



AMERICAN ACADEMY *of* ACTUARIES

November 26, 2002

The Honorable Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: *Proposed Rules on Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, (SEC File No. S7-40-02)*

Dear Mr. Katz:

The American Academy of Actuaries (the “Academy”) submits these comments to the Securities and Exchange Commission (the “SEC”) on the proposed rules on disclosure required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 (the “Act”). Our comments, which appear at greater length below, may be summarized as follows:

Section 407: The proposed definition of “financial expert” is too narrowly focused on individuals with accounting backgrounds and may effectively prevent other qualified individuals (including qualified Academy members) from serving as financial experts on audit committees. The Academy recommends that the definition be clarified to (1) focus on the importance of understanding relevant financial concepts rather than having specific expertise; and (2) identify the ability to perform a meaningful oversight role over auditors. The Academy suggests that the SEC may wish to consider rewriting the proposed rule. Alternatively, we suggest specific revisions to the current form of proposed rule.

Section 406: The Academy supports the code of ethics proposal but believes it would be strengthened by: (1) requiring codes of ethics to compel executive or financial officers to decline to participate in matters in which they have a conflict of interest that could impair their judgment; (2) defining the threshold of conduct (short of actual violations of the code by another person) that requires action by executive or financial officers; (3) requiring executive or financial officers to consider a method for resolving informally an apparent code of ethics violation before reporting such violation formally to an appropriate reporting person or persons; and (4) imposing an affirmative duty on executive or financial officers to take reasonable steps to prevent statements made from being misleading.

Section 404: The SEC should make clear that the internal controls for financial reporting are intended to foster principle-based standards that permit and encourage innovation provided that the person altering the internal control discloses the nature and effect of and rationale for any change.

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I. Statement of Interest

Actuaries quantify and evaluate future financial risks, providing the professional services that support the solvency of and underlie the public trust in pension, insurance and other financial services and products. In their role as the architects of financial security, actuaries have a direct and substantial interest in these SEC rulemakings.

The Academy is a professional association established in 1965 to provide a common membership organization for actuaries of all specialties practicing in the United States. Approximately 85% of U.S. actuaries are members of the Academy. The Academy serves as the actuarial profession's primary vehicle for public policy outreach, communications and professionalism. The Academy has adopted a rigorous set of ethical standards for Academy members called the *Code of Professional Conduct* (the "Code"), for itself and its four sister organizations.¹ The Academy establishes minimum qualification standards for actuaries' basic education, continuing education and experience and, through the *Code*, prohibits its members from performing professional services unless they are qualified to do so. The Academy supports the Actuarial Standards Board, the independent body with sole authority to establish standards of practice for the actuarial profession. The Academy also supports the Actuarial Board for Counseling and Discipline, the independent body that investigates complaints against actuaries, counsels actuaries in good professional practice, and recommends to the membership organizations that actuaries who have breached the *Code* be appropriately disciplined.

The financial expertise demanded of an actuary is so exacting that few attain membership in the profession. To become an actuary, an individual must pass a series of challenging examinations that test candidates' knowledge of actuarial mathematics, statistics, risk theory, interest theory, finance, economics, insurance, employee benefits, various actuarial methods and techniques, and applicable laws and regulations. The average candidate takes over nine years to complete the examinations, and more than half of the candidates who begin the examination process fail to complete it. Fewer than 19,000 individuals nationwide have been able to achieve membership in the actuarial profession.

Actuaries play a key role in monitoring the financial health of the nation's private and governmental pension and other retirement benefit systems by computing the amount of plan contributions and reserves through the selection and application of a complex series of economic and demographic assumptions and, by assisting with plan design and administration. In addition to designing products that pool, spread and control risk, actuaries play a crucial role in monitoring the solvency of the nation's insurance companies, by identifying and quantifying the

¹ The Academy has four sister organizations in the United States: the American Society of Pension Actuaries; the Casualty Actuarial Society; the Conference of Consulting Actuaries; and the Society of Actuaries. All of these organizations look to the Academy as the organization with primary responsibility for fostering actuarial professionalism.

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risks those companies face and opining on the adequacy of reserves to meet the insurance obligations; their work is well-known to the insurance industry oversight branches of the SEC's Division of Corporate Finance. Based on their sophisticated understanding of risk management and finance, actuaries are increasingly providing risk management advice to a variety of organizations ranging from banks and securities firms to utilities.

