

# DM EXTRA!

July 30, 2004

## SOX Is Still on a Roll

**At year two, Sarbanes-Oxley influence moves beyond public companies to affect private companies, nonprofits, and mutual funds.**

It has now been two years since President **George W. Bush** signed into law the Public Accounting Reform and Investor Protection Act of 2002. Known as Sarbanes-Oxley (or SOX) after its sponsors **Sen. Paul Sarbanes** (D-MD) and **Rep. Charles Oxley** (R-OH), the law strengthens accounting practices and legal compliance in public companies. But as of its second anniversary, the law's influence continues to reverberate beyond the public company universe.

SOX's forceful impact proves physics' second law of motion: an object's acceleration depends on both *mass* (the smaller the faster) and *force* (the more forceful the faster). Section by section, pushed ever more forcefully, SOX is on a roll.

### Director Summary >

This *DMX* briefly outlines SOX's impact overall on four sectors—public companies, pri-

vate companies, nonprofits, and mutual funds—with a note about the law's overall impact on director and officer (D&O) liability insurance.

### SOX Impact on Public Companies

Strictly speaking, most of SOX applies only to public companies (with one exception noted in the final bullet point on page 2). But this does not mean only companies traded on the self-regulatory organizations (SROs)—the **New York Stock Exchange**, **NASDAQ**, and **Amex**—it also means all companies that register securities with the **Securities and Exchange Commission (SEC)**.<sup>1</sup> Thus, roughly 15,000 companies are affected directly by the law. All these companies are feeling the momentum of SOX thanks to actions from the SEC, the courts, the SROs, and the new accounting oversight board.

## About NACD

**National Association of Corporate Directors (NACD)**, an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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## Since President Bush signed SOX into law, the SEC has issued 75 new rules, many of them pertaining to the law.

**SEC Actions.** Implementation of Sarbanes-Oxley has been through the SEC, which sets forth rules affecting public companies (that is, all companies selling securities to the public). Since President Bush signed SOX into law, the SEC has issued 75 new rules, many of them pertaining to the law. See <http://www.sec.gov/rules/final.shtml>. Past DMXs have described the sections that have the most impact on corporate boards—namely:

- **Section 201.** Services Outside the Scope of Auditors (banning nine types of professional services deemed to be consulting rather than auditing).
- **Section 301.** Public Company Audit Committees (strengthening the requirements for independence).
- **Section 307.** Rules of Professional Responsibility for Attorneys (stating that if companies do not respond to their concerns, attorneys must report them to regulators).
- **Section 404.** Management Assessment of Internal Controls (requiring companies to have an internal audit function to be evaluated by management).<sup>2</sup>
- **Section 406.** Codes of Ethics for Senior Financial Officers (requiring companies to have an ethics code, and defining such a code).
- **Section 407.** Disclosure of Audit Committee Financial Expert (requiring audit committees to have such an expert).
- **Section 409.** Real Time Issuer Disclosures (speeding time frame for disclosures).
- **Section 806.** Protection for Employees Who Provide Evidence of Fraud (protecting whistleblowers in both public and private companies).

For details on final SEC rules in these areas, see past DMXs (<http://www.nacdonline.org/dm/xtra.asp>).

**Court Actions.** Courts have been busy enforcing Section 806 in particular over the past two years. At least seven companies have had to deal with lawsuits from people suing companies under this section, claiming to be victims of retaliation after blowing the whistle on alleged impropriety. Many of the defendants have been

large public companies—e.g., Coca-Cola, Levi-Strauss, Lucent, and Xerox. Some, however, have been small: e.g., Cardinal Bancshares, Colonial Bank, and TXU Corp.<sup>3</sup>

By definition, Section 806 lawsuits have come from employees—always a major source of lawsuits against directors and officers, research shows. See [http://www.towersperrin.com/tillinghast/press/2004\\_press/pr01262004.htm](http://www.towersperrin.com/tillinghast/press/2004_press/pr01262004.htm). But rank-and-file employees are not the only ones who can blow a whistle. At least one Section 806 lawsuit came from an advisory board member employed by the firm. The complaint against Colonial came from **Anthony Gonzalez**, chairman of the bank's local advisory board. (Gonzalez approached Colonial's two top officers after learning that they had started a side business in competition with the company. When they ignored his comments, he informed the parent company. Gonzalez alleges that he was fired the next day.)

