

Regulation

Keep What Works to Make SOX Better

Five reform measures that are worth celebrating. By Christopher Duca

Over the past six years, it has been difficult and at times frustrating for directors to digest the audit bill after paying for the privilege of working through the rigid application of our accounting rules. Directors serve shareholders best in the key areas of strategic planning and oversight of the company's executive management team. Yet a director's value to the company is diminished when too much of a director's time is spent on compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) and the resulting arcane accounting rules.

"While the spirit and letter of [SOX] never contemplated the costly and burdensome result that [404] has generated," said SEC Commissioner Kathleen L. Casey in February, "the law's implementation undoubtedly facilitated such a result."

Accounting firms need to do their part and heed SEC Chairman Christopher Cox's leadership on improving the implementation of 404. In April, Chairman Cox replaced the 404 auditing standard with what he said was "a new, shorter, and completely rewritten standard (AS 5) that is top-down, risk-based, and scalable for companies of all sizes."

Despite 404's difficulties, SOX has brought some meaningful reforms. The five most significant and valuable changes to securities laws stemming from SOX include:

- Section 401's enhancement of the financial disclosure requirements
- Section 906's requirement that the CEO and CFO certify the financial statements
- Section 102's transformation of the accounting profession into a government-regulated industry
- Section 804's expansion of the statute

of limitations for bringing a private right of action of securities fraud against directors and officers to five years

■ Section 403's amendment of Section 16 of the Securities Exchange Act of 1934 to provide for timely electronic filing of ownership of equity shares

In fact, section 403 of SOX may have saved publicly traded companies billions of dollars, as well as embarrassment to their

potential backdating problems. Of the 220, 7 out of 10 were subject to an SEC or DOJ investigation; 6 out of 10 were subject to a derivative securities lawsuit; 1 in 5 experienced management changes; 1 in 5 have been subject to shareholder lawsuits; and regulators have brought charges against 1 in 20 of these corporations.

The scope of options backdating has cost companies hundreds of millions of dollars,

Absent SOX, the potential for losses could have been much worse, with directors and corporations facing billions of dollars more in damages from lawsuits.

directors from the public perception of lax oversight on executive compensation and the costs associated with defense and settlement of the backdating of options scandal.

To place into context the gravity of the backdating corporate scandal that did not hatch, one can look to the recognition received by *The Wall Street Journal*, which won a Pulitzer Prize for its series investigating executives' ill-gotten gains from backdated stock options.

Playing catch-up to the media were government regulators at the SEC and Department of Justice, who also reacted to a study authored by a University of Iowa business professor. The study estimated that more than 23 percent of options from 1996 to August of 2002 were backdated or otherwise manipulated. The end date is significant: It has been acknowledged that SOX—which became law on July 30, 2002—may have saved us from a path of capital destruction.

The *Journal* identified approximately 220 publicly traded corporations, or 11 percent of the purported 2,000 companies with

with investigative and defense costs mounting and \$1.35 billion in shareholder-suit settlements to date. Absent SOX, the potential for losses could have been much worse, with directors and corporations facing many more billions in damages from investors' class-action lawsuits, which in turn would likely have driven up D&O insurance costs.

Beyond the monetary costs, federal prosecutors have ardently filed criminal charges, which has sometimes resulted in guilty pleas or convictions on disputed mental-state evidence. In totality, then, and despite its drawbacks, SOX is a good law that has in some cases acted as a circuit breaker to prevent major corporate scandal and has lowered D&O insurance premiums.

Christopher Duca is president of Navigators



Pro, a division of Navigators Management Company, and a director of Navigators Insurance Company and NUAL, Ltd. Contact him at: cduca@navg.com.