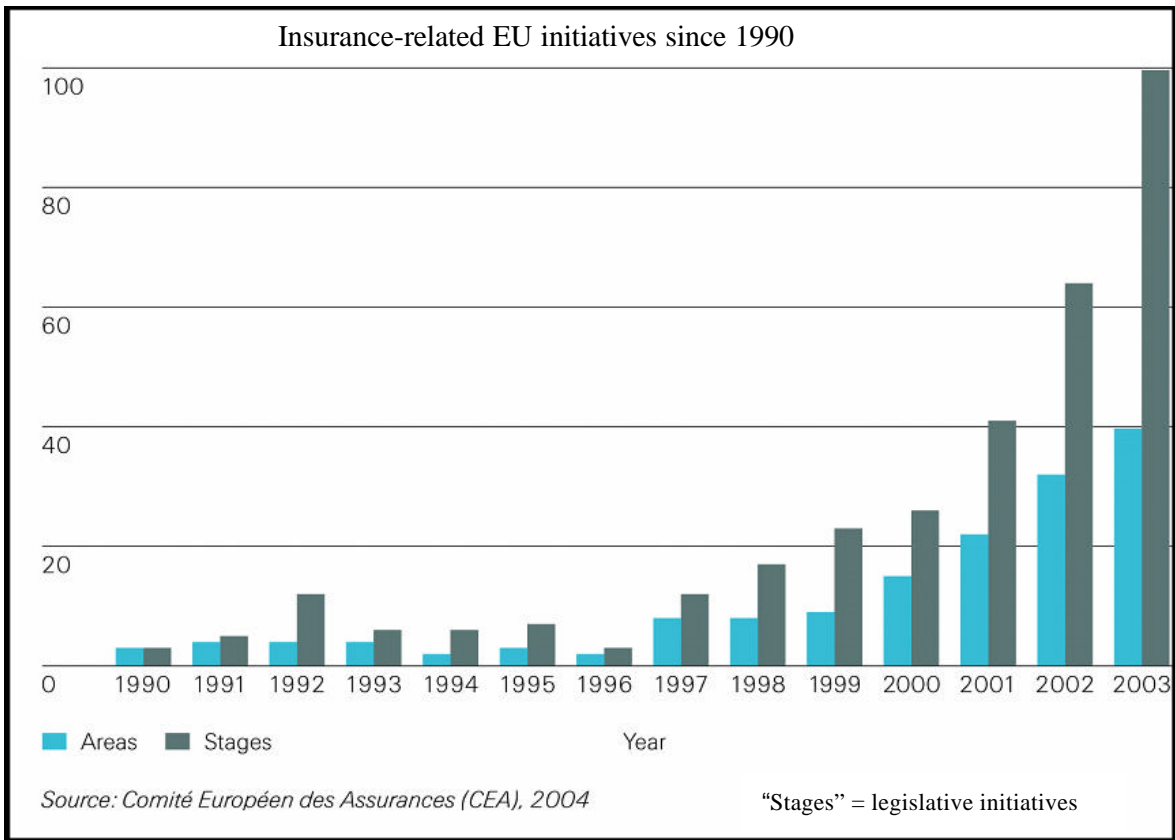


Figure 1

Despite pleas from the CEA for the pace of change to slow down, it would appear that the regulatory environment will not reach a stable position until sometime after 2009, when IFRS 4 Phase 2 and Solvency II are both in place.

Drivers of change and the resultant themes in regulation

While it may appear that insurance regulators in Europe, and around the world, have started changing the rules without a clearly focused, common strategy, most of the major recent and upcoming changes can be classified into one or other major theme, each of which is rooted in recent events. Among the events that are driving the prevailing regulatory changes are the following:

Investment losses for insurers

For a period starting in March 2000, the insurance industry suffered unprecedented investment losses. The problem was exacerbated by the failure, of many insurers, to appropriately recognise the investment guarantees embedded in their policies and to adequately match assets against liabilities. Almost every developed market where insurance products form a significant part of the savings industry has its own examples of this problem. These include the Guaranteed Annuity Options in the UK, which is expected to cost the industry GBP 12 billion, the US Guaranteed Minimum Death Benefits, the return guarantees in the Swiss occupational pension business, and numerous others. The underlying cause of these problems was mispricing of embedded options, but this initial error was almost universally aggravated by firms' late recognition of their problems as available investment yields declined. This, in turn, meant that proper reserving and/or hedging strategies were not put into place to mitigate the impact. The mispricing, and subsequent mismanagement, of these investment guarantees has led the various regulatory and accounting bodies to adopt the concept of marking assets and liabilities to market values. The move to 'fair value' reporting is the first regulatory theme considered in this paper.

Major insurer insolvencies/closures

In several countries, the insurance industry has been shocked by the closure to new business of many old and established companies. In the UK, after 239 years as a standard bearer for mutual insurance, Equitable Assurance closed its doors in 2000 and, while policyholders' contractual liabilities will be met, the projected policy payouts have significantly reduced compared with the level expected before this event. Similar problems occurred in Germany with the near insolvency of Mannheimer Leben in 2003. The company's portfolio was moved into the Protektor Pool, set up by the German insurance federation and capitalised by German life insurers to safeguard policyholders by ensuring a controlled run-off of such blocks. Until very recently, the insolvency of a German insurer would have been considered unthinkable and, even now, some parts of the industry do not seem to have fully grasped the threat they face. Successfully managing a controlled insolvency of a financially-impaired insurer is closely related to the level of solvency capital held by the firm at the point of insolvency. Therefore, while these events have boosted support for mark-to-market reporting and enhanced corporate governance, one of the major regulatory themes resulting from these developments has been a move towards risk-based calculations for solvency capital requirements.