**SRO Actions.** Section 301 of SOX requires the SROs to improve their listing standards for audit committee independence. This requirement spurred completion of a long-time SRO effort to tighten corporate governance requirements for listed companies. It is hard to believe that a short two years ago, the SROs required only the audit committee to be independent. Now at NYSE all three committees (audit, compensation, and governance) must be independent, among other changes. NASDAQ has followed suit, but allows the independent directors acting as a group to function as the compensation and/or governance committees, if the company has not established such committees. For a chart comparing new SRO standards, see [http://weil.com/wgm/cwgmhomep.nsf/Files/SOXACorpGovRequirements/\\$file/SOXACorpGovRequirements.pdf](http://weil.com/wgm/cwgmhomep.nsf/Files/SOXACorpGovRequirements/$file/SOXACorpGovRequirements.pdf).

**PCAOB Actions.** SOX's influence is also expanding because of the **Public Company Accounting Oversight Board (PCAOB)** (<http://www.pcaob.us>). Although this board does not regulate companies directly, its authority to regulate accountants does have an indirect effect on companies and their audit committees.

### SOX Impact on Private Companies

SOX applies mainly to the nation's 15,000 public companies, as noted above. It preempts any state laws pertaining to public companies. But what about private companies? Not surprisingly given the nature of our federalist system, state legislatures have adapted SOX-like provisions to all the corporations in their jurisdictions, including private companies.<sup>4</sup>

A past issue of DMX (see <http://www.nacdonline.org/dm/NACD-May-12-2003-DMX.pdf>) describes pending

## Box 1. Recommendations to Enhance the Independence of Fund Independent Directors

- A fund's board should adopt a statement of fundamental ethical principles to the effect that all actions taken on behalf of the fund must be in the best interests of its shareholders.
- The chairman of a fund's board of directors should be a person who is independent of the investment advisor and of entities affiliated with the advisor.
- At least 75 percent of a fund's directors should be persons who are independent of the investment advisor and of entities affiliated with the advisor.
- The definition of "independent of the investment advisor" should be broader than the definition of "interested person" in the Investment Company Act, adding a requirement that such "independent director" should not have been affiliated with the fund's advisor or its affiliates for at least five years.
- A fund's independent directors should retain knowledgeable independent legal counsel to advise them on an ongoing basis and should have express authority to employ staff, other independent consultants, and advisors to assist them in carrying out their fiduciary duties to the fund's shareholders.
- A fund's independent directors should be solely responsible for determining the level of their compensation.

Source: Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004).

actions in 11 states (California, Colorado, Illinois, Kentucky, Maryland, Montana, New Jersey, New Mexico, New York, Ohio, and Texas) as of mid-2003. Since that time, others including Pennsylvania and Massachusetts have added themselves to the SOX bandwagon.<sup>5</sup> Many of these actions have now resulted in final laws. For example, most recently, on July 1, 2004, inspired by Section 201 of SOX, the state of Illinois passed Public Law 93-683 (SB 2108) requiring the president or CEO to acknowledge in writing if their company's CPA is performing both auditing and nonauditing services. See [http://www.aicpa.org/download/statelegis/StAcctngReformLeg\\_2004.pdf](http://www.aicpa.org/download/statelegis/StAcctngReformLeg_2004.pdf).

The American Institute of Certified Public Accountants, noting the cost of compliance with SOX, has published a 40-page policy paper calling for a "reasoned approach" to state laws mimicking SOX for private companies. See [http://www.pcps.org/pdf/reasoned\\_approach\\_to\\_reform.pdf](http://www.pcps.org/pdf/reasoned_approach_to_reform.pdf). In the paper, the AICPA estimates that SOX is causing an increase of 32 percent in the cost of internal auditing, and an increase of 16 percent in

the cost of information systems. The paper also cites a study from the **Financial Executives Institute** estimating the average cost of SOX compliance for all public companies at \$480,000.

### SOX Impact on Nonprofits

SOX-like rules have moved into the nonprofit sector as well. "Charity Oversight and Reform" was the topic of a June 22 **Senate Finance Committee** hearing. See <http://www.senate.gov/~finance/sitepages/hearing062204.htm>. The committee, co-chaired by **Sen. Charles Grassley (R-IA)**, with ranking minority member **Sen. Max Baucus (D-MT)**, released a staff white paper with recommended courses of action for better oversight. The hearings focused on disclosures in IRS Form 990, pertaining to the independence of persons approving executive compensation. The report suggests changes to increase nonprofit board transparency and accountability, many of them explicitly modeled on SOX.