Many actuaries have a thorough understanding of financial statements and internal controls, and actuaries often have substantial familiarity with generally accepted accounting principles. Many actuaries are affiliated with auditing firms. Actuaries also work closely with auditors, accountants and senior financial officers in both public reporting companies and private companies that are subject to significant state oversight and supervision, with important public sector reporting responsibilities. In many instances, actuaries prepare significant portions of financial statements, or assist management in that preparation by establishing or reviewing the value of pension plan assets and liabilities as well as fixing the amount of insurance reserves. As a result of these responsibilities, many Academy members are familiar with both SEC and other public sector reporting requirements.

II. Section 407 of the Act

The proposed definition of "financial expert" in the rule implementing Section 407 of the Act implies that only individuals with education and experience as accountants or auditors truly satisfy the definition. The Academy believes that restricting financial experts to members of the accounting profession is unwise as a matter of public policy because there can be no assurance that such persons have the crucial qualifications to enable them effectively to perform a meaningful role on an audit committee. The purpose of qualifying a person as a financial expert is to ensure that the person possesses sufficient financial expertise to enable him or her to perform an oversight role over auditors and a level of business sophistication to manage them. This does not necessarily require a person to be able to perform the tasks of an accountant, but requires a level of financial sophistication sufficient to enable the person to understand accounting principles, the type of issues that arise in the preparation and reporting of financial information and the limitations of audits and the auditor's role. Although prior experience as an accountant or auditor for a public company may indicate some evidence of financial sophistication, they provide little insight into the ability of the person to perform the crucial oversight role.

The Act expressly recognizes that a person may qualify as a financial expert based on a position involving the performance of similar functions. The proposed rule implements this statutory exception by recognizing two alternatives (1) for persons with experience in positions that "involve the performance of similar functions" and (2) for persons who, in the judgment of the board of directors, have "similar expertise and experience." Because the proposed rule places so much emphasis on accounting or auditing education and experience, we are concerned that

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boards of directors may be reluctant to select persons as “financial experts” who are not accountants or auditors but nonetheless have a thorough understanding of the financial principles at issue. Further, we are concerned that boards of directors will overlook the more important qualification for service on an audit committee – the maturity of judgment and business sophistication to manage auditors.

The Academy believes that some of its members who are not accountants clearly should qualify based on their knowledge and experience as “financial experts” and can perform a meaningful role on audit committees. Where Academy members do not have sufficient expertise, they are bound by the Academy’s *Code* not to perform that role. Nevertheless, the Academy does not here ask the SEC to expressly identify actuaries as among the possible alternative types of training from which the pool of financial experts may be drawn. The Academy recognizes that members of the Academy -- just like accountants -- need to have sufficient education and experience or maturity of judgment to serve audit committees effectively as “financial experts.” They just should not be closed out of serving as the “financial expert” on an audit committee because the definition of “financial expert” is too restrictive.

Accordingly, the Academy recommends that the SEC rewrite its proposed rule to (1) make it clear that persons other than accountants may have the necessary financial expertise, and (2) more clearly articulate the other characteristics that will enable the financial expert to play an oversight role on an audit committee.

Should the SEC determine to keep the current rule structure, our specific suggestions to revise the proposed rule are appended as Attachment A.

III. Section 406 of the Act

The Academy believes that executive and financial officers should adhere to a code of ethics. Based upon our experience in administering the Academy’s *Code*, however, there are some concepts that the SEC may wish to add to its definition of the term “code of ethics” to strengthen the proposed rule.

First, the Academy’s *Code* not only requires actuaries to disclose real or apparent conflicts of interest to their affected clients or employers, it also requires them to decline to provide professional services if such conflicts would impair their ability to act fairly. A comparable requirement, requiring an executive officer or financial officer subject to the code of ethics not to participate in matters in which he or she had a real or apparent conflict of interest that impaired his or her ability to act fairly, might enhance the self-policing mechanism of the code.

Second, the *Code* calls for an actuary who discovers another actuary’s “apparent, material violation” of the *Code* to consider an informal response by discussing the matter with the other

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actuary in an attempt to resolve such violation. If a discussion resolves the apparent, material violation, the discovering actuary is not required to report the matter to the Actuarial Board for Counseling and Discipline. If, however, no such discussion is attempted or the discussion is unsuccessful, the discovering actuary must report the apparent, material violation. State regulatory authorities have advised us that the option to discuss and resolve apparent, material violations informally has been particularly helpful to them. We have also found that giving members the option to resolve apparent, material violations of the *Code* without resort to the profession's disciplinary process is an efficient means to enhance the quality of professional services that actuaries provide while making the *Code* more effective.