Public scandals relating to accounting

The well known scandals at Enron, WorldCom and Parmalat made global headlines. Whilst these are not insurance companies, it should not be assumed that these events have not impacted the insurance industry: the resultant focus on sound corporate governance will affect all industries, and those with complex and long-term assets or liabilities, such as insurance, will be harder hit than others. The final regulatory theme considered in this paper is the move towards stronger corporate governance.

Consumer protection

It could be argued that the general increase in consumer protection in many developed economies in recent years has created a regulatory focus in this, fourth, area – including limitations on underwriting, product design and distribution methods. However, with the exception of the EU ‘Gender’ Directive¹, this trend has been fragmented across Europe, with the majority of such changes occurring in the UK. In years to come, such a trend will likely affect a broader European base. These issues are not, however, explored further in this paper.

The following sections consider the first three of the above themes and outline the recent or upcoming regulatory changes and proposals associated with each. In many cases, a particular area of regulation is connected with more than one theme but, for ease of reference, the commentary is set out where the link is strongest.

Fair value reporting

The move to fair value reporting is, for many reasons, considered to be a positive step. A primary cause of this change is a desire on the part of regulators to avoid a repetition of the huge losses associated with Guaranteed Annuity Options in the UK, Guaranteed Minimum Death Benefits in the US, and Guaranteed Minimum Interest Rates in Continental Europe. There is also a desire amongst the accounting profession, rating agencies and investment analysts for better comparability between the insurance industry and other financial services companies.

The general principle of fair value reporting is that all balance sheet entries should be recorded using the price at which the asset or liability could be disposed of today in a liquid market. The challenge of such an approach for life insurers is that there is no liquid market for the majority of their liabilities and it is unclear to what extent policyholder behaviour, based on past experience, can be used in estimating market value. In practice, this means that insurance company liabilities are split into those which are purely actuarial in nature, such as death or disability claims, and those which are closely linked to the investment environment, such as surrender and maturity values. The terms “marked to market” and “market consistent” are also used to describe this approach and are, to a great extent, interchangeable.

The centre of attention at the current time is the new International Financial Reporting Standards (IFRS) for insurance. More widely, this theme covers a variety of associated developments within Europe and Asia, including the new European Embedded Value rules and the accounting aspects of Solvency II².

IFRS 4

IFRS 4 deals with insurance contracts and is part of the IFRS³ standards which are published by the International Accounting Standards Board (IASB). More importantly, for EU-based companies, the prevailing member states agreed in July 2002 that all publicly-traded companies in the EU must prepare their consolidated accounts on an IFRS basis with effect from 1 January 2005. The IFRS rules have been accepted as drafted with one exception: IAS 39 (Financial Instruments: Recognition and Measurement). Some paragraphs within IAS 39 were ‘carved-out’ and not endorsed by the EU. This applies to the so called “fair value option”, dealing with the option to use a fair value measurement approach for insurance liabilities, and the so called “macro hedging”, which is particularly relevant for banks. Besides the EU, jurisdictions including

¹ European Directive on Equal Treatment Between Women and Men in the Access to and Supply of Goods and Services

² See below for further discussion and an explanation of Solvency II.

³ More information about IFRS is available in Swiss Re’s *sigma* No 7/2004.

Phase 2

The date for implementation of Phase 2 has not yet been confirmed, but it will be later than the original plan of 2007. Phase 2 will focus on the fair value measurement of insurance liabilities.

The insurance industry will face a time of much greater volatility in reported earnings and equity capital during Phase 1. This is because most financial assets will be valued under IAS 39 at fair value while insurance liabilities will continue to be reported on current standards, which generally use a locked-in nominal valuation method. Insurers do have the option to classify their assets as “held-to-maturity” which would minimise the problem, but the highly penal ‘tainting’ rules that come into play if a held-to-maturity asset is sold make this a dangerous and, likely, unpopular option. Although this volatility is based on inconsistent accounting bases rather than on economic reality, insurers will certainly expend a large amount of resources on communicating this fact to investors and analysts.

A key component of the new IFRS rules is the classification of insurance policies as “insurance” or “investment” contracts, with or without the need to unbundle the separate elements. For many types of policy, the Phase 1 rules will not require a change to liability calculations. However, the same categories will be applied in Phase 2 and “insurance” contracts will be subject to, as yet, unknown fair value accounting standards. Also, some insurers may find their reported premium volume dropping sharply under IFRS. This is because policies with little true insurance risk may be classified as investment contracts and valued under IAS 39 as deposits rather than insurance contracts. Table 1 and Figure 3 below show how some common types of insurance policies will be treated and illustrate the decision process used to determine which rules apply to a given policy.