As noted in a recent report from the **U.S. Chamber of Commerce Center for Corporate Citizenship** (<http://www.uschamber.com/cc/default>), if the new benchmarks for filing Form 990 bring greater uniformity to the reporting process, this will make it "easier for companies to assess the relative efficiency of their social investments." If the changes make it into law, they would "have a significant effect on nonprofit accountability and transparency."

### SOX Impact on Mutual Funds

The reforms mandated by SOX quickly spread to the mutual fund sector. On July 27, the SEC posted a new rule on Investment Company Governance.<sup>6</sup> The new rule requires investment companies to adopt certain governance practices designed to "enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve." The rule is effective September 7, 2004, with full compliance required by January 16, 2006.

The same day, the **Mutual Fund Directors Forum**, chaired by former SEC chairman **David Ruder**, released a report suggesting recommendations and best practices regarding:

- The independence of fund independent directors (see Box 1).
- Oversight of soft-dollar-directed brokerage and revenue sharing arrangements.
- Review of management agreements and management fees.
- Valuation and pricing.
- Effectiveness of fund independent directors with respect to conflicts of interest.

Chairman William Donaldson hailed the Mutual Fund Directors Forum report as required reading for mutual fund directors, saying that “the best practices report complements the Commission’s recent rulemaking initiative to enhance the fund governance framework and represents an independent director-led effort to provide meaningful guidance to fund directors.”

### SOX Impact on D&O Premiums

One of the most obvious effects of SOX was an increase in directors and officers (D&O) liability insurance premiums. They increased approximately 33 percent on average from 2002 to 2003, according to the Tillinghast business of Towers Perrin’s *2003 Directors & Officers Liability Survey*. This is one of the largest annual increases in premiums in decades. Fortunately for boards, premium rates are coming back down in 2004 based on competition in the marketplace.

### Conclusion

Clearly SOX has been on a roll, increasing the burden and costs of compliance, not only for public companies but also for private companies, nonprofits, and mutual funds. Is there any good news? In the upcoming August issue of *Directors Monthly*, NACD President and CEO Roger Raber writes, “An eternal optimist, I see the glass half full, recognizing the many beneficial outcomes of SOX these past two years.” The benefits he cites include general governance improvements such as more “engaged” audit committees.

To ensure that such outcomes remain beneficial for your company, stay vigilant. Ensure that your company’s compliance oversight programs are strong. If you need help, guidance for compliance programs appears in the NACD *Ethics and Compliance Handbook*. See <http://nacdonline.org/publications/pubDetails.asp?pubID=99>. One benefit could be a lower insurance premium. But the greatest benefit of all will be improved governance, a SOX legacy of lasting value.

PS: To keep current on the changing regulatory environment, it’s best to be where the action is. This fall, NACD will hold its annual conference, dedicated to both the current governance revolution and the evolution of future governance initiatives. See <http://nacdonline.org/annualconference/conference04/>. This suggests an unwritten law of motion for governance: *be there!*

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### Endnotes

- 1 These “registrants” register stock under Section 12 of the Securities and Exchange Act of 1934 and file financial information under Section 15(d) of the same act. In addition, many private companies are affected as well, since they have signed bond indentures with covenants requiring that they file periodic reports with the SEC. These companies are referred to as “voluntary filers,” and thus subject to parts of the new law. *DMX* editors acknowledge the expertise of John C. “Jack” Moore III, director of NACD family business initiatives, in writing the private company section of this report.
- 2 For a pertinent standards, see <http://www.pcaobus.org/rules/Release2003-017.pdf>.
- 3 Source: David L. Barron, an attorney with Epstein Becker Green Wickliff & Hall PC, quoted in the *Houston Business Journal*, July 5, 2004.
- 4 Under the federalist system in the United States, both the federal government (Congress) and state legislatures determine laws. The 10th Amendment to the U.S. Constitution, called the “supremacy clause,” states that “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” In 1996, the Congress exercised its power under the supremacy clause by enacting the National Securities Markets Improvement Act, which significantly limited the role of state law in securities regulation.
- 5 See Geoffrey R. Morgan, “Viewpoint: With State Legislators Trying to Extend Concepts of Sarbanes-Oxley, Let’s Not Get Too Comfortable Just Yet,” *BNA Corporate Accountability Report*, May 30, 2003. 414-225-2752 <http://www.mbf-law.com/pubs/articles/sarbanes.pdf>. See also [http://www.mbf-law.com/pubs/articles/sarbanes\\_broc.pdf](http://www.mbf-law.com/pubs/articles/sarbanes_broc.pdf).
- 6 Release No. IC-26520; File No. S7-03-04 17 CFR Part 270, <http://www.sec.gov/rules/final/ic-26520.htm>.