

Issue Brief

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SOX Title IV Update: 'Guiding Principles' to Add Section 404 Content to State Regulation Still 'Problematic' for Mutual Companies

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Executive Summary

NAMIC has engaged in lengthy and expensive remonstrance against the NAIC's proposal to add objectionable elements of the federal Sarbanes-Oxley (SOX) Act to state regulation. NAMIC members' concerns have been focused on SOX prescriptions in the Act's Section 404 that would cause mutual insurers to perform expensive and burdensome measures about internal accounting control.

Although the federal Act was directed at publicly owned corporations, including "stock-company" insurers regulated by the U. S. Securities and Exchange Commission, state insurance regulators proposed in early 2004 that non-public insurers be subject through state insurance regulation to SOX-like prescriptions. This proposal for symmetry between state and federal regulation with respect to SOX Titles II, III, and IV was made without deliberation by state regulators on the crucial matter of whether there existed any weakness in state regulation. NAMIC companies have also noted that such added regulation is unwarranted and does not deliver solvency benefits remotely commensurate with implementation costs.

Confronted with NAMIC's reasoned remonstrance and similar objection from other insurer trade associations, regulators most closely associated with adding SOX content have asserted the "full blown 404" is no longer under consideration. Although they have scaled back their initial project, they remain determined still to add some measure of such incremental regulation to state solvency regulation.

An NAIC committee, known as the Title IV Subgroup, is now laboring, often via contentious deliberation, toward that end. One device for the added regulation they propose is a list of "guiding principles" that generally frame SOX content imported into state regulation. An August 11 update of "guiding principles" for building certain Sarbanes-Oxley (SOX) Act content into state solvency regulation remains problematic for non-public insurers.

Analysis of the Guiding Principles

A product primarily of input from regulators and from insurers already compliant with requirements of SOX Section 404, the "guiding principles" are the desiderata of some solvency regulators for moving the most burdensome SOX strictures from the world of SEC-regulated corporations into the realm of state solvency regulation applied to insurers. The "principles" are intended by Title IV Subgroup as the bridge for moving SOX content on internal accounting controls into what states would apply to all insurers, including mutual companies.

Created originally during a Subgroup meeting in April, 2005, and slightly modified during an August 11, meeting of the Title IV Subgroup, the “Guiding Principles” remain problematic for mutual insurers.

The Subgroup is nexus the of deliberation on adding the SOX Section 404 content on internal accounting controls to the NAIC’s Model Audit Rule, which is used by all states and could, if amendments become part of the NAIC accreditation system, apply to all insurers, including mutuals.

NAMIC’s approach to transplant of the SOX Section 404 content into state solvency regulation is that it is not warranted, based on occurrence of insolvencies among mutual insurers, and is too expensive. That position has been stated repeatedly to the Title IV Subgroup, the NAIC committee considering the transplant, and demonstrated in NAMIC’s cost-benefit study of the Section 404 content as may apply to non-public insurers, of which mutual insurers are the largest component. While regulators have scaled back the scope of their initiative, the “principles” they have offered still present questions and concerns.

Cost Effectiveness

The “principles,” appended below at least acknowledge that the additional regulation contemplated—the 404 content on internal controls or some subset of it—should be cost effective, although what would constitute cost-effectiveness is left undefined. NAMIC’s study on costs and benefits of implementing all of the 404 prescriptions showed \$8 spent for every \$1 saved in guaranty-fund assessments, a negative result that brought NAMIC to oppose addition of the 404 content to state regulation. Proposals now being considered since the NAMIC study was presented in June, would reduce the amount of 404 content that would be transplanted into state regulation. In NAMIC’s view they may still be of dubious benefit for their cost. True economic practicality is the appropriate standard, not providing regulators with comfort that result in net additional cost and no proved benefit.

Regulatory Burden

The cost-benefit principle may have some conflict with another among the “guiding principles” that prescribes a framework for internal control that would appear burdensome for small companies. Sought in that

principle is use of what is known as the “COSO” framework or others. The “COSO” framework, unless greatly simplified, would appear quite burdensome for large-numbers of the NAMIC membership.

Risk-Based Solvency Regulation

Another principle notes that whatever 404 content may be put into state regulation needs to be “risk-based with focus on financial reporting risks.” Most observers, whether reflecting on financial examinations or internal control for GAAP/SAP reporting, agree with the premise of identifying areas of risk—both in terms of probability of failure and materiality of amounts reported—as appropriate for emphasis. Regulators, however, appear to want a rather explicit trade, the elements of which seem to be addition of 404 content to state regulation in exchange for briefer financial examinations. Most in the non-public industry believe that more emphasis on risk does not need to be accompanied by 404 content.

Confidentiality

Confidentiality in reporting of weaknesses in internal control as part of the yearly audit process, including whatever 404 content may eventually apply, appears something both regulators and industry agree on. Inconsistency in confidentiality laws from state to state is now a problem in this context and makes reporting to regulators on matters of internal control still more problematic.

Revised Guiding Principles for Title IV Internal Controls

The “guiding principles” used by the Title IV Working Group, provided by the NAIC and current as of August 11, are as follows:

- Needs to have a solvency focus
- Should be risk based with focus on significant “financial reporting” risks
- Reporting at the appropriate level
- Management should utilize an appropriate (risk) approach for the framework, e.g., NAIC risk assessment; COSO, AICPA definitions and guidance or any suitable framework

- Reasonable implementation dates
- Confidentiality of information provided to regulators
- Should have minimal impact on SEC registrants who have prepared reports required by the Sarbanes-Oxley Act or those who have fully complied with all elements of SOX Title IV provisions on a voluntary basis
- Should address the issues associated with small companies (e.g., limited availability of resources)
- Needs to be part of accreditation process so as to ensure uniformity in implementation and enforcement among states
- Improvements to the regulatory oversight process over internal controls should be cost effective