Classification of Insurance Contracts under IFRS 4			
	Insurance contract: significant insurance risk	Investment contract: insignificant insurance risk	Classification unclear
Term life, disability and critical illness	X		
Pure endowment	X		
Whole life	X		
Deferred annuity with insurance risk (i.e. conversion rate set prior to retirement age)	X		
Guaranteed investment contract		X	
Variable or unit-linked life without significant death benefit		X	
Savings contract with lapse or expense risk only		X	
Deferred annuity with no insurance guarantee (i.e. conversion rate set at retirement age)		X	
Annuity with return of premiums on death			X

Sources: Ernst & Young, Swiss Re Economic Research & Consulting

Table 1

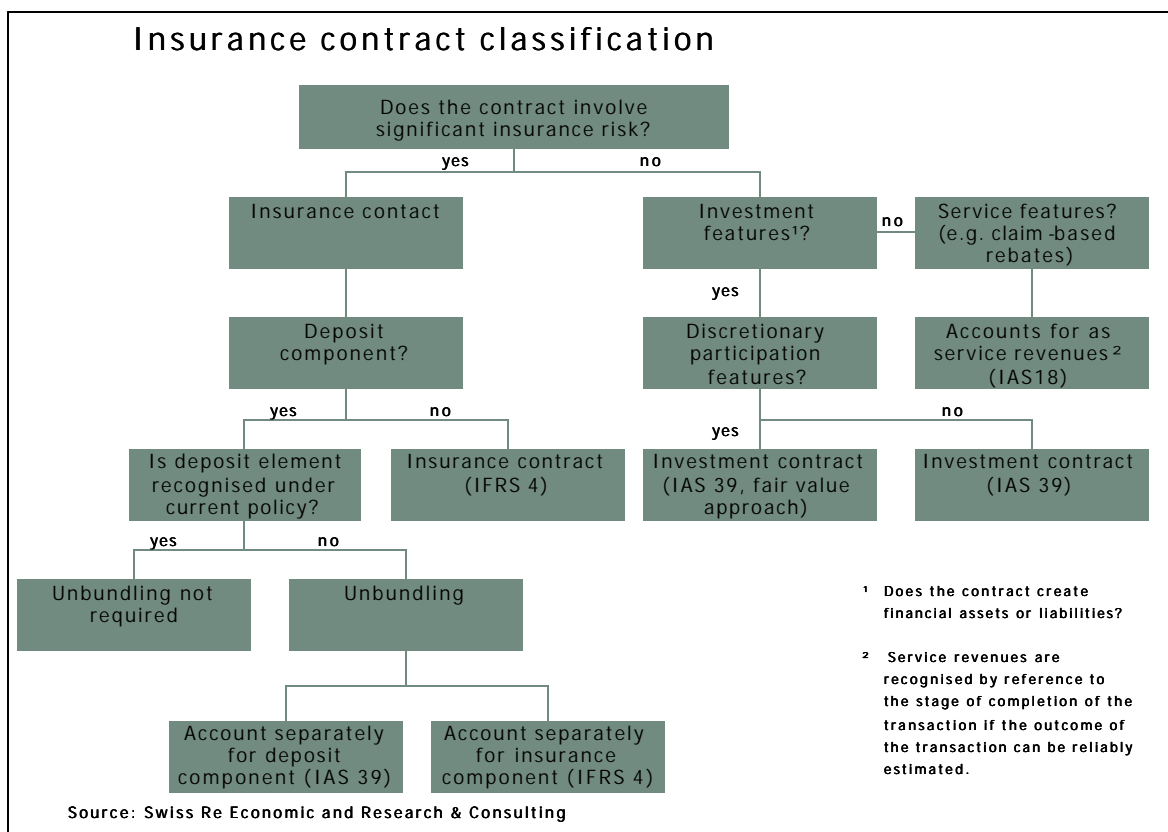


Figure 3

The real impact of implementing the IFRS rules for insurance companies will only be felt in Phase 2. One likely outcome is that investment guarantees, whether on death, surrender, or maturity – these have long been a standard part of insurance savings contracts – will be subject to fair value accounting to bring them in line with the valuation of financial assets. While this will eliminate the volatility problem described earlier, it may also significantly increase the reported value of many of these embedded options, hence increasing insurers' liabilities. The exact rules to be implemented in Phase 2 have yet to be set; the IASB has stated that it regards previous work on this topic as a useful resource but that it does not feel bound by it. It is likely that the solvency regulation relating to valuation of insurance liabilities now being implemented in the UK, Switzerland and the Netherlands will have a significant impact on the final design.

Ahead of Phase 2 and its possible effect on liability calculations, accounts that are prepared in accordance with IFRS 4 will require a large volume of disclosure regarding risk and sensitivity to key assumptions, allowing investors to understand more about the existence and scale of embedded options than has been the case in the past. All assumptions regarding major risks including mortality, equity exposures, credit default and many more must be disclosed. The effect of each such risk on the amount, timing and uncertainty of future cash flows from insurance contracts must be demonstrated. In addition, the insurer's risk management objectives and policies relating to these risks must be set out.

In response to this uncertainty surrounding liability valuation and increased disclosure, along with a similar issue raised by Solvency II, many insurers are reducing or eliminating the guarantees offered in their products. However, these guarantees are one of the key differentiating factors for life insurance investments and it is likely that they will be reduced and priced-for more appropriately rather than disappearing entirely.