The Academy's experience in administering its own *Code* identifies two issues that the SEC should address in its proposed rule: (A) the threshold of potentially violative conduct that triggers a duty on the part of a person subject to the code of ethics to act; and (B) whether the code of ethics may have an informal process for resolving potential issues prior to requiring the person subject to the code of ethics to report the violation by another to an appropriate identified person.

As to (A), it is possible that a person subject to the code may discover information revealing conduct by another short of an actual violation that warrants further inquiry. A code of ethics should clearly define when such a person has a duty to act. The Academy after considering alternatives has defined in its own *Code* that threshold as an "apparent, material violation" and suggests that the SEC likewise may wish to adopt a clear definition of this type in order to define the threshold for action by persons subject to its provisions.

As to (B), the Academy has found that the option in its own *Code* to engage in informal resolution of possible ethics violations has actually fostered compliance with the Code's guidelines. If the ultimate purpose of the SEC's proposed rules is to facilitate compliance with the code of ethics and foster responsible oversight of companies' management and financial reporting, a comparable informal process in corporate codes of ethics is needed.

Third, the Academy's *Code* requires actuaries to take reasonable steps to prevent their work from being used to mislead or to violate or evade the law. This concept clearly falls within the general deterrent purpose of the code of ethics and the requirement to act honestly, not to mislead, and to promote full, fair, accurate and timely, and understandable reporting. In light of the goal of the Act and the code of ethics to inspire public confidence in financial reports prepared by management and senior financial officers, however, the SEC should consider adding a requirement that obligates each person under the code of ethics to take reasonable steps to prevent statements made in publicly filed reports and otherwise from being misleading.

IV. Section 404 of the Act

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The Academy recognizes the importance of effective internal controls and procedures for financial reporting. However, we believe that unnecessarily rigid controls can stifle innovation and limit management's ability to oversee and manage a company's finances.

Reasoned application of professional judgment in applying standards to particular assignments is central to effective actuarial practice. For this reason, the *Code* and all of the actuarial standards of practice expressly permit actuaries to deviate from procedures that are set forth in an applicable standard of practice, so long as the actuary discloses in an appropriate communication the nature and effect of, as well as the rationale for, the deviation. The actuary must also be prepared to justify the deviation if called upon to do so. We believe that this approach strikes an appropriate balance between requiring actuaries to follow standards of practice in most cases and permitting them to deviate (with disclosure) where, in their professional judgment, a different or more innovative procedure is called for.

We recommend that the SEC consider a similar approach in the rules implementing Section 404 of the Act, namely, that the internal controls for financial reporting foster principle-based standards that permit and encourage innovation provided that the person altering the internal control discloses the nature and effect of and rationale for any change.

V. Conclusion

The Academy appreciates the opportunity to comment on these important proposed rules. Please contact us through Patricia A. Teufel, the Academy's Vice President of Financial Reporting, or the Academy's Executive Director, Richard C. Lawson, Director of Public Policy, M. Todd Tuten, or General Counsel and Director of Professionalism Lauren M. Bloom at (202) 223-8196, if you require any additional information.

Sincerely,

Robert A. Anker
President

Attachment A

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ATTACHMENT A

Revised Definition of “Financial Expert”

The provisions of Instruction 1 to Item 309 should be modified as follows:

1. The term “financial expert” means a person who:

- a. has through education and experience as a public accountant or auditor; or
- b. has experience as a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such a position, was required to file reports pursuant to section 13(a) or 15(d) of the Exchange Act; or
- c. has experience in one or more positions that involve the performance of similar functions to those described in (a) or (b) above that result in the following attributes;
 1. An understanding of financial statements and generally accepted accounting principles;
 2. Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant’s financial statements;
 3. Experience preparing or reviewing material portions of financial statements that present accounting issues that are generally comparable to those raised by the registrant’s financial statements;
 4. Experience with internal controls and procedures for financial reporting;
 5. Experience in responsible business or public sector management positions with regulatory reporting responsibilities; and
 6. An understanding of audit committee functions; or
- d. in the judgment of the board of directors, has similar expertise and experience to those individuals described in (a), (b) or (c) above.