Risk-based capital requirements

Historically, most solvency requirements for the insurance industry, including the existing EU regulations, were calculated using highly simplified formulaic methods which did not recognise many of the diverse risks inherent in a life insurance operation. Several countries have already moved to a more complex risk-based method. These include the US (Risk-Based Capital), Canada (Minimum Continuing Capital and Solvency Requirements) and Australia (Solvency and Capital Adequacy Standards). Driven by the insolvencies of recent years and linked to the new risk-based concepts developed under the Basel II regime, the EU member states, Switzerland, Taiwan, Singapore and others have enacted, or are in the process of enacting, similar legislation. The key aim of the regulators in designing these systems is not to guarantee against any future financial impairment whatsoever, which would be impossible, but to catch companies sufficiently early to enable a controlled run-off, the transfer of business to a more solvent insurer, or a solution paving the way for a company to trade through its difficulties.

As outlined below, the main regulatory change linked to this driver in Europe is Solvency II and a number of related developments (“Solvency II” is the project name given to the “fundamental and wide-ranging review of the overall financial position of an insurance undertaking” that began in 2000). This theme also includes the EU Financial Conglomerates Directive, which seeks to avoid the double leveraging of capital within a group, and the EU Reinsurance Directive, which will bring European reinsurers within the framework for insurance solvency regulation.

Solvency II

Currently, Solvency II is work in progress, with many of the key elements still subject to debate. The European Commission is aiming to propose a draft Directive in 2006. Recent experience with Basel II has shown that the scale and complexity of such broad regulation will require significant time to complete and will need to include extensive industry consultation. Based on the current timetable, a new EU-wide solvency regime for insurers and reinsurers will not be in place prior to 2009.

However, several sources of information may provide an early insight into the final form of the Solvency II regulation. The UK, the Netherlands, and Switzerland have already drafted legislation incorporating many of the principles underlying Solvency II. It is broadly accepted that the regulation in these three countries, and the problems they will inevitably encounter in implementation, will heavily influence the development of the EU-wide regulation. All of the new solvency measurements in these three countries share the following features:

- Capital levels are targeted to allow a safe run-off of the existing insurance liabilities
- Scenario testing is used in setting target solvency levels
- Company-specific capital models are considered and even encouraged
- Assets and liabilities are valued on a market-consistent basis
- The measures complement, rather than replace, the existing solvency standards
- A degree of risk management regulation beyond pure solvency requirements is included

The basic form and implementation of the relevant solvency measures is as follows:

United Kingdom

The solvency aspects of the new UK regulation can be separated into two key aspects, both of which are in force for the 2005 reporting year.

The first is the Enhanced Capital Requirement (ECR), which builds on the existing UK solvency requirement by introducing alongside it a more ‘realistic’ market-consistent solvency test. The

ECR and the existing requirement are collectively referred to as the “twin peaks” test. The use of ECR has been restricted to life insurers with aggregate with-profits liabilities of GBP 500 million or more. These firms represent 95% of the total UK with-profits life insurance liabilities. In addition to using a market-consistent approach, the ECR allows for discretionary benefits whereas the traditional solvency test only considered guaranteed benefits. It also relaxes some very conservative assumptions, such as the assumption that all policyholders will elect to take any guaranteed annuity option.

The second aspect requires all companies to perform and submit to the Financial Services Authority (FSA) an Individual Capital Adequacy Standards (ICAS) assessment. Note that the UK system requires each insurer to develop a company-specific capital assessment based on its own particular mix of risk factors. The FSA’s stated aims in implementing the ICAS system are:

- For firms to hold capital that is appropriate to their particular business and to control risks
- To emphasise the responsibility of a firm’s senior management for ensuring that the firm has adequate financial resources
- To provide incentives for better risk management
- To enhance consumer protection and market confidence through a reduced, but non-zero, risk of financial failure

The results of the ICAS assessment will be reviewed by the FSA. Based on the ICAS results, the regulator may require the company to hold additional capital in excess of the normal twin peaks requirement. The need for such additional capital is confidential between the regulator and the insurer.

Netherlands

The Dutch regulator has consulted extensively with the insurance industry and intends to launch its new solvency regulations, Financieel Toetsingskader (FTK), in 2006. Under FTK, an insurer’s available solvency capital is the difference between the market-consistent value of its assets and its liabilities. This is then measured against the required solvency capital over a one-year time horizon, measured on one of three bases: a simplified model for use by small companies, a standard model, or the insurer’s own internal economic capital model. Because it is assumed that any internal model put forward by an insurer will produce a lower result than the standard model, even though an insurer may be eligible for use of an internal model, it must also report the level of capital required by the standard model.

The Dutch regulator plans to extend the one-year capital projection through the use of a continuity analysis. This additional analysis will include a five-year time horizon, projection of new business over that period, and management response to the various scenarios considered. A continuity test should be performed by every Dutch insurer before the end of 2008.

Switzerland

The Swiss Solvency Test (SST) is a new solvency measure to be gradually implemented as from 2006. According to market observers, capital requirements for insurers may increase significantly. The capital requirement under the SST is based on financial risks, including market and credit risks, and insurance risks. This ‘target’ capital is the total amount of capital required under the SST and is composed of two components; the one-year risk capital and the risk margin. The risk margin is defined as the regulatory capital needed to support the run-off of a book of insurance liabilities, assuming a risk-free portfolio of assets. The one-year risk capital is defined as the amount of risk-bearing capital necessary today to survive for one year under various scenarios (such as stock market crashes of 1987 and 2000, and the 1918 influenza epidemic translated into today’s scale) at a 99% confidence level. Where the nature of liabilities requires it, stochastic

analysis or option pricing techniques must be used to assess the market consistent value of liabilities.

Increased corporate governance

After the shocks at global giants like Enron and Parmalat, the accounting profession and various regulatory bodies have started to push towards a much stronger risk control environment for all companies. As mentioned earlier, this is having a particular impact on the insurance industry due to the need for it to estimate many of its liabilities.

To a great extent, this final theme overshadows the previous two. The fair value approach ensures that investment guarantees are reasonably valued and consistent with other financial services companies, and the move to risk-based capital ensures that companies have sufficient funds to continue operating. However, neither of these changes would provide much extra comfort if the reported figures and risks could not be relied upon. The new corporate governance regulation will demand an unprecedented level of documentation and independent scrutiny and impose significant personal liability upon decision makers.

While this move to increased corporate governance can be seen in many areas of regulation, including the non-capital related sections of Solvency II and its predecessors, the main regulatory change linked with this theme is the Sarbanes-Oxley Act in the US.

Sarbanes-Oxley

The Sarbanes-Oxley Act (SOX) came into force in June 2002, following which the Securities and Exchange Commission (SEC) implemented the legislation in the form of rules for US publicly-traded companies. The primary goal of the Act is to restore investor confidence in a company by improving the quality and transparency of its financial reporting. CEOs and CFOs must now make a formal statement related to the controls and procedures related to financial reporting of the company for which they are responsible. The implementation of SOX has been charged to the Public Company Accounting Oversight Board (PCAOB), which was created by the legislation and sits at the SEC. The SOX regulation is comprised of a number of sections which are summarised in the Appendix.

SOX applies to all publicly-traded companies in the US, including foreign private issuers. As such, SOX is largely expected to be adopted by global corporations in their corporate governance as best practice. Certainly, a list of companies, including all those with a US parent, a US equity listing or the need to keep the option of such a listing open, would include most major international European insurers. Given the similarity between SOX and some of the disclosures required under IFRS 4 and Solvency II, SOX-style compliance is expected to spread even beyond this broad group of companies as a gold-standard of best practice risk management. Also, as with the new country-specific solvency regulation covered earlier, the successes and failures of the SOX implementation will be heavily influential on Solvency II. Therefore, this US-based legislation is having a significant impact on large European insurers.

The implementation of SOX and its formal requirements of independence, accountability, integrity and transparency are intended to re-establish the trust of the investor and the investment community. Key amongst these wider stakeholders are the rating agencies which, as a result of the newly-defined clarity, will be able to add further support to investor confidence by providing a more autonomous analysis than was previously possible. Auditors will also reap the positive effects of SOX by being able to demonstrably show the complete independence of their opinion. Such stringent internal controls will play an important part in restoring investor confidence in corporations.

Ensuring compliance with SOX, and being able to demonstrate effective control over internal systems and financial reporting, is a complex and time-consuming project. Many corporations are testing tens of thousands of controls across the entire company. Section 404 (see section 4 of the Appendix, on Enhanced Financial Disclosures), which refers to the internal control structures and the issuer's publication of the scope, adequacy and effectiveness of such structures for financial reporting, is one area of SOX which is proving to be particularly costly to implement and effectively audit.

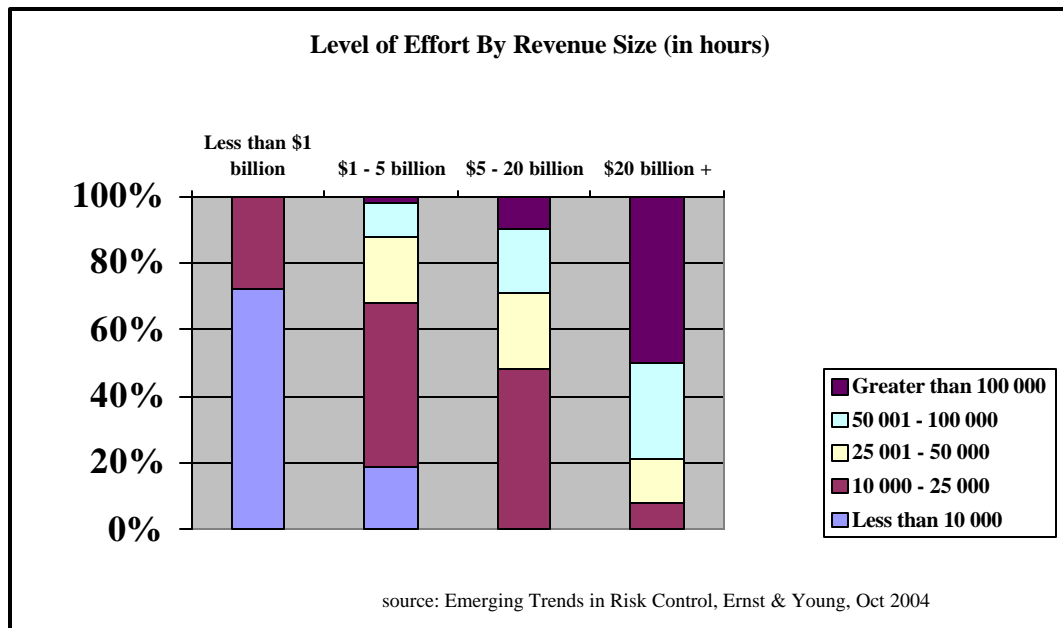


Figure 4

As Figure 4 illustrates, the largest companies – those with greater than USD 20 billion in annual revenue – anticipate that they will spend more than 100 000 hours ensuring compliance with SOX, and Section 404 in particular (note that this chart covers all industries, not just insurers). This spend is due to the large number of controls being identified for testing, the implementation of a technology platform to assist with implementation, the time necessary on the part of senior executives for oversight and communication, and the cost of sustaining compliance after the initial implementation phase.

For many corporations, preparing for SOX brings a time of in-depth and comprehensive internal changes, which may alter the very foundations of how the company operates. For many companies, such exhaustive analysis is both necessary and, possibly, long overdue and will be of benefit in the long term by ensuring compliance with SOX and, ultimately, the confidence of the investment community.

Likely impact on the insurance industry and products

The new regulatory measures discussed above – fair value reporting, risk-based capital requirements and increased corporate governance – will trigger a variety of product changes. These potentially include a reduction in the level of investment guarantees, more insurance risk being added to savings policies to ensure the desired IFRS classification, and various structural changes to maximise capital efficiency under the new solvency rules. However, one of the largest

impacts will be indirect, namely the dramatic increase in the cost of regulatory compliance for the insurance industry.

Costs of compliance

Taking Figure 1, used earlier in this report, and adding a *hypothetical* line to infer the cost of compliance, may produce a result along the following lines:

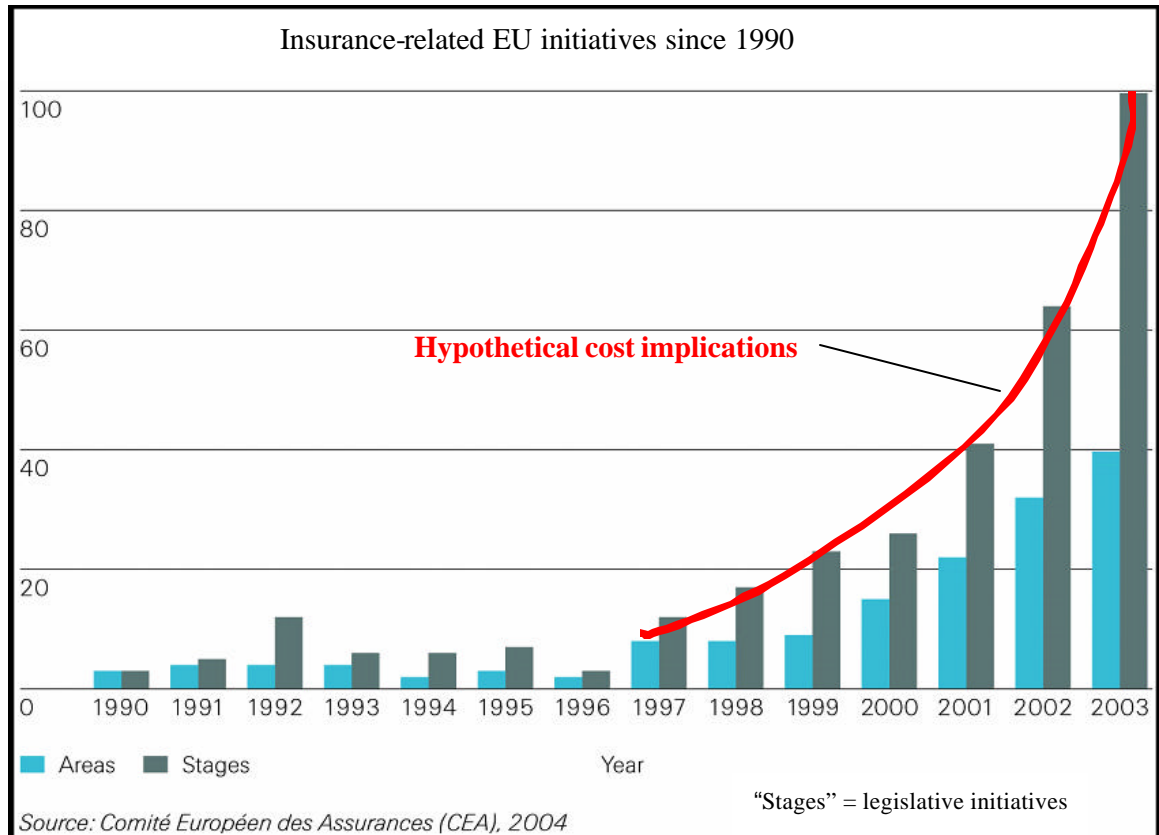


Figure 5

The reason it has proved necessary to speculate so widely about this cost line is because it is very difficult to source any firm estimate of the total cost. However, the following quotations give a flavour to the issue and show the level of concern present in the industry about regulatory costs :

“Protection insurance [in the UK] will be regulated by the Financial Services Authority (FSA) for the first time from January 14. Insurers will then have to follow more stringent sales procedures. But the cost of regulatory compliance will probably be borne by the consumer. Kevin Carr of Lifesearch, a broker, said: ‘Insurers will need to introduce new systems, which will cost money. We believe protection insurance of all kinds will increase in price by between 10% and 20% by the end of 2005.’”

Sunday Times, 14 November 2004

“Simply to conform to the European-based Basel II risk management framework ... means UK firms will have to spend about USD 360 million purely on IT by 2006 compared with USD 240 million in 2002. Moreover, to comply with the new Pensions Bill, the UK’s five largest life and pensions companies will each spend between GBP 15 million and GBP 30 million on overhauling their IT systems (according to Accenture).”

MIS UK, 1 July 2004

“Excessive industry regulation also raised concerns. 72% of chief executives said they were very worried about the growing cost of FSA and EU regulation.”

Survey by the Association of British Insurers, 2004

“IFRS implementation, domestic regulatory reform in many if not most countries of the EU ... and the reform of insurance solvency all demand significant resource and management attention...”

PwC, Nov 2003

The Geneva Association surveyed 40 leading insurance and reinsurance corporations worldwide and found some consensus on the cost of implementing a full fair value or fair-value valuation system as required for both Solvency II and IFRS Phase 2. The results of this study are shown in Table 2.

	Initial increase as % of current direct reporting costs	Longer-term impact as % of current reporting costs	Increase in total operating costs
Life	Around 35%	Around 30%	Around 5% *
Non-life	Around 30%	Around 20%	Around 4% *

* These estimates varied considerably between companies, however they fell mainly in the range of 3% to 10%.

Source: Geneva Association (2004), Impact of a Fair Value Financial Reporting System on Insurance Companies, A Survey

Table 2

The cost of complying with all of these extra regulatory obligations coincides, somewhat painfully, with a time when low interest rates, in itself a partial driver of the changes, have already trimmed insurers’ profit margins to a minimal level. Despite the above quote from MIS, which focuses on distribution regulation, it is often the case that these costs are directly impacting insurers’ margins.

Opportunity costs

A second effect of the current volume of regulation is that it distracts key staff from product development while they focus on compliance issues. Every company has its core of intelligent, experienced and reliable managers – people who make things happen – who have historically focussed their efforts on distribution and product development. However, these individuals are focusing an increasing amount of time on new processes and systems to deal with the regulatory deluge. Even before a new item of regulation comes into force, lobbying and ensuring that an insurer’s views are appropriately represented in the consultation process absorbs experienced resources. This change of emphasis has significantly reduced the amount of real product innovation seen in the European markets over the last five years. Clearly, compliance is key in the interests of sound markets and consumer protection, but the balance in terms of where peoples’ attention is focused needs to be redressed if the industry is going to meet consumer needs and desires effectively.

Proportionality

Finally, the cost of compliance does not, in most cases, increase linearly with the size of the insurer. This, combined with the financial impairment caused by the overall falls in bond and equity values, has created an environment in which consolidation has occurred, and is likely to accelerate rather than slow down. Figure 6 shows that, in many primary European markets, the number of life insurers has generally declined. It is also interesting to note that, of the five markets shown, the two who are leading the way in regulatory reform are also leading the consolidation process. This relationship is only partially direct of course, as the same financial difficulties that pushed the UK and Swiss regulators to accelerate the pace of regulatory change are also part of the reason for the consolidation in the market. These figures show the companies which are still operating and include those closed to new business. The number actually open to new business has declined at a faster pace than suggested here.

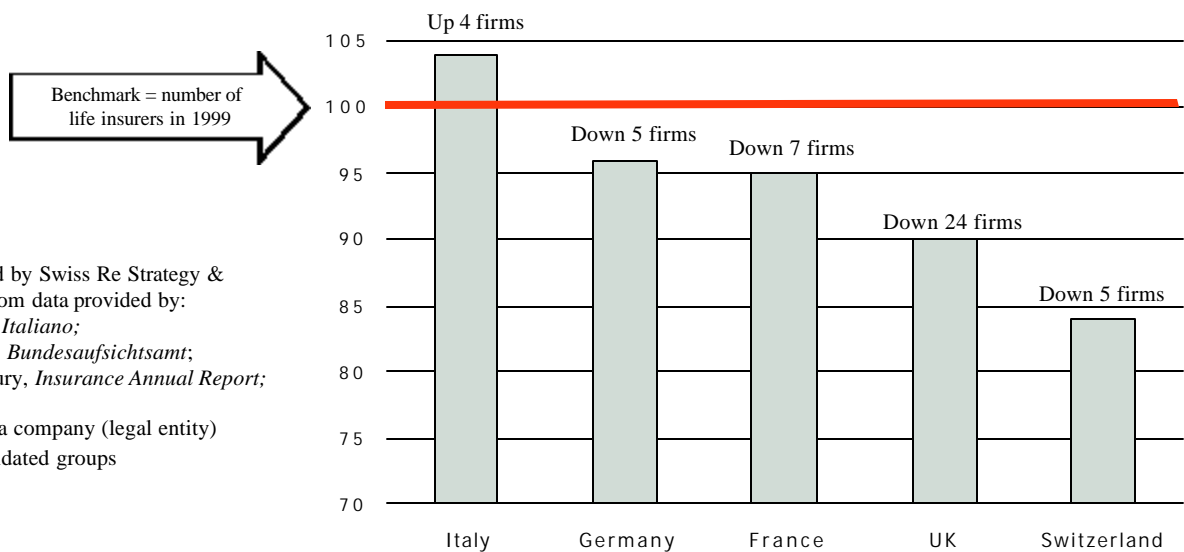


Figure 6

Overall, it appears that the life insurance industry, both in Europe and globally, will face several more years of regulatory development and it is unlikely that a stable operating environment will be established much before the end of this decade. However, it is likely that many of the systems and process changes required to deal with these changes will be established within two to four years of today, bringing a welcome return towards further investment in product development.

Appendix – Sarbanes-Oxley Act

The SOX regulation is comprised of the following sections:

1. Public Company Accounting Oversight Board (PCAOB)

This section establishes a five member board, the PCAOB, which is charged with the oversight of the audit of public companies, establishing audit report standards and rules, and the inspection of registered public accounting firms and their associates. The PCAOB can impose disciplinary or remedial sanctions on registered firms and their associates for intentional conduct or repeated negligent conduct

2. Auditor Independence

This section sets out the various measures of independence, the required reporting lines, and minimum reporting standards from the auditors to the audit committee.

3. Corporate Responsibility

This is one of the key sections of the act for many companies. In addition to setting out detailed rules for the selection and actions of a company's audit committee and setting out rules on stock trading blackout periods, this section requires the CEO and CFO to personally certify a number of elements of the financial reports. These include:

- That the report does not contain untrue statements or material omissions and the financial statements fairly represent the financial conditions and results of operations
- That they, and other certifying officers, are responsible for establishing and maintaining disclosure controls and procedures and have designed such disclosure controls and procedures to ensure that material information is made known to them during the period in which the periodic report is being prepared
- That the disclosed internal controls have been reviewed for effectiveness within 90 days prior to the report
- That any significant changes to the internal controls have been disclosed
- That any significant deficiencies or material weaknesses in the internal controls have been disclosed to the audit committee and outside auditors

The clear personal statements from key senior managers that they take responsibility for the above factors is core to the SOX approach. These individuals are responsible for having the disclosed controls in place and working effectively. This responsibility cannot be delegated although, of course, execution will be.

4. Enhanced Financial Disclosures

Section 4, and more specifically section 404, is the most talked-about section of SOX. This outlines in detail the internal control structure and procedures that must be in place and disclosed. Entitled *Management Assessment of Internal Controls*, Section 404 states that companies must take responsibility for maintaining an effective system of internal control and must obtain an external auditors report on the system's effectiveness. This process is expected to include:

- Documentation of all internal controls relating to assertions in the financial statements of the company (note that the enhanced disclosures under SOX broaden this list beyond controlling the pure numerical entries)
- Testing of all controls sufficient to develop and maintain evidence of their effectiveness
- The use of third party assistance, external or internal, for assistance but without delegation of responsibility

- A disclosure of any material weakness found during testing
- A prohibition against claiming fully effective controls if one or more material weaknesses are found during the audit process or management testing

SOX defines a “material weakness” as a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a *material* misstatement of the financial statements will not be prevented or detected. In turn, a “significant deficiency” is defined as an internal control deficiency that adversely affects the company’s ability to initiate, record, process or report information in its external financial statements reliably in accordance with GAAP. A significant deficiency is a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential in amount will not be prevented or detected.

Considering, as outlined in the main body of this paper, that many large firms have identified tens of thousands of individual controls, the sheer scale of effort required for documentation and testing is potentially overwhelming.

In addition, this section includes issues such as requiring senior management, directors and principal stockholders to disclose changes in securities ownership or securities-based swap agreements within two business days, mandates electronic filing and availability of such disclosures one year after the date of enactment and, with some exceptions, prohibits personal loans extended by a corporation to its executives and directors.

5. Analyst Conflicts of Interest

This section contains detailed requirements for investment analysts to prove the absence of, or disclose, conflicts of interest. For example, it requires specific conflict of interest disclosures regarding the company in question by research analysts making public appearances and by brokers or dealers in research reports including:

- Whether the analyst holds securities in the public company
- Whether any compensation was received by the analyst or broker or dealer
- Whether the public company is, or during the prior one year period was, a client of the broker or dealer
- Whether the analyst received compensation with respect to a research report based on banking revenues of the registered broker or dealer

6. Commission Resources and Authority

This section outlines the authority of the SEC, whose remit is expanded as a result of the act, and provides for the hiring of at least 200 additional qualified professionals to provide improved oversight of auditors and audit services.

7. Studies and Reports

This section describes and initiates a variety of reports and studies including:

- Role of credit rating agencies in the securities markets
- Act violations and SEC enforcement actions

8. Corporate and Criminal Fraud Accountability

This section sets out a variety of modifications to existing fraud rules, such as:

- The imposition of criminal penalties for failure of an auditor to maintain for a five year period all audit or review work papers pertaining to an issuer of securities

- The provision of whistleblower protection to prohibit a company from retaliating against an employee because of any lawful act by the employee to assist in an investigation of fraud
- Mandating the fining or imprisonment of any person who knowingly defrauds shareholders of publicly traded companies

9. White Collar Crime Penalty Enhancements

This section requires the CEO and CFO to submit a statement with specified filings stating that the filing “fully complies” with the Exchange Act reporting requirements and “fairly presents” in all materials respects the company’s financial condition and results of operations. It also establishes criminal liability for falsifying such statements including a maximum of 10 years imprisonment and a fine of up to USD 1 million for knowingly making false certification under the act or a maximum of 20 years and USD 5 million for willful violations of the act.

10. Corporate Tax Returns

This section supports the signing of federal income tax returns of a corporation by its CEO.

11. Corporate Fraud Accountability

The final section again focuses on a variety of enforcement clauses for breach of the act. These include:

- A prison term of upto 20 years for tampering with a record or otherwise impeding an official proceeding
- Authority for the SEC to seek a temporary injunction to freeze extraordinary payments for designated persons or corporate staff under investigation for violations of Federal securities law
- Increased penalties for violations of the Securities Exchange Act 1934 to upto USD 25 million and upto 20 years in